Part 1

Formulation of Financial Strategy
1

Formulation of Financial Strategy
Financial and non-financial objectives

Questions on this section will typically be asked in conjunction with aspects of one of the other main syllabus areas. For example, the objectives of not-for-profit entities combined with an investment appraisal. For profit making entities the main strategic objective is to maximise the wealth of the proprietors. This means investing in projects that expect to generate a positive NPV at a specific risk adjusted rate that on average provides a return commensurate with investors’ expectations and risk profile. In practice this may be interpreted as achieving maximum profits for shareholders, measured by the return generated from ownership. This might be considered too narrow a view and the achievement of this single objective is subject to various constraints, both internal and external, and conflicting demands on management by self-interest groups.

The concept of shareholder wealth is absent in not-for-profit entities. The objectives of the entity will be determined by the purpose for which it was established. This might be set out in a charter or trustee arrangement. However, many of the general principles of financial strategy are still available for these entities to help them manage their finances to meet their objectives and maintain their duty of care to their key stakeholders. The differences between financial management in the private and public sectors are diminishing as governments seek to make the public sector more commercially aware.

The three key decisions of financial management

The practical application of financial strategy can be grouped into three main areas of decision that reflect the responsibilities of acquiring financial resources and managing those resources:

- Investment decisions are those which determine how scarce resources are committed to projects; e.g. acquisition of new plant, takeovers and mergers, divestment from unsuccessful projects.
- Financing decisions relate to acquiring the optimum finance to meet financial objectives and seeing that non-current assets and working capital are effectively managed.
- Dividend decisions relate to the determination of how much and how frequently cash can be paid out of the profits of an entity as income for its proprietors.
Dividend policy and dividend decisions

In theory, and within a narrow range of assumptions, the value of an entity is unaffected by dividend decisions. In reality, dividend policy, and in particular the signalling effect of dividend announcements is considered to be extremely important. This section of the syllabus requires a thorough knowledge of the various policies available to an entity and the implications of each for investors.

Modigliani and Miller expressed the view that dividends are irrelevant to the value of the entity. Their argument is that the entity has a duty to maximise the value of that entity, and that involves investing in all positive NPV projects. If shareholders need cash they can sell some of their shares. However, this assumes:

- No taxes or transaction costs
- Fixed investment and borrowing programmes
- Additional needed funds come from retained earnings and extra cash is paid as dividends
- Capital markets are efficient.

External constraints on financial strategy

External constraints imposed on managers by governments and society include: legislation, e.g. laws to protect the environment or employees; accounting concepts and conventions; economic factors, and the effect of regulatory controls. Detailed knowledge of any specific legislation, accounting or reporting standard, or regulatory control is not required. What is required is an understanding of how the broad concepts and conventions affect business operations and strategic decisions.

Use of financial analysis

An ability to calculate ratios and performance measures based on accounting numbers is taken for granted at this level. What is more important is an ability to select appropriate information and evaluate it as part of an entity’s strategy.

It is important to realise that a ratio on its own tells you very little and no absolute targets can be set without reference to the circumstances of a particular organisation. To make informed comments we need to make comparisons. These can be with:

- the previous year
- the budget
- an investor’s expectations
- a competitor
- the industry average.

Profitability ratios

(a) Return on capital employed (ROCE) = \( \frac{\text{Profit before interest + tax (PBIT)}}{\text{Long-term debt + equity}} \)

(b) Operating profit margin = \( \frac{\text{PBIT}}{\text{Sales revenue}} \)
(c) Asset turnover = \( \frac{\text{Sales revenue}}{\text{Capital employed}} \)

(d) Return on equity = \( \frac{\text{Profit after interest and tax}}{\text{Shareholders’ funds}} \)

(e) Expense ratio = \( \frac{\text{Expense}}{\text{Sales revenue}} \)

**Modelling and forecasting cash flows and financial statements**

Questions on this area of the syllabus usually require the construction of forecast income statements, balance sheets, and cash flow statements from base year data. The construction of these statements may require you to make a number of assumptions. Discussion or analysis of the financial performance and position may constitute a significant proportion of the marks available.

**Sensitivity analysis**

Sensitivity analysis will almost always be examined in conjunction with modelling and forecasting cash flows and financial statements. An ability to describe and discuss the steps required to undertake sensitivity analysis, its usefulness, and the problems that might be encountered is required.
Questions

Question 1 – Objectives

This question concerns two entities, one in the private sector and one in the public sector.

