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 organization. An understanding of how value is created or destroyed is therefore central to the governance of organizations in all sectors.

Although not normally 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 organization 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 maximization of value in investment, finance and risk management, and the delivery of value for money in achieving the objectives of not-for-profit organizations.

Learning outcomes

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

- Explain how organizations make value optimizing 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 analyze 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

1. **Financial governance: objectives and environment – weighting 10%**
    - Objectives of financial decision making
        - The role of shareholder wealth maximization in modern financial management
        - Shareholder v stakeholder perspectives
        - Role of the finance function

    - Balancing risk and return
    - Shareholder wealth maximization and ethical behaviour
    - Ethics and the finance function
- Corporate governance
    - Corporate governance and the agency problem
    - Financial aspects of the public listing or corporate statutes
    - Public company certifications

2. Management performance measurement – weighting 5%

- Financial ratio analysis
- Financial ratio analysis, including ratios relating to:
    - Profitability
    - Efficiency
    - Liquidity
    - Leverage
    - Investment performance
- Value for money
- Economic Value Added
- Revenue Recognition
    - The nature of revenue recognition, including:
        - The problems of revenue recognition
        - The factors that may lead to revenue recognition problems
        - Financial ratios that may help to detect revenue recognition issues
- Financial distress and insolvency, including the use of financial ratios to detect problems

3. Making distributions to shareholders – weighting 10%

- Dividend policy and shareholder wealth measures
- Reasons for the importance of dividends
- Factors determining the level of dividends
- Stock dividends and share buybacks

4. 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
        - Risk-adjusted discount rate
    - Portfolio effects and risk reduction
- Shareholder value analysis
    - Shareholder value and is measurement
    - Share value using net present value measurements
    - Economic value added
    - Total shareholder return (TSR) and market value added (MVA)

5. 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
        - Debt
    - 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.

6. 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 private equity, venture capitalists and business angels in helping smaller companies
- Main sources of long-term finance
    - Common shares
    - Preference shares
    - Share warrants

- Borrowings, including
  - Term loans and mortgages
  - Loan notes and bonds
  - Eurobonds (international bonds)
- Finance leases (including sale and leaseback)
- Operating leases
- Securitization 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
    - Tender issues
    - Offers for sale and public issues
    - Private placements
- 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 debt
  - Weighted average cost of capital
  - Leverage and its effect on risk and returns to shareholders
  - Factors influencing the level of leverage in practice
  - The optimum capital structure

7. 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 management
  - 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
        - Optimum level of cash
        - 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
        - Receivable factoring
        - Invoice discounting
    - Internal sources of short-term finance, including:
        - Reducing inventories
        - Tighter credit control
        - Delaying payments to payables

8. 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 and forwards
        - Options
        - Forward rate agreements
        - Swaps
        - Money market hedges

Overview

Financial decision making is central to modern entity management and adding value for stakeholders of entities. The Chartered Secretary must be familiar with the follow areas to properly advise the board of an entity

- Financial markets and institutions
- The strategic projects of the entity

- Stakeholder expectations for value creation
- 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