CPA Ireland Skillnet

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The CPA Ireland Skillnet provides excellent value CPE (continual Professional Education) in accountancy, law, tax and strategic personal development to accountants working both in practice and in industry. However our attendees are not limited to the accountancy field as we welcome all interested parties to our events.

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Trainee Accountant Workshop Series

July 2016

Current Issues in Strategic Corporate Finance

Solutions to June 2015 Exam

Current Issues in Strategic Corporate Finance

How to approach the SCF open book examination

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Some Current Issues

In some ways it might be better to think of recurring issues in Corporate Finance rather than current issues. But I will mention some recent innovations in the literature regarding these issues.

Some recurring issues include

- Valuation
- Is price equal to value?
- Corporate Governance

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Structure of the Session

- General comments about some current issues
- How these are examined in the SCF paper.
- Open book versus closed book examinations
- Practical example - answering a SCF examination paper

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Valuation

- This is the cornerstone of Finance
- It is a perennial issue and must be understood that it depends on what is going to happen in the future
- A valuation is therefore an uncertain estimate
- Its importance ordains that it will be examined
  - Typically you will have to value a company

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Valuation of a Company

1. This is done by means of estimating the Free Cash Flow (FCF) of the company and discounting these FCFs at the WACC over a period of time.
2. Estimating a terminal value for the company based on a terminal growth rate. Getting the present value of the terminal value (PVTV).
3. Valuing the equity of the company as 1 + 2 – Value of Debt = Value of Equity.
4. Note 1+2 = Enterprise Value

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Uncertainty/Risk

- How do we deal with risk?
- The cost of capital must reflect the risk of the business.
- The cost of equity must reflect the risk of the business and the financial risk of borrowing.
- The risk is measured by the beta of the assets (business risk) or the stock (risk to equity).

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There is risk attaching to the estimate of the cost of capital

- Sensitivity analysis
- IRR

Really don’t expect this to any great extent under examination conditions.

But be careful when estimating the cost of capital – it always be an estimate.

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Corporate Governance

'Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment'
Shleifer and Vishny JOF 1997

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Corporate Governance – OECD 1999

- 'a set of relationships between a company's board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives, and monitoring performance are determined'.

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Why does Corporate Governance Matter in Finance?

Because it can affect the value of a company.

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Agency Theory

- In simple terms Corporate Governance exists in order to reduce agency costs which arise from the separation of ownership from control.
- It is often cast in terms of the owners being outsiders and the managers being insiders.
- However, agency problems can arise between controlling shareholders and minorities as well.

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Principal – Agent Problems

- Managers have the motivation and opportunity to act in their own self interest rather than in the interests of their shareholders.
- The