Entity 1
This is a listed entity in the electronics industry. Its stated financial objectives are:

- to increase earnings per share year on year by 10% per annum; and
- to achieve a 25% per annum return on capital employed.

This entity has an equity market capitalisation of £600 m. It also has a variety of debt instruments trading at a total value of £150 m.

Entity 2
This entity is a newly established purchaser and provider of healthcare services in the public sector. The entity’s legal status is a trust. Its total income for the current year will be almost £100 m. It is considering funding the building of a new healthcare centre via the Private Finance Initiative (PFI). The total debt will be £15 m. Capital and interest will be repaid over 15 years at a variable rate of interest, currently 9% each year. The trust’s sole financial objective states simply ‘to achieve financial balance during the year’. Its other objectives are concerned with qualitative factors such as ‘providing high quality healthcare’.

Requirements

(a) Discuss

(i) the reasons for the differences in the financial objectives of the two types of entity given above; and
(ii) the main differences in the business risks involved in the achievement of their financial objectives and how these risks might be managed.

Use the scenario details given above to assist your answer wherever possible.

(b) Explain how the financial risks introduced into the public sector organisation by the use of PFI might affect the achievement of its objectives and comment on how these risks might be managed.

Note: Candidates from outside the UK may use examples of private financing of public sector schemes in their own country in answering part (b) of this question if they wish.

Question 2 – Educational

(a) You are a newly appointed Finance Manager of an Educational Institution that is mainly government funded, having moved from a similar post in a service company in the private sector. The objective, or mission statement, of this Institution is shown in its publicity material as:

To achieve recognised standards of excellence in the provision of teaching and research.
The only financial performance measure evaluated by the government is that the Institution has to remain within cash limits. The cash allocation each year is determined by a range of non-financial measures such as the number of research publications the Institution’s staff have achieved and official ratings for teaching quality.

However, almost 20% of total cash generated by the Institution is now from the provision of courses and seminars to private sector companies, using either its own or its customers’ facilities. These customers are largely unconcerned about research ratings and teaching quality as they relate more to academic awards such as degrees.

The Head of the Institution aims to increase the percentage of income coming from the private sector to 50% over the next five years. She has asked you to advise on how the management team can evaluate progress towards achieving this aim as well as meeting the objective set by government for the activities it funds.

**Requirement**

Discuss the main issues that an institution such as this has to consider when setting objectives.

Advise on

- whether a financial objective, or objectives, could or should be determined; and
- whether such objective(s) should be made public.

**(9 marks)**

(b) The following is a list of financial and non-financial performance measures that were in use in your previous company:

<table>
<thead>
<tr>
<th>Financial</th>
<th>Non-financial</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value added</td>
<td>Customer satisfaction</td>
</tr>
<tr>
<td>Profitability</td>
<td>Competitive position</td>
</tr>
<tr>
<td>Return on investment</td>
<td>Market share</td>
</tr>
</tbody>
</table>

**Requirement**

Choose two of each type of measure, explain their purpose and advise on how they could be used by the Educational Institution over the next five years to assess how it is meeting the Head of the Institution’s aims.

**(16 marks)**

*Note: A report format is NOT required in answering this question.*

**(Total = 25 marks)**

**Question 3 – Police**

A regional police force has the following corporate objectives:

- to reduce crime and disorder
- to promote community safety
- to contribute to delivering justice and maintaining public confidence in the law.

The force aims to achieve these objectives by continuously improving its resources management to meet the needs of its stakeholders. It has no stated financial objective other than to stay within its funding limits.
The force is mainly public-funded but, like other regional forces, it has some commercial operations, for example policing football matches when the football clubs pay a fee to the police force for its officers working overtime. The police force uses this money to supplement the funding it receives from the government. The national government is proposing to privatise (i.e. sell off) these commercial operations and has already been in preliminary discussions with an international security company. This company’s stated financial objectives are:

- to increase earnings per share year on year by 5% per annum; and
- to achieve a 20% per annum return on capital employed.

Arguments put forward by government in favour of privatisation focus on the conflict of objectives between mainstream operations and commercial activities, and savings to the taxpayer. However, the proposals have met with strong opposition from most of the force’s stakeholders.

