ACCA Paper P4

Advanced Financial Management

For exams in 2015
Contents

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About ExPress Notes

We are very pleased that you have downloaded a copy of our ExPress notes for this paper. We expect that you are keen to get on with the job in hand, so we will keep the introduction brief.

First, we would like to draw your attention to the terms and conditions of usage. It’s a condition of printing these notes that you agree to the terms and conditions of usage. These are available to view at www.theexpgroup.com. Essentially, we want to help people get through their exams. If you are a student for the ACCA exams and you are using these notes for yourself only, you will have no problems complying with our fair use policy.

You will however need to get our written permission in advance if you want to use these notes as part of a training programme that you are delivering.

WARNING! These notes are not designed to cover everything in the syllabus!

They are designed to help you assimilate and understand the most important areas for the exam as quickly as possible. If you study from these notes only, you will not have covered everything that is in the ACCA syllabus and study guide for this paper.

Components of an effective study system

On ExP classroom courses, we provide people with the following learning materials:

- The ExPress notes for that paper
- The ExP recommended course notes / essential text or the ExPedite classroom course notes where we have published our own course notes for that paper
- The ExP recommended exam kit for that paper.
- In addition, we will recommend a study text / complete text from one of the ACCA official publishers, but we do not necessarily give this as part of a classroom course, as we think that it can sometimes slow people down and reduce the time that they are able to spend practising past questions.

ExP classroom course students will also have access to various online support materials, including:

- The unique ExP & Me e-portal, which amongst other things allows “view again” of the classroom course that was actually attended.
- ExPand, our online learning tool and questions and answers database

Everybody in the World has free access to ACCA’s own database of past exam questions, answers, syllabus, study guide and examiner’s commentaries on past sittings. This can be
an invaluable resource. You can find links to the most useful pages of the ACCA database that are relevant to your study on ExPand at www.theexpgroup.com.

How to get the most from these ExPress notes

For people on a classroom course, this is how we recommend that you use the suite of learning materials that we provide. This depends where you are in terms of your exam preparation for each paper.

<table>
<thead>
<tr>
<th>Your stage in study for each paper</th>
<th>These ExPress notes</th>
<th>ExP recommended course notes, or ExPedite notes</th>
<th>ExP recommended exam kit</th>
<th>ACCA online past exams</th>
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</thead>
<tbody>
<tr>
<td><strong>Prior to study, e.g. deciding which optional papers to take</strong></td>
<td>Skim through the ExPress notes to get a feel for what’s in the syllabus, the “size” of the paper and how much it appeals to you.</td>
<td>Don’t use yet</td>
<td>Don’t use yet</td>
<td>Have a quick look at the two most recent real ACCA exam papers to get a feel for examiner’s style.</td>
</tr>
<tr>
<td><strong>At the start of the learning phase</strong></td>
<td>Work through each chapter of the ExPress notes in detail before you then work through your course notes. Don’t try to feel that you have to understand everything - just get an idea of what you are about to study.</td>
<td>Work through in detail. Review each chapter after class at least once. Make sure that you understand each area reasonably well, but also make sure that you can recall key definitions, concepts, approaches to exam questions, mnemonics, etc.</td>
<td>Nobody passes an exam by what they have studied - we pass exams by being efficient in being able to prove what we know. In other words, you need to have effectively input the knowledge and be effective in the output of what you know. <strong>Exam practice is key</strong> to this. Try to do at least one past exam question on the learning phase for each major chapter.</td>
<td>Don’t use at this stage.</td>
</tr>
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<td><strong>Practice phase</strong></td>
<td>Work through the ExPress notes again, this time <strong>annotating</strong> to explain bits that you think are easy and be brave enough to cross out the bits that you are confident you'll remember without reviewing them.</td>
<td><strong>Avoid reading through your notes again.</strong> Try to focus on doing past exam questions first and then go back to your course notes/ExPress notes if there's something in an answer that you don't understand.</td>
<td>This is your most important tool at this stage. You should aim to have worked through and understood at least two or three questions on each major area of the syllabus. You pass real exams by passing mock exams. Don’t be tempted to fall into “passive” revision at this stage (e.g. reading notes or listening to CDs). Passive revision tends to be a waste of time.</td>
<td>Download the two most recent real exam questions and answers. Read through the technical articles written by the examiner. Read through the two most recent examiner’s reports in detail. Read through some other older ones. Try to see if there are any recurring criticisms he or she makes. You must avoid these!</td>
</tr>
<tr>
<td><strong>The night before the real exam</strong></td>
<td>Read through the ExPress notes in full. Highlight the bits that you think are important but you think you are most likely to forget.</td>
<td>Unless there are specific bits that you feel you must revise, avoid looking at your course notes. Give up on any areas that you still don’t understand. It’s too late now.</td>
<td><strong>Don’t touch it!</strong></td>
<td>Do a final review of the two most recent examiner’s reports for the paper you will be taking tomorrow.</td>
</tr>
<tr>
<td><strong>At the door of the exam room before you go in.</strong></td>
<td>Read quickly through the full set of ExPress notes, focusing on areas you’ve highlighted, key workings, approaches to exam questions, etc.</td>
<td><strong>Avoid looking at them in detail, especially if the notes are very big. It will scare you.</strong></td>
<td><strong>Leave at home.</strong></td>
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</table>
Our ExPress notes fit into our portfolio of materials as follows:

