Chapter 1

Financial Objectives – Review of FM Knowledge

1 Primary Financial Objective

1.1 For profit making business "maximize shareholders wealth"

1.2 How is this done? Through dividends payments and increase in company value (share price) Po

1.3 Company Value (Po)

Value of equity = number of ordinary shares x current share price (Po)

1.4 To find Po;

- Given in the question if it is a listed company
- Ascertain using "business valuation" methods to be covered in the class notes.

1.5 Check the question very carefully for the size of the company, is it

- Listed (Plc)
- Private Company (Ltd)

2 Indicators

2.1 Financial indicators pointing towards maximization of shareholder wealth include:-

- Earnings Per Share (EPS)
- Dividend Per Share (DPS)
- Return on Capital Employed (ROCE)
- Return on Shareholder Capital (ROSC)
- Profit after tax
- Revenue

2.2 Non-financial indicators include:-

- Market Share
- Customer Satisfaction
- Quality Measures

The above are Key Performance Indicators (KPI's) that need to be measured and reviewed on a regular basis by the board of directors (BoD).

3 External Factors affecting Ve and Po

3.1 The board cannot control all factors that affect Ve and/Po. One of the major factors are macroeconomic variables.

3.2 Economic variables- what are they and how may directional changes affect share price?

3.2.1 Interest rates- if they fall:-

- Stimulate demand and revenue
- Lower the cost of debt and improve profits
- Investors switch to share market for better returns

3.2.2 Inflation rates- if it rises:-

- Costs rise causing a drop in profits
- Cause interest rates to rise
- Devalues the home currency

3.2.3 Foreign Exchange Rate (FOREX) – if home currency strengthens:-

- Reduces cash receipts for exporters
- Lowers the costs for importers
- Discourages exporting

3.2.4 General Taxation – if it rises:-

- Damage company profits
- Discourages investment by companies
- More savings from tax effects of tax allowable depreciation (capital allowances)

3.3 Agency Problem

3.3.1 Shareholders are the owners of the company and expect their directors (agents) to take decisions to maximise S/H wealth. The agency problem occurs when directors take decisions that DO NOT lead to maximization of S/H wealth.

3.3.2 Examples of decisions that 'may' damage S/H wealth:

- Directors pay
- Taking high risk business decisions
- Non-payment of dividends
- Using debt finance (against the wishes of the S/H)

3.3.3 Solutions to this problem include:

- Management audits
- Corporate Governance (e.g. UK Combined Code)
- Goal Congruence through performance related pay and share options (ESOPS)

3.3.4 ESOPS

Executive Share Option Schemes (ESOPS) are designed as incentives to both managers and members of the BoD to maximise S/H wealth.

This is achieved by granting them the RIGHT to buy shares in their company at a price FIXED TODAY, but the right cannot be exercised until a date in the FUTURE. This is known as a CALL OPTION

Hence, the managers and BoD will implement policies that will seek to increase the market price of the company's shares creating the 'win win' scenario for both them and the owners.

These options can be valued from the time of being granted and up until the time they can be exercised. The valuation technique is called the BLACK SCHOLES OPTION PRICING (BSOP) and this is a KEY part of ACCA AFM.

4 The Five Key Decisions

4.1 To Maximise S/H wealth the BoD must consider the following:

- Investment
- Finance
- Dividend
- Risk
- Ethics

4.2 Investment

4.2.1 Cash is a key resource for a company. It can be allocated and used for two types on investments:

- Organic Growth (Projects)
- Acquisitions

4.2.2 Both of these will be looked at in detail later in the class notes as they are VERY IMPORTANT parts of ACCA AFM.

4.3 Finance

4.3.1 Company's need to raise cash for three main reasons:

- Finance the INVESTMENTS stated above
- To enable the company to pay DIVIDENDS
- Bolster the LIQUIDITY position for the business

4.3.2 There are THREE sources of finance:-

- Equity
- Debt
- Islamic Finance

4.3.3 Past ACCA AFM questions have tested this area in two ways:-

- Facts – knowing the key points on each source of finance.

- Cost of Capital – being able to compute the company's Weighted Average Cost of Capital (WACC) and knowing how and when to use it.

4.4 Dividends

4.4.1 As stated above, cash can be allocated to pay dividends to the shareholders. The dividend decision taken by the BoD is not as straightforward as it seems. The creation of a dividend policy is affected by several factors.

4.4.2 Dividend Policy questions have appeared on several occasions under the current examining team and hence a latter chapter will look at this topic in detail.

4.5 Risk

4.5.1 The BoD has a responsibility to:-

- Identify the risks that will affect the entity.
- Put into force risk management strategies

4.5.2 There are 4 major risk areas tested in ACCA AFM:-

- Business
- Financial
- Foreign Currency
- Interest Rate

4.5.3 It is fair to say, that based upon past evidence, students have found this topic one of the more

"challenging" part of ACCA AFM.

4.6 Ethics

4.6.1 The BoD cannot simply take decisions that maximise S/H wealth and ignore all other stakeholders. There must be aware of how their decisions will impact uponothers.

4.6.2 Candidates must:-

- Identify the key stakeholders.
- Specify the impact upon them of decisions takenby the BoD
- Mitigate these with appropriate strategies.

RELEVANT ACCA ARTICLE – MYOPIC MANAGEMENT