Requirements

(a) Discuss the reasons for the differences in the objectives of the two types of organisation given above. Use the scenario details given above to assist your answer wherever possible. (12 marks)

(b) Discuss the influence the commercial operations might currently have on the police force’s ability to meet its stated objectives. Include in your discussion an evaluation of the possible effects on mainstream services and the various stakeholder groups if the commercial operations were to be privatised. (13 marks)

(Total = 25 marks)

Question 4 – Healthcare

Two senior executives have recently met on a course where they were being taught about setting financial objectives and the three key policy decisions listed below:

1. the investment decision
2. the financing decision
3. the dividend decision.

One of the executives works for a large healthcare company listed on the stock exchange, the other works in the public sector health service where all services are provided free of charge to users at the point of delivery. The public sector health service is financed through an annual cash budget funded entirely by taxes and government borrowing and has no treasury department.

The following extracts are from their conversation after the course:

Healthcare company executive

Life must be so much easier for you. We have to raise finance from various sources to fund any new investment. We also have to ensure that we pay a dividend that keeps our shareholders happy.

Public sector health service executive

I don’t think you would find a cash-constrained life, as we experience it, very easy. I would like to be able to raise money on the stock market to fund our business requirements. I would also much prefer to have my own treasury department to go to at any time rather than having to wait and see what we have been allocated in our annual budget.
Requirements:

(a) Identify in which of the three key policy decisions listed above the public sector health service would have least involvement, and explain why. Additionally, identify in which of the three key policy decisions listed above a treasury department would have most involvement, and explain why.

(8 marks)

(b) Describe each of the three key policy decisions listed and discuss the importance of each of them to the shareholders in the healthcare company.

(9 marks)

(c) Describe the main methods of raising new equity finance and recommend the most appropriate method for the healthcare company to raise equity finance on the stock market.

(8 marks)

(Total = 25 marks)

Question 5 – RJ

RJ plc is a supplier of surgical instruments and medical supplies (excluding drugs). Its shares are listed on the UK’s Alternative Investment Market and are currently quoted at 458 pence per £1 share. The majority of its customers are public sector organisations in the UK. RJ plc is doing well and now needs additional capital to expand operations.

The forecast financial statements are given below.

Extracts from the Income Statement for the year ended 31 December 2005

<table>
<thead>
<tr>
<th>£’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
</tr>
<tr>
<td>Costs and expenses</td>
</tr>
<tr>
<td>Operating profit</td>
</tr>
<tr>
<td>Finance costs</td>
</tr>
<tr>
<td>Profit before tax</td>
</tr>
<tr>
<td>Tax</td>
</tr>
</tbody>
</table>

Note: Dividends declared for 2005 are £1,392,000

Balance Sheet as at 31 December 2005

<table>
<thead>
<tr>
<th>£’000</th>
<th>£’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL ASSETS</td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td>14,425</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>4,510</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>3,700</td>
</tr>
<tr>
<td>Cash</td>
<td>198</td>
</tr>
<tr>
<td></td>
<td>8,408</td>
</tr>
<tr>
<td></td>
<td>22,833</td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th>£'000</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EQUITY AND LIABILITIES</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>8,350</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,750</td>
</tr>
<tr>
<td><strong>13,100</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Non-current liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>(Secured bonds, 6% 2008)</td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Current liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Trade payables</td>
<td>2,850</td>
</tr>
<tr>
<td>Other payables (tax and dividends)</td>
<td>2,883</td>
</tr>
<tr>
<td><strong>5,733</strong></td>
<td></td>
</tr>
<tr>
<td><strong>22,833</strong></td>
<td></td>
</tr>
</tbody>
</table>

You have obtained the following additional information:

1. Revenue is expected to increase by 10% per annum in each of the financial years ending 31 December 2006 and 2007. Costs and expenses, excluding depreciation, are expected to increase by an average of 5% per annum. Finance costs are expected to remain unchanged.

2. RJ plc expects to continue to be liable for tax at the marginal rate of 30%. Assume tax is paid or refunded the year following that in which the liability or repayment arises.

3. The ratios of trade receivables to revenue and trade payables to costs and expenses will remain the same for the next two years. The value of inventories is likely to remain at 2005 levels.

4. The non-current assets are land and buildings, which are not depreciated in RJ plc’s books. Capital (tax) allowances on the buildings may be ignored. All other assets used by the entity (machinery, cars and so on) are either rented or leased on operating leases.

5. Dividends will be increased by 5% each year.

6. RJ plc intends to purchase for cash new machinery to the value of £6,000,000 during 2006, although an investment appraisal exercise has not been carried out. It will be depreciated straight line over 10 years. RJ plc intends to charge a full year’s depreciation in the first year of purchase of its assets. Capital (tax) allowances are available at 25% reducing balance on this expenditure.

