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Steve Crossman
CEO The ExP Group

Hello

Thank you for downloading a copy of these ExPress notes and I hope you find them useful for your studies.

We provide these ExPress notes free of charge to individual students as part of our CSR initiatives. The notes are designed to help students assimilate and understand the most important areas for the exam as quickly as possible.

A word of warning though in that they have not been designed to cover everything in the syllabus so you should only use these notes for either an overview of the key areas before you start your main studies or as part of your final revision in the run up to your exams.

Importantly though, we want you to be successful in your exams so good luck with your studies and please do let us know how you get on.

All the best,

Steve

About The ExP Group

We were born with one passion, with one aim, with one desire. To use technology the way it should be used. To use technology to open up education, and in particular financial education, to whoever needs it regardless of their income, wealth, race, sex, religion or location.

We wanted to use technology to empower individuals to develop themselves through financial expertise, organisations to improve their performance through enhanced human capital and ultimately communities and families to benefit as a result.

We're on target and since our birth we have had the privilege of working with and learning from inspirational individuals and organisations from all 4 corners of the world in countries as varied as the UK in the north, Singapore in the east, South Africa in the south and the Cayman Islands in the west.

We're only part way through our journey but we're doing better than we expected. The best is yet to come though,

Education + Technology = Ethical Empowerment.

Thank you for being part of our story.

01

Role and Responsibility towards Stakeholders

The Big Picture

In selecting appropriate strategies, the firm must ensure that those strategies are congruent – i.e. consistent – with its overall corporate goals.

The Role of Senior Financial Executives

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

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.

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 a 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.

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 publicly-quoted 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 membership representatives from the trade union.

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.

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02

Economic Environment for Multinationals

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.

03

Advanced Investment Appraisal

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.

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 = nominal (or money) rate

r = real rate

h = 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 FM (F9):

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

Note: be sure to use market values of Debt (D) and Equity (E) wherever possible.

The cost of equity (k_e) is derived from the Capital Asset Pricing Model (CAPM).

The cost of debt is after-tax (the cost of the company!). The pre-tax cost of debt (k_d) must therefore be multiplied by $(1-t)$ to obtain the after-tax cost.

- 2) The alternative method to modelling cash flows is to derive the Free Cash Flow to Equity (Holders). In order to arrive at this level of cash flow, one must perform the following steps:

(Starting point)	Free Cash Flow to Capital Providers (as in 1 above)
Less:	Interest payments on debt (cash outflow)
Less:	Repayments of debt (cash outflow)
Add:	New debt raised (cash inflow)

Free Cash Flows to Equity must be discounted at the company's Cost of Equity (note the difference to 1 above)

Both approaches (1 & 2) are equivalent to each other, i.e. different paths to ultimately determining the share value of the same company. Method 1, however, is considered easier to apply (reduces errors). It is also conceptually more satisfying, as it "isolates" debt and equity from operating cash flows.

Many industry practitioners recommend Method 1 for its conceptual clarity, as debt and equity are addressed directly when considering the company's capital structure.

Calculating the value of a company using the discounted cash flow method (DCF) is covered in a later section of these Notes.

IRR and MIRR

The internal rate of return (IRR) is defined as the discount rate (r) at which the net present value (NPV) of a stream of cash flows will be equal to zero. In other words,

If, at a discount rate r , $NPV = 0$, then $r = IRR$

The IRR includes among its assumptions the following: any cash flows generated in the course of the project being evaluated are calculated as being reinvested at the IRR rate. This is illustrated thus:

Time	Cash flows
0	(20,000)
1	5,000
2	30,000

The IRR of the above cash flows (using interpolation or a calculator) is 35.61%.

The above cash flows are equivalent to re-investing the 5,000 (in Year 1) at the IRR rate (35.61%) to maturity (Year 2).

Time	Cash flows (A)	Cash flows (B)
0	(20,000)	(20,000)
1	5,000	0
2	30,000	36,780.5 (30,000 + 6,780.5*)

$$* 5,000 \times 1.3561 = 6,780.5$$

The IRR of the cash flows shown in Column (B) is 35.61% -- exactly the same as in Column (A).

Note: Column (B) cash flows now resemble that of a zero-coupon bond, with investment at time 0 and no cash returns until the final year.

This calculation confirms that interim cash flows are re-invested at the IRR rate. This assumption has been criticized for being unrealistic, since cash paid out of a project (returned to the investors, for example) is unlikely to obtain the same rate if invested elsewhere: they may be higher (i.e. interest rates may have risen in the meantime), or lower (placed in the bank to earn deposit interest).

Modified IRR (MIRR)

This method modifies the "re-investment rate" assumption by applying a different interest rate to the interim cash flows. Thus, to take our example above, suppose the 5,000 in Year 1 would earn only 12% if invested (outside the project).

In this case, the MIRR would be calculated as follows:

Time	Cash flows (A)	Cash flows (C)
0	(20,000)	(20,000)
1	5,000	0
2	30,000	35,600 (30,000 + 5,600*)

$$* 5,000 \times 1.12 = 5,600$$

The IRR modified this way (the MIRR) is 33.42%.

CAPM

The Capital Asset Pricing Model (CAPM) provides the return that a security should provide, given its risk. Risk is measured in terms of the beta factor. Beta measures how variable the returns of the investment are, compared to returns for the market as a whole. (Technically, beta measures the covariance of the returns of an investment with returns on the market).

Having established the beta factor of an investment (beta would always be given in exams) the beta factor is input into the CAPM equation to calculate the required return:

$$E(r_i) = R_f + \beta_i(E(r_m) - R_f)$$

Where R_f is the return on risk free investments (usually government bonds), $E(r_m)$ is the return on the market and β_i is the beta value of the investment.

There are different types of beta:

- Asset betas reflect only business risk. They can be used to calculate the cost of equity of ungeared companies.
- Equity betas reflect financial and business risk. They give the cost of equity of a geared company. An equity beta can be calculated using the following formula (given in the exam)
- Debt betas reflect the level of risk relating to debt. They would give the cost of debt. We often assume that the debt beta is zero, which means that the cost of debt would be the risk free rate.

The asset beta can be calculated using the following formula:

$$\beta_a = \left[\frac{V_e}{(V_e + V_d(1-T))} \beta_e \right] + \left[\frac{V_d(1-T)}{(V_e + V_d(1-T))} \beta_d \right]$$

In exam questions, we normally assume that β_d is zero, so the last term can be ignored. The formula then becomes:

$$\beta_a = \left[\frac{V_e}{(V_e + V_d(1-T))} \beta_e \right]$$