

# Financial Decision Making

## Module outline and aims

The Chartered Secretary has the responsibility of helping to ensure that decisions are properly made and implemented, and that appropriate risk management systems are in place, to maximise value for key stakeholders of the organisation. An understanding of how value is created or destroyed is therefore central to the governance of organisations in all sectors.

Although not always required to perform detailed treasury or finance functions, Chartered Secretaries need to have a clear understanding of how the process of creating and safeguarding value is managed in the organisation to assess the implications for shareholders and other stakeholders, and the need for effective corporate governance. They are involved in the implementation of this process through activities such as processing board memoranda relating to investment or financing proposals, raising capital and other funding, managing profits or surpluses, and ensuring both compliance with regulations and good financial administration.

The module aims to provide you with the knowledge and skills necessary to evaluate the impact of financial decisions on different constituencies of stakeholder. It will also enable you to participate in decision making and processes concerning the maximisation of value in investment, finance and risk management, and the delivery of value for money in achieving the objectives of not-for-profit organisations.

## Learning outcomes

On successful completion of this module, you will be able to:

- Explain how organisations make value optimising financial decisions, and reflectively and critically assess the ethical issues arising from these decisions.
- Demonstrate a clear conceptual understanding of the fundamental financial theories relevant to financial decision making.
- Critically analyse and evaluate various financial models and decision making techniques and their impact on different constituencies of stakeholder.
- Apply financial analysis skills in the facilitation of strategic decision making.
- Assess the features of alternative and diverse sources of finance and critically evaluate their appropriateness under different circumstances.
- Evaluate elements of risk, return and value in a range of strategic operational financial decisions and understand the implications in regulatory and governance terms of the consequences of doing so.
- Prepare reports to boards and senior managers setting out options for financial decision making.

## **Syllabus content**

### Financial governance: objectives and environment – weighting 10%

#### Objectives of financial decision making

The role of shareholder wealth maximisation in modern financial management

Shareholder v stakeholder perspectives

Role of the finance function

Balancing risk and return

Shareholder wealth maximisation and ethical behaviour

Ethics and the finance function

#### Corporate governance

Corporate governance and the agency problem

Financial aspects of the UK Corporate Governance Code

New public management

### Management performance measurement – weighting 5%

Financial ratio analysis

Financial ratio analysis, including ratios relating to:

- Profitability
- Efficiency
- Liquidity
- Gearing
- Investment performance

Value for money

Economic Value Added

#### Trading legitimacy

The nature of overtrading, including:

- The problems of overtrading
- The factors that may lead to overtrading
- Financial ratios that may help to detect overtrading

Financial distress and insolvency, including the use of financial ratios based on univariate and multivariate analysis to predict financial failure.

Making distributions to shareholders – weighting 10%

Dividend policy and shareholder wealth – Traditional v Modigliani and Miller arguments

Reasons for the importance of dividends

Factors determining the level of dividends

Scrip dividends

Special dividends and share buybacks

Long-term investment decisions – weighting 20%

Investment appraisal

The nature of investment decisions

Investment appraisal methods

- Payback period (including discounted payback period)
- Accounting rate of return
- Net present value
- Internal rate of return

Advantages and disadvantages of the various investment appraisal methods

Practical issues in investment appraisal, including:

- Cash flow estimation
- Identifying relevant costs and benefits
- The impact of taxation
- The problem of inflation

Comparing investment opportunities with unequal lives

Single-period capital rationing and the profitability index

The process of approving, monitoring and controlling investment projects

Investment opportunities and risk

The problem of risk and the risk preferences of investors

Risk appraisal methods, including:

- Sensitivity analysis
- Scenario analysis
- Simulations
- Expected net present value
- Event tree diagrams
- Risk-adjusted discount rate

Portfolio effects and risk reduction

Shareholder value analysis

Shareholder value and the need for new forms of measurement

Shareholder value analysis and net present value

Comparison of shareholder value analysis and economic value added

Total shareholder return (TSR) and market value added (MVA)