RJ plc’s main financial objectives for the years 2006-2007 are to earn a pre-tax return on the closing book value of equity of 35% per annum and a year-on-year increase in earnings of 10%.

**Requirements**

Assume you are a consultant working for RJ plc. Evaluate the implications of the financial information you have obtained. You should:

(i) Provide forecast income statements, dividends and retentions for the two years ending 31 December 2006 and 2007.  

(6 marks)

(ii) Provide cash flow forecasts for the years 2006 and 2007. Comment briefly on how RJ plc might finance any cash deficit.  

(8 marks)
Note: This is not an investment appraisal exercise; you may ignore the timing of cash flows within each year and you should not discount the cash flows. You should also ignore interest payable on any cash deficit.

(iii) Discuss the key aspects and implications of the financial information you have obtained in your answer to (i) and (ii) of the question, in particular whether RJ plc is likely to meet its stated objectives. Provide whatever calculations you think are appropriate to support your discussion. Up to 4 marks are available for calculations in this section of the question.

(11 marks)
(Total = 25 marks)
Answers

Question 1 – Objectives

(a) (i) Differences in financial objectives

Objectives in the private and public sectors have come closer together in recent years, as private companies appreciate the needs of other stakeholders apart from shareholder, and the public sector concentrates more on value for money and the best use of the financial resources.

However, the financial objectives remain the key areas for the private sector, whose primary responsibility is to their shareholders, and the public sector’s primary objectives are the provision of a quality service.

In addition, the private sector will generally set their objectives, by reference to the needs of their stakeholders, while the public sector organisation will have many of its objectives imposed by the government.

**EPS**

Earnings per share are used by shareholders to judge the growth achieved. While it can be misleading, it gives an idea of the profits generated in the year. The public sector generally does not have such a financial measure but concentrates more on the service provided.

**ROCE**

The private sector company has to give a sufficient return to its investors for the risk they perceive in the investment. This can be approximated by tracking the return on capital employed.

In the public sector, to convince the ‘investors’, usually the government, to release funds and not to withdraw resources, the organisation needs to persuade them that the activities represent value for money. This is often politically driven rather than being based on long-term financial analysis.

**Cash limits**

The public sector has a major objective to achieve financial balance during the year, as it is unable to raise more during the year. The private sector charges customers and can raise more revenue by selling more.

(ii) Business risks and management

A major difference between the two is how risk in the organisation is built into the objective. A private sector company has the risk that it may fail to attract any customers and hence any revenue. Hence the objectives are focused around the revenues and profits generated.

In the trust, the ‘customers’ have little choice in the healthcare in the area, so there is little risk to the trust in terms of the quantity of service required dropping. However, there is a major risk in terms of the quality of service delivered, so the main objectives relate to this. This is bound to be more difficult to measure, so a number of targets have been developed by government to assess progress in these areas.
Generally, we could say the main risk to a private sector organisation is that demand for the product falls, while for a public sector one, demand for the service increases beyond what can be managed within its resources.

The private sector company could manage its major commercial risk by:

- maintaining and monitoring its quality
- analysing customers and competitors
- ensuring against risks where possible.

The public sector trust has to manage the risk that it fails to give a service of sufficient quality within its financial constraints, by:

- monitoring value for money of the services provided, both internally and externally
- ensuring that services bought are the most effective
- using private finance where possible to ease financial constraints.

(b) Financial risks

The original aim of PFI was to allow services to be expanded and quality enhanced without increasing the public funds provided. This was done by private sector providing assets such as the new centre for relatively low financial rates; this is possible because there is much less risk of default on payments and the private sector company is therefore happy with a lower return than normal.

The main risks to the trust’s financial objective from this PFI debt are:

- interest rates might rise and not be matched by government finance
- income falls but interest and capital still have to be paid.

However, annual payments will be £15m/8.06 = £1.86m which is less than 2% of annual income, so it is unlikely that this will be a problem for the trust. If it does materialise, the trust may be able to negotiate longer terms (15 years is shorter than the usual PFI).

**Question 2 – Educational**

(a) Setting objectives

The main issues to consider in setting objectives are:

- deciding who the main stakeholders are
- assessing and estimating the level of financial resources which are likely
- whether one objective can meet all the needs of the various stakeholders
- can the objective be measured
- should the objectives and performance be made public.

A financial objective is fairly easy to measure against progress, and performance can also be compared to other similar educational institutions. However, one objective is probably not sufficient, given the different nature of the two markets.

