**PAPER F3**

**FINANCIAL STRATEGY**

**Acorn Chapters**

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|---|---|
| 1 | Introduction to financial strategy |
| 2 | Analysing performance |
| 3 | Planning and forecasting |
| 4 | Long term finance |
| 5 | Cost of capital & capital structures |
| 6 | CAPM |
| 7 | Dividend policies, EMH & treasury function |
| 8 | Business valuation |
| 9 | Corporate reorganisation |
| 10 | Investment appraisal – Part 1 |
| 11 | Investment appraisal – Part 2 |

**The syllabus comprises:**

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| A | Formulation of Financial Strategy | 25% |
| B | Financing Decisions | 30% |
| C | Investment Decisions and Project Control | 45% |

**Learning Aims**

Paper F3 deals with the key elements in designing and managing the organisation's financial strategy, in the context of contributing to achieving the organisation's objectives and within its external constraints, such as the general regulatory and investment environment. The features and implications of the full range of major financing instruments are covered. A broad range of types of investment decision is also covered and it is recognised throughout that such decisions need to take account of broader strategic issues as well the financial analysis.

**Assessment Strategy**

There will be a written examination paper of three hours, plus 20 minutes of pre-examination question paper reading time. The examination paper will have the following sections:

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| Section A | 50 marks | A maximum of four compulsory questions, totaling fifty marks, all relating to a pre-seen case study and further new un-seen case material provided within the examination.<br>(Note: The pre-seen case study is common to all three of the strategic level papers at each examination sitting i.e. Paper P3, E3 and F3). |
| Section B | 50 marks | Two questions, from a choice of three, each worth twenty five marks. Short scenarios will be given, to which some or all questions relate. |

**Learning Outcomes and Syllabus Content**

**A - Formulation of Financial Strategy - 25%**

**1. discuss potential strategic financial objectives, and the relationships among and constraints on the elements of financial strategy**.

(a) discuss the potential strategic financial objectives of an organisation;
(b) discuss the interrelationships between decisions concerning investment, financing and dividends;
(c) discuss the impact of internal and external constraints on financial strategy, including the impact of regulation on business combinations.

- The financial and non-financial objectives of different organisations (e.g. value for money, maximizing shareholder wealth, providing a surplus).
- The three key decisions of financial management (investment, financing and dividend) and their links.
- Benefits of matching characteristics of investment and financing in the longer term, (e.g. in cross-border investment) and in short-term hedging strategies.
- Considerations in the formulation of dividend policy and dividend decisions, including meeting the cash needs of the business.
- External constraints on financial strategy (e.g. funding, regulatory bodies, investor relations, strategy, and economic factors).
- Developing financial strategy in the context of regulatory requirements (e.g. price and service controls exercised by industry regulators) and international operations.
- The implications of regulation for business combinations. (Note: Detailed knowledge of the City Code and EU competition rules will not be tested).

**2. evaluate the strategic financial strategies and objectives of an organisation and the extent of their attainment.**

(a) identify an organisation's objectives in financial terms;
(b) evaluate the attainment of an organisation's financial objectives;
(c) evaluate current and forecast performance taking account of potential variations in economicand business factors;
(d) evaluate alternative financial strategies for an organisation taking account of external assessment of the organisation by financiers and other stakeholders, including likely changes to such assessment in the light of developments in reporting.

- The financial objectives of an organisation and economic forces affecting its financial plans (e.g. interest, inflation and exchange rates).
- Assessing attainment of financial objectives.
- Use of financial analysis in the external assessment of a company (e.g. in assessing creditworthiness and compliance with financing covenants).
- Modelling and forecasting cash flows and financial statements based on expected values for economic variables (e.g. interest rates) and business variables (e.g. volume and margins) over a number of years.
- Analysis of sensitivity to changes in expected values in the above models and forecasts.
- Assessing the implications for shareholder value of alternative financial strategies, including dividend policy. (Note: Modigliani and Miller's theory of dividend irrelevancy will be tested in broad terms. The mathematical proof of the model will not be required, but some understanding of the graphical method is expected).
- The lender's assessment of creditworthiness.

- Current and emerging issues in financial reporting (e.g. proposals to amend or introduce new accounting standards) and in other forms of external reporting (e.g. environmental accounting).

**B. FINANCING DECISIONS (30%)**

**1. evaluate the financing requirements of an organisation and strategies for meeting those requirements.**

(a) analyse the short- and long-term financing requirements of an organisation;
(b) evaluate alternative methods of meeting financing requirements, taking account of the implications for the organisation's financial statements, its tax position and financial stakeholders;
(c) evaluate the weighted average cost of capital of an organisation;
(d) recommend methods of funding specific investments, taking account of basic tax considerations and risk exposures (to interest and currency exchange rate fluctuations);
(e) recommend optimal strategies for the management of working capital and satisfaction of longer term financing requirements.