- **Express Notes**: Provide a base understanding of the most important areas of the syllabus only.
- **Expedite Notes**: Provide a comprehensive coverage of the syllabus and accompany our face to face professional exam courses.
- **Exper Notes**: Provide detailed coverage of particular technical areas and are used on our Professional Development and Executive Programmes.

To maximise your chances of success in the exam we recommend you visit www.theexpgroup.com where you will be able to access additional free resources to help you in your studies.

**START**

**About The ExP Group**

Born with a desire to be the leading supplier of business training services, the ExP Group delivers courses through either one of its permanent centres or onsite at a variety of locations around the world. Our clients range from multinational household corporate names, through local companies to individuals furthering themselves through studying for one of the various professional exams or professional development courses.

As well as courses for ACCA and other professional qualifications, our portfolio of expertise covers all areas of financial training ranging from introductory financial awareness courses for non-financial staff to high level corporate finance and banking courses for senior executives.

Our expert team has worked with many different audiences around the world ranging from graduate recruits through to senior board level positions.

Full details about us can be found at www.theexpgroup.com and for any specific enquiries please contact us at info@theexpgroup.com.
Chapter 1
Role and Responsibility towards Stakeholders

START
The Big Picture

Strategic choices and the Relationship with Corporate Goals
In selecting appropriate strategies, the firm must ensure that those strategies are congruent – i.e. consistent – with its overall corporate goals.

KEY KNOWLEDGE
The Role of Senior Financial Executive / Advisor

The CFO Role
Consistent with the principles of corporate governance outlined above, the role of the Chief Financial Officer (CFO) is to advise the board of directors of the firm in setting the financial goals of the business and its financial policies.

A CFO will typically address the following areas:
(a) The allocation of capital and investment choices;
(b) Minimising the cost of capital;
(c) Dividend policy;
(d) Communicating with key constituencies;
(e) Planning, control and risk management;
(f) Ethical standards

**KEY KNOWLEDGE**

**Business risks**

This is a broad category with indistinct boundaries, but it generally covers risks to a company’s ability to generate returns from its ordinary operations, including its strategy, business model, competitive position, political/legal environment (including regulatory/compliance/intellectual property), products, marketing, clients and reputation.

**KEY KNOWLEDGE**

**Risk management and diversification**

Risks can be managed through mitigating, hedging or diversification strategies.

Diversification can be demonstrated through the 2-asset portfolio:

The expected return of the portfolio is the weighted average return of the individual shares.