However, other educational institutions may not have the same political influences. In addition, the results of the two areas will be affected by the apportionment of costs
between them. Lastly, the institution may not be in full control of its policies in areas such as fees and selection, so that it may be misleading to draw conclusions from its performance, particularly in comparison with others.

(b) Performance measures

Financial measures were traditionally those used by management, but there has been an increasing focus on non-financial areas as well in order to judge success in terms of meeting objectives. These will tend to pick up objectives relating to the needs of different stakeholders.

Financial measures

(i) Value added

This measure looks at the performance of an organisation by trying to identify the value added to the service by the organisation’s own efforts. It is more common in the private sector, but has been introduced in some areas of the public sector to allow better comparisons to be made. A school with an intake from a wealthy intelligent background would be expected to produce better results than one with a poor deprived intake, but the second school might have added more value in terms of improving the level which the children attained between entering and leaving the school.

The institution could try to look at the background of students and assess the improvement made, compared with competitors or against expected performance based on their prior attainment. This would be complicated to undertake and an approximation might look at the student body for each year as a whole, comparing the average intake background and attainment to the average results on leaving. An even cruder measure would be to look at the average degree class or the percentage of firsts and 2.1s.

This measure is included under financial measures as the private sector often use (Sales value – Cost of purchases and services) to measure it. The public sector is less likely to use financial terms to measure it, as seen above.

(ii) Profitability

This measure looks at the profits generated per unit of input (such as per staff member), but does not look at the quality of those profits. It can therefore lead to short-term focus, as the risk to longer-term profits is not considered. In the context of the institution, this might mean putting a very large number of students in one lecture room in order to decrease cost per student or increase revenue per lecturer.

However, in the long term, results and hence the reputation and recruitment might suffer, leading to lower profits.

Used in conjunction with other measures, it can give useful information on how the institute compares to others.

This measure does not connect directly to the stated mission statement of the institute, so it may need to rethink its objectives as discussed in part (a) before introducing this measure.

(i) Customer satisfaction

This is an important measure because if customers are not satisfied, they could go elsewhere and other potential customers could be discouraged. In the context of the institution, the two sets of ‘customers’ are government-funded students and
companies. Although the first group have limited ability to seek redress if not satisfied, poor performance in exams could reduce government funding, as could a high percentage of student drop-out, and reduce applications for courses. The second group could show their disappointment much more quickly by not booking further courses or seminars and having an immediate impact on income.

Measuring customer satisfaction can be difficult, but course assessments at the end of every course, quality audits by regulatory bodies, company discussions and peer reviews could help.

(ii) Competitive position

In a competitive marketplace, an organisation needs to be aware of its position in that market. The institution needs to be aware of how it is doing compared with its competitors. Government funding now partly relies on the level and quality of research, and as this is externally assessed it will make comparisons in this area easier. The amount of revenue generated by company work for competitors will be less easy to ascertain. Student courses can be easily compared against competitors as the number on particular courses are publicly available, and absolute numbers and trends can be compared for all the courses offered.

Question 3 – Police

(a) Differences in objectives

Objectives in the public and private sectors have been coming closer together, as the public sector has become more aware of the need to give value for money, and the private sector has started to recognise other stakeholders apart from shareholders.

Despite this, the private company’s primary responsibility is to their shareholders within the constraints imposed by society and government. Public bodies generally have their objectives imposed by government rather than setting their own.

Earnings per share are used by shareholders to judge performance by looking at the growth achieved. While it can be misleading, it gives an idea of the profits generated in the year. The public sector generally does not have such a financial measure but concentrates more on the service provided. Indeed, some public sector organisations would consider it a failure to have not spent all the revenue received (i.e. to have achieved a ‘nil profit’ position).

ROCE

The private sector company has to give a sufficient return to its investors for the risk they perceive in the investment. This can be approximated by tracking the return on capital employed.

In the public sector, to convince the ‘investors’, usually the government, to release funds and not to withdraw resources, the organisation needs to persuade them that the activities represent value for money. This is often politically driven rather than being based on long-term financial analysis.
Cash limits
The public sector has a major objective to stay within its cash resources, as it is unable to raise more during the year. The private sector charges customers and can raise more revenue by selling more.

Risk
A major difference between the two is how risk in the organisation is built into the objectives. A private sector company has the risk that it may fail to attract any customers and hence any revenue. Hence the objectives are focused around the revenues and profits generated.