Evaluation of the shareholder value approach

Business combinations and share valuation – weighting 15%

Mergers and acquisitions

The economic rationale for mergers and acquisitions

Evaluation of the different forms of purchase consideration, including:

- Cash
- Shares
- Loan capital

The motivation for mergers and acquisitions

The potential effect of a merger on the wealth of shareholders in each business

The main methods of resisting a proposed merger or acquisition

Regulatory and procedural issues concerning mergers and acquisitions

Valuation of potential business acquisitions, using:

- Asset based methods
- Stock market methods
- Cash flow and dividend-based methods

The advantages and disadvantages of each valuation method

The rationale for divestment and demerger activity and the potential effect of each form of restructuring on shareholder wealth.

Capital markets and long-term financing decisions – weighting 20%

Financial markets and institutions

The role of the Stock Exchange

Advantages and disadvantages of a Stock Exchange listing

Stock market efficiency

The roles of AIM, private equity and business angels in helping smaller companies

Main sources of long-term finance

Ordinary shares

Preference shares

Share warrants

Raising equity through profit retention

Borrowings, including

- Term loans and mortgages
- Loan notes and bonds
- Eurobonds (international bonds)

Finance leases (including sale and leaseback)

Hire purchase

Securitisation of assets

Government assistance

Raising long-term finance

Identification of financing needs through financial planning (projected financial statements)

Types of share issue, including:

- Rights issues
- Bonus issues
- Offers for sale and public issues
- Placings

Private Finance Initiative

Basic features

Issues and problems

Cost of capital and the capital structure decision

Cost of equity, including basic principles of Capital Asset Pricing Model

Cost of loan capital

Weighted average cost of capital

Gearing and its effect on risk and returns to shareholders

Factors influencing the level of gearing in practice

The capital structure debate – Traditional v Modigliani and Miller arguments

Working capital management and short-term financing – weighting 10%

Working capital management

The nature and purpose of working capital

The working capital cycle

Working capital needs of different forms of business

The interpretation of working capital ratios

The financial impact of changes to working capital policies

The management of inventories, including:

- Forecasting future demand
- Determining appropriate levels of inventory control
- Methods of inventory recording and re-ordering
- Inventory management methods such as economic order quantity model, materials requirement planning and just-in-time inventory management systems

The management of receivables, including:

- Factors to be taken into account in determining which customers should receive credit and how much credit should be offered
- Sources of information available when assessing creditworthiness
- Policies to be adopted for efficient collections of outstanding receivables
- Methods available for reducing risk of non-payment
- The financial impact of changes to receivables policies, such as changes to the credit period and changes to discount policies

The management of cash, including:

- Factors affecting the amount of cash held
- Cash management models
- The use of cash flow statements in managing cash
- The cash conversion cycle

The management of payables, including:

- The benefits of taking trade credit and the problems of taking excessive credit
- The policies to be adopted for the efficient management of trade payables
- The cost of discounts taken for prompt settlement

Short-term financing

External sources of short-term finance, including:

- Bank overdrafts
- Bills of exchange
- Debt factoring
- Invoice discounting

Internal sources of short-term finance, including:

- Reducing inventories
- Tighter credit control

- Delaying payments to payables

Corporate risk management – weighting 10%

*The nature of risk and risk policies*

The nature of risk and the distinction between operating and financial risks

Key risk concepts including exposure, volatility, severity and probability.

Risk responses including risk transfer, risk reduction, risk avoidance and risk retention.

The relationship between risk and expected returns

Risk management policies and the risk appetite and values of a business

Frameworks for risk management policies, such as Enterprise Risk Management (ERM)

*Managing financial risk*

The main forms of financial risk – credit risk and market risk

Methods for hedging financial risk, including:

- Futures
- Options
- Forward rate agreements
- Swaps
- Money market hedges

Key areas of the syllabus

- Financial markets and institutions
- Dividend policy and alternatives to cash dividends
- Investment appraisal and the assessment of investment risk
- The rationale, financing and wealth effects of mergers and acquisitions
- Sources of long-term finance and their evaluation
- Cost of capital and the capital structure decision
- Working capital management and short-term financing