The risk of the portfolio is represented by the standard deviation, denoted as $\sigma$ (sigma):

$$\sigma_p = \sqrt{x_a^2 \sigma_a^2 + x_b^2 \sigma_b^2 + 2x_ax_b(\sigma_a \sigma_b \rho)}$$

The terms are defined as follows:

- $\sigma_a$, $\sigma_b$ = standard deviation of the returns of share “a”, resp. share “b”
- $x_a$, $x_b$ = the proportions of shares “a” and “b” in the portfolio ($a+b = 100\%$).
- $\rho$ = correlation coefficient between shares “a” and “b”

The correlation coefficient ($\rho$) varies between +1 and -1.
KEY KNOWLEDGE
Conflicting Stakeholder Interests

The formal separation between management and ownership in a corporation has important behavioral and organizational consequences.

Maximize shareholder value: It is the duty of management (toward the owners of the business, the shareholders) to maximize shareholder value (or wealth).

Shareholder value is measured by the dividends that shareholders receive and by the increase in the value of their shares (capital gain).

Agency theory: addresses the risk that management will not act in the best interest of the shareholders, but will make decisions that will serve its own interests.

Examples of self-serving management behavior could include: (a) artificially boosting corporate profits in the short-term in order to earn bonuses; (b) paying too much to acquire another company for reasons of prestige or in order to “build empires”; (c) rejecting opportunities, such as takeover bids, or restructuring initiatives, that might jeopardize their positions (an orientation to maintain the “status quo”).

Transaction cost economics refer to the evaluation of corporate alternatives in search of the most beneficial outcomes for the company. As seen in the foregoing paragraph, what is best for the company may not coincide with self-interest of the managers.

Other stakeholder conflicts

The agency problem between management and shareholders is only one of many potential conflicting interests that can exist between various stakeholder groups. A stakeholder is defined as anyone with an interest in the affairs of a company:

- Management and employees are most intimately interested in the company, since they seek to preserve employment and to collect salaries/wages. Unions represent the employees collectively, seeking job security and good wages;
- Customers, suppliers and creditors are also closely interested in a company based on financial and other benefits received;
- The public, via public interest groups and concerned citizens, may take an interest in the company for reasons of product safety and environmental concerns;
- The government has an interest in seeing that a company creates/maintains jobs and also generates corporate taxes;
• Even competitors may be regarded as stakeholders, though usually with a less than generous motives.

Management must understand the power/influence and level of active interest of the various stakeholder groups in order to reconcile, or at least prioritize, and address their concerns.

Mendelow’s matrix is one tool which can be used in order to examine stakeholder influence and to actively manage the relationship with relevant stakeholders.

KEY KNOWLEDGE
Corporate Governance

Corporate governance structures have been developed setting forth guidelines and principles on which corporate management is expected to conduct its business.

The need for good corporate governance has been spurred by such highly-publicized corporate scandals as the failure of Enron; however, corporate governance is not limited to the detection of fraud and crime.

Good corporate governance includes:

• Strengthening the role of non-executive directors on the board of directors;
• Holding management accountable for their actions;
• Ensuring that the interests of shareholders are protected;
• An ethical approach to behavior towards all stakeholders;
• Clear policy-making processes;
• Explicit risk management policy and monitoring systems; and
• Transparency and professionalism.

Corporate governance models

There are several models of corporate governance: Shareholder based models and (continental) European-based models.

Shareholder-based models

The US and UK are typically cited as basing their principles of corporate governance on a shareholder-based system, where shareholdings are widely dispersed among many individuals and therefore require protection:

Sarbanes-Oxley: Refers to legislation in the USA that imposes corporate governance principles on publiclyquoted US corporations. It seeks to safeguard the economic interests of shareholders;
• **UK Corporate Governance Code:** In the UK, these are a set of principles that are voluntarily adopted by public companies.

In contrast to the US/UK, there is the

• **European model:** Continental Europe has a greater prevalence of bank and industrial shareholdings, which concentrate corporate control; such interests tend to take a broader and more participatory approach to stakeholder interests.

In Germany, for example, there is a two-tier board structure: the supervisory board and the executive/management board. The supervisory board, which monitors the activities of the management board, has among its members representatives from the trade union.

### KEY KNOWLEDGE

**The Impact of Environmental & Ethical Issues**

**Environmental concerns**

Issues of environmental concern and sustainability have become established and recognized agenda points for corporations. Many stakeholders are coming to expect explicit acknowledgment of such matters.

The “triple bottom line” approach expands the scope of a company’s concerns, beyond the merely economic, to social and ecological as well.