In the police force, the ‘customers’ have little choice in the police services in the area, so there is little risk to the police operations in terms of the quantity of the service required falling. However, there is a major risk in terms of the quality of service delivered, so the main objectives relate to this. This is bound to be more difficult to measure, so a number of targets have been developed by government to assess progress in these areas.

Generally, we could say the main risk to a private sector organisation is that demand for the service falls, while for a public sector one its demand for the service increases beyond what can be managed within its resources.

(b) Influence of commercial operations
The government has argued that there is a conflict of objectives, as they feel that senior police officers may divert resources to activities such as football matches, which will have a negative impact on the resources available for other mainstream operations, in order to ease financial constraints.

However, it could be argued that a visible police presence at football matches will help to maintain public confidence in the law and reduce crime and disorder on the streets.

Additional finance raised could also help the force to meet its other objectives by providing more resources.

The impact on the various stakeholder groups is likely to be:

- Senior police officers will probably fear a reduction in the financial resources and hence a reduction in mainstream activities, unless the government make up the shortfall.
- Police officers will lose a major opportunity to earn overtime and is likely to be an unpopular move.
- Football clubs and other organisations that have the police force may be concerned that the quality of service will deteriorate. The police have wide experience of managing crowds at matches and have wider powers than a private company if there are problems in surrounding streets.
- The local community is likely to be concerned in a similar way that trouble in the area on football match days will not be dealt with effectively.
- The government will receive cash for selling the service.

Question 4 – Healthcare

(a) Key policy decisions
The public sector health service will have little involvement in a dividend decision. This determines how much of the surplus cash is returned to shareholders. As the
public sector health service does not have shareholders, this is not relevant; surplus cash is used to provide additional services.

A treasury department in a private sector company is likely to have most involvement in the financing decision. Although the department may be involved in the dividend decision and, to some extent, assessing investment opportunities, this is to the extent that they impinge on their primary role. This is to ensure that funds are available when needed and that surplus funds are put to good use.

(b) Importance to shareholders

The investment decision considers the benefits of investing cash, either in projects or in working capital, or even in high yield deposit accounts. This is important to shareholders, as it will determine the cash flows which are generated by the company and will ultimately affect the dividends paid and the share price. Assessing projects in the healthcare industry can be difficult as large investments are often required which promise the possibility of returns over many years, making the cash flows hard to estimate. Shareholders will also be concerned to compare the risk as well as the return between projects, as a higher risk investment should carry a higher return to compensate.

The financing decision considers the source of the finance required for the business operations. This will be a mixture of equity and long-term debt finance; companies need to balance the benefits to their shareholders – debt is a cheaper form of finance as the returns required are lower (due to lower risk) and the debt interest is tax allowable, but excessive gearing can increase the risk to the company, and hence the shareholders, dramatically.

The dividend decision looks at how much of the surplus cash generated should be paid out to the shareholders, and how much retained for future investments. Companies often make two payments a year, and shareholders generally prefer a predictable, steadily rising, dividend rather than one, which follows the fluctuations of the profits. A dividend policy is often declared for a number of years to give this predictability. A company which then delivers what it promised will generally be regarded as less risky, and hence more valuable, by shareholders.

(c) Raising equity finance

Equity can be raised via a placing, an offer for sale or a public offer.

A placing is when shares are offered to a small number of investors, usually institutions. The costs are likely to be lower but will concentrate ownership.

An offer for sale allots shares to an issuing house which then offers them to the public. Issuing costs are higher, but it will create a wider share base.

In a public offer, the company itself offers them to the public. This will involve high issue costs to cover publicity and underwriting.

The healthcare company is already listed on the stock exchange; it is likely that a rights issue, in which existing shareholders are given the right to subscribe for more shares, will be the method used. The shareholders buy them at a price below the market price, but can sell these rights if they cannot afford to subscribe. Theoretically, although the proportional shareholdings may change, an investor should be no worse off or better off whether they take up or sell the rights.