- Identifying financing requirements (both in respect of domestic and international operations) and the impacts of different types of finance on models and forecasts of performance and position.
- Working capital management strategies. (Note: No detailed testing of cash and stock management models will be set since these are covered at a lower level within the syllabus).
- Types and features of domestic and international long-term finance: share capital (ordinary and preference shares, warrants), long-term debt (bank borrowing and forms of securitised debt, e.g. convertibles) and finance leases, and methods of issuing securities.
- The operation of stock exchanges (e.g. how share prices are determined, what causes share prices to rise or fall, and the efficient market hypothesis). (Note: No detailed knowledge of any specific country's stock exchange will be tested).
- The impact of changing capital structure on the market value of a company. (Note: An understanding of Modigliani and Miller's theory of gearing, with and without taxes, will be expected, but proof of their theory will not be examined).
- The capital asset pricing model (CAPM): calculation of the cost of equity using the dividend growth model (knowledge of methods of calculating and estimating dividend growth will be expected), the ability to gear and un-gear betas and comparison to the arbitrage pricing model.
- The ideas of diversifiable risk (unsystematic risk) and systematic risk. (Note: use of the two-asset portfolio formula will not be tested).
- The cost of redeemable and irredeemable debt, including the tax shield on debt.
- The weighted average cost of capital (WACC): calculation, interpretation and uses.
- The lease or buy decision (with both operating and finance leases).
- Criteria for selecting sources of finance, including finance for international investments.
- The effect of financing decisions on balance sheet structure and on ratios of interest to investors and other financiers (gearing, earnings per share, price-earnings ratio, dividend yield, dividend cover gearing, interest cover).

**2. discuss the treasury function.**

a) discuss the role and management of the treasury function.

- The role of the treasury function in terms of setting corporate objectives, liquidity management, funding management, and currency management.

- The advantages and disadvantages of establishing treasury departments as profit centres or cost centres, and their control.

## C. INVESTMENT DECISIONS AND PROJECT CONTROL (45%)

### 1. evaluate investment choices.

(a) analyse relevant costs, benefits and risks of an investment project;
(b) evaluate investment projects (domestic and international), including their financial and strategic implications, taking account of potential variations in business and economic factors;
(c) evaluate potential investments in organisations of different types and intangible assets;
(d) recommend investment choice in the presence of capital rationing and/or real options.

- Identification of a project's relevant costs (e.g. infrastructure, marketing and human resource development needs), benefits (including incremental effects on other activities as well as direct cash flows) and risks (i.e. financial and non-financial, including reputation risk arising from ethical considerations and risks of legal change or uncertainty).
- Linking investments with customer requirements and product/service design.
- Linking investment in IS/IT with strategic, operational and control needs (particularly where risks and benefits are difficult to quantify).
- Calculation of a project's net present value and internal rate of return, including techniques for dealing with cash flows denominated in a foreign currency and use of the weighted average cost of capital.
- The modified internal rate of return based on a project's "terminal value" (reflecting an assumed reinvestment rate).
- The effects of taxation (including foreign direct and withholding taxes), potential changes in economic factors (inflation, interest and exchange rates) and potential restrictions on remittances on these calculations.
- Recognising risk using the certainty equivalent method (when given a risk free rate and certainty equivalent values).
- Adjusted present value. (Note: The two step method may be tested for debt introduced permanently and debt in place for the duration of the project).
- Valuation bases for assets (e.g. historic cost, replacement cost and realisable value), earnings (e.g. price/earnings multiples and earnings yield) and cash flows (e.g. discounted cash flow, dividend yield and the dividend growth model).
- The strengths and weaknesses of each valuation method and when each is most suitable, e.g. by reference to type of investee organisation (service, capital intensive etc).
- Forms of intangible asset (including intellectual property rights, brands etc). and methods of valuation.
- Application of the efficient market hypothesis to business valuations.
- Selection of an appropriate cost of capital for use in valuation.
- Capital investment real options (i.e. to make follow-on investment, abandon or wait).
- Single period capital rationing for divisible and non-divisible projects. (Note: Multi-period rationing will not be tested).

### 2. evaluate opportunities for merger, acquisition and divestment.

(a) evaluate the financial and strategic implications of proposals for mergers and acquisitions, including their terms, post-transaction values and processes, and exit strategies;

(b) evaluate the financial and strategic implications of demergers and divestments.

- Recognition of the interests of different stakeholder groups in mergers, acquisitions and company valuations.
- The reasons for merger or acquisitions (e.g. synergistic benefits).
- Forms of consideration and terms for acquisitions (e.g. cash, shares, convertibles and earn-out arrangements), and their financial effects.
- The post-merger or post-acquisition integration process (e.g. management transfer and merger of systems).
- The function/role of management buy-outs and venture capitalists.
- Types of exit strategy and their implications.
- The reasons for (e.g. strategic change, opportunity cost of investment) and mechanisms of demerger or divestment.

**3. evaluate procedures for investment projects.**

(a) evaluate procedures for the implementation and control of investment projects.

- Project implementation and control in the conceptual stage, the development stage, the construction stage and initial manufacturing/operating stage.
- Post completion audit of investment projects.