**Carbon trading** programmes are schemes by which a company which outperforms its environmental targets is rewarded by being able to sell its credits to companies that pollute beyond permitted limits. To operate properly, this arrangement requires supervision by a central authority (government) in what is known as a “cap and trade” regime.

**Ethical Issues**

An ethical approach to doing business is not just a matter of personal virtue, but needs to be addressed by policy (and action) at the company level as well. Ethical frameworks are not merely “nice to have”, but are considered crucial to building long-term professionalism. Their absence can undermine motivation and the sense of purpose a company must have in order to succeed.
Chapter 2
Economic Environment for Multinationals

KEY KNOWLEDGE
Management of International Trade & Finance

International Trade and Finance -- Institutions

An understanding of the global financial and trade systems is a basic requirement for anyone involved in business activities.

Since World War II governments have sought to facilitate world trade by reducing barriers to trade (tariffs, quotas, etc.). The current international body coordinating this effort is the World Trade Organisation.

Barriers to trade remain in place for reasons of national preference and economic protectionism. Agriculture in the western countries enjoys considerable protection in the form of government subsidies.

The international financial architecture is under-going significant reforms as a result of the recent financial crisis. The International Monetary Fund (IMF) was formed to assist governments in overcoming balance of payments deficits. The World Bank focused on financing developing and emerging economies to modernize and achieve growth through infrastructure projects.

The Bank of International Settlements (BIS) was created as an institutional coordinating body between central banks and now hosts (and gives its name to) efforts to devise international capital adequacy standards in the banking sector.
The monetary policy setting powers at the national level are located within the central banks of those countries which maintain their own currencies (Federal Reserve in the US, Bank of England, Bank of Japan, and the Swiss National Bank) and at the supra-national level for the European currency (at the European Central Bank).

Regular reading of international business publications is the best way to understand the above organizations in their contemporary context.
Chapter 3

Advanced Investment Appraisal

START
The Big Picture

Discounting Free Cash Flows

In order to value a project or company, it is necessary to forecast free cash flows and to discount these at an appropriate cost of capital.

Note: Be sure to review your mathematical discounting methods from earlier papers.

KEY KNOWLEDGE
Free cash flow

This is the amount of net cash generated from period-to-period and available to capital providers (i.e. it is not re-invested in the project/company).

Free cash flow is “relevant”: non-cash, sunk, committed or allocated costs should be ignored when forecasting revenues, costs and investments.
Free cash flow = Revenues – Costs – Investments (capital expenditures / working capital)

Forecasting of cash flows must take the following into consideration:

(i) The role of inflation

It is conceptually most straightforward to use nominal values when forecasting cash flows, particularly if there are differential inflation rates applying to the future cash flows, i.e. if there is no uniform (single) price change for revenues and various cost categories (materials, labor, etc.).

Fisher formula: used to convert nominal rates to real (and vice versa)

\[(1 + i) = (1 + r)(1 + h)\]

\[i = \text{nominal (or money) rate}\]
\[r = \text{real rate}\]
\[h = \text{inflation rate}\]

If the nominal interest rate is 8% p.a. and inflation is running at 6%, then the real rate is 1.88%.

(ii) Taxation

The impact of taxation is reflected in the cash flows showing explicitly:

1) Tax payable on operating cash flows; and
2) Tax relief derived from Written Down Allowances (WDA)

Be sure to preserve this distinction when performing calculations.

Free Cash Flows to Equity vs. Free Cash Flows to Capital (providers)

When forecasting cash flows, there are two “levels” of Free Cash Flow one can choose from:

1) One can model operating cash flows (revenues, costs and investments, including taxation effects) and derive a bottom line entitled “Free Cash Flow to Capital Providers”, which represents the cash flow available to providers of debt and equity to the company.

This is the recommended method and follows the definition of Free Cash Flow presented earlier.

Free Cash Flows to Capital Providers must be discounted at the company’s Weighted Average Cost of Capital (WACC).

Recall from Paper F9:

\[WACC = \frac{E \times k_e}{D+E} + \frac{-D \times k_d (1-t)}{D+E}\]