## Question 5 – RJ

(i) *Extracts from the Income Statements for the years ended 31 December*

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>£'000</td>
<td>£'000</td>
<td>£'000</td>
</tr>
<tr>
<td><strong>Costs and expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(including depreciation)</td>
<td>(22,500)</td>
<td>(24,225)</td>
<td>(25,406)</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td>7,620</td>
<td>8,907</td>
<td>11,039</td>
</tr>
<tr>
<td><strong>Less: Finance costs</strong></td>
<td>(2,650)</td>
<td>(2,650)</td>
<td>(2,650)</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>4,970</td>
<td>6,257</td>
<td>8,389</td>
</tr>
<tr>
<td><strong>Tax</strong></td>
<td>(1,491)</td>
<td>(1,607)</td>
<td>(2,359)</td>
</tr>
<tr>
<td><strong>Profit after tax (earnings)</strong></td>
<td>3,479</td>
<td>4,650</td>
<td>6,030</td>
</tr>
<tr>
<td><strong>Dividends declared</strong></td>
<td>(1,392)</td>
<td>(1,462)</td>
<td>(1,535)</td>
</tr>
<tr>
<td><strong>Retained earnings for year</strong></td>
<td>2,087</td>
<td>3,188</td>
<td>4,495</td>
</tr>
</tbody>
</table>

### Examiner’s Note

The question did not require candidates to show the figures for 2005; they are shown here in italics for convenience.

Capital allowances calculation:

- **Cost of machinery**: 6,000
- **2006WDA@25%**: 1,500
- **WDV**: 4,500
- **2007WDA@25%**: 1,125
- **WDV**: 3,375

* Tax is calculated on profit plus depreciation less capital allowances

2006  \[(6,257 + 600 - 1,500) \times 30\% = 1,607\]

2007  \[(8,389 + 600 - 1,125) \times 30\% = 2,359\]

### Examiner’s Note

It was not intended that candidates should consider the impact of deferred taxation in their answer here. Credit was available for those who did so.

(ii) *Cash flow forecasts for 2006 and 2007*

Calculations of cash receivable and cash payable:

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>33,132</td>
<td>36,445</td>
</tr>
<tr>
<td><strong>O/B trade receivables</strong></td>
<td>3,700</td>
<td>4,075</td>
</tr>
<tr>
<td><strong>C/B trade receivables at 12.3%</strong></td>
<td>(4,075)</td>
<td>(4,483)</td>
</tr>
<tr>
<td><em>(2005 - 3,700/30,120 X 100%)</em></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Formulation of Financial Strategy

The table below outlines the cash flow forecasts for the years 2006 and 2007.

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash receivable</td>
<td>32,757</td>
<td>36,037</td>
</tr>
<tr>
<td>Costs and expenses</td>
<td>23,625</td>
<td>24,806</td>
</tr>
<tr>
<td>O/B trade payables</td>
<td>2,850</td>
<td>2,993</td>
</tr>
<tr>
<td>C/B trade payables at 12.67%</td>
<td>(2,993)</td>
<td>(3,143)</td>
</tr>
<tr>
<td></td>
<td>(2005 - 2,850/22,500 X 100%)</td>
<td></td>
</tr>
<tr>
<td>Cash payable</td>
<td>23,482</td>
<td>24,656</td>
</tr>
</tbody>
</table>

**Cash flow forecasts**

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from sales</td>
<td>32,757</td>
<td>36,037</td>
</tr>
<tr>
<td>Costs and expenses</td>
<td>23,482</td>
<td>24,656</td>
</tr>
<tr>
<td>Machinery</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td>1,491</td>
<td>1,607</td>
</tr>
<tr>
<td>Dividends</td>
<td>1,392</td>
<td>1,462</td>
</tr>
<tr>
<td>Finance costs</td>
<td>2,650</td>
<td>2,650</td>
</tr>
<tr>
<td>Total outflows</td>
<td>35,015</td>
<td>30,375</td>
</tr>
<tr>
<td>Net cash flow</td>
<td>(2,258)</td>
<td>5,662</td>
</tr>
<tr>
<td>Opening balance</td>
<td>198</td>
<td>(2,060)</td>
</tr>
<tr>
<td>Closing balance</td>
<td>(2,060)</td>
<td>3,602</td>
</tr>
</tbody>
</table>

An alternative, equally acceptable, approach to presenting the cash flow forecasts is as follows. Note that IAS 7 allows for some discretion in the presentation format of cash flow statements. The question here required a forecast rather than a published statement and any sensible format gained credit. There is also the potential for different figures depending on rounding assumptions on accounts receivable and accounts payable.

#### Operations

<table>
<thead>
<tr>
<th></th>
<th>2006 £'000</th>
<th>2007 £'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profit</td>
<td>8,907</td>
<td>11,039</td>
</tr>
<tr>
<td>Add back depreciation</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>Change in receivables</td>
<td>(375)</td>
<td>(407)</td>
</tr>
<tr>
<td>Change in payables</td>
<td>143</td>
<td>149</td>
</tr>
<tr>
<td>Sub-total</td>
<td>9,275</td>
<td>11,381</td>
</tr>
<tr>
<td>Interest paid</td>
<td>(2,650)</td>
<td>(2,650)</td>
</tr>
<tr>
<td>Taxation</td>
<td>(1,491)</td>
<td>(1,607)</td>
</tr>
<tr>
<td>Net cash flow from operations</td>
<td>7,519</td>
<td>7,124</td>
</tr>
</tbody>
</table>

#### Investments

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>New Machinery</td>
<td>(6,000)</td>
<td></td>
</tr>
</tbody>
</table>

#### Financing

<table>
<thead>
<tr>
<th></th>
<th>2006 £'000</th>
<th>2007 £'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends paid</td>
<td>(1,392)</td>
<td>(1,462)</td>
</tr>
<tr>
<td>Total net cash flows</td>
<td>(2,258)</td>
<td>5,662</td>
</tr>
<tr>
<td>Opening cash balance</td>
<td>198</td>
<td>(1,060)</td>
</tr>
<tr>
<td>Closing cash balance</td>
<td>(2,060)</td>
<td>(3,602)</td>
</tr>
</tbody>
</table>
Exam Practice Kit: Financial Strategy

Examiner’s Note

The question stated dividends of £1,392,000 were declared in 2005. It would be usual, but not inevitable that these would be paid in 2006. Candidates who assumed payment would be made in 2005 were not penalised.

There is need to finance a cash shortfall of just over £2 m by the end of 2006. Of course, if the machinery was bought early in 2006, there may well be a requirement to finance a much greater cash shortfall earlier in the year. There is insufficient information in the question to comment further on this. However, this would be a very short-term requirement as by the end of 2007 there is a healthy cash surplus of £3.6 m. As the shortfall is caused by the purchase of new machinery, there should be no problem in raising finance. Suitable methods include bank overdraft, supplier credit or short-term leasing. However, as this is a long-term asset, it could be argued it should be funded by long-term finance and the cash surplus used for additional investments or, alternatively, repaid to shareholders.

(iii) Key aspects and implications Preliminary calculations:

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>8,350</td>
<td>8,350</td>
<td>8,350</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,750</td>
<td>7,938</td>
<td>12,433</td>
</tr>
<tr>
<td>Total equity</td>
<td>13,100</td>
<td>16,288</td>
<td>20,783</td>
</tr>
<tr>
<td>Return on equity %</td>
<td>37.9</td>
<td>38.4</td>
<td>40.4</td>
</tr>
</tbody>
</table>

\[
\frac{(4,970/13,100) \times 100}{(6,257/16,288) \times 100} = \frac{(8,389/20,783) \times 100}{100}
\]

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPS - pence</td>
<td>41.6</td>
<td>55.7</td>
<td>72.2</td>
</tr>
<tr>
<td>% increase</td>
<td>33.9</td>
<td>29.6</td>
<td></td>
</tr>
<tr>
<td>Market value of company if P/E — 11 (Share price of 458/EPS)</td>
<td>38,269</td>
<td>51,160*</td>
<td>66,316*</td>
</tr>
<tr>
<td>Dividend payout percentage</td>
<td>40%</td>
<td>31.4%</td>
<td>25.5%</td>
</tr>
<tr>
<td>DPS - pence</td>
<td>16.7</td>
<td>17.5</td>
<td>18.4</td>
</tr>
</tbody>
</table>

Examiner’s Note

Return on equity
The entity easily meets its objectives of return on equity in all three years, even though a target of 35% is quite high for an entity such as this.

Investment and financing
No investment appraisal has been carried out for the purchase of the new machinery. This should be done before the investment is made, even though the entity appears more than capable of funding the purchase out of cash flow.

Increase in earnings and dividends
Earnings increase almost 34% in 2006 over 2005 and 30% in 2007 over 2006. Figures are not available for years before 2005, but an increase in two consecutive years of over 30% suggests either 2004 was an unusually poor year or there has been a substantial improvement in prospects.
Effect of government/policy changes
The entity’s main customer is the government which means RJ may be vulnerable to changes in government, government policy or regulation - or all three.

Effect on market value/rating
If the P/E ratio stays at 11, then the company can expect a significant increase in its market value in 2006, from £38 m to £51 m. However, the comment above about apparent lack of investment opportunities could have an adverse effect on its growth rating and the P/E ratio could actually fall despite the forecast increase in profits over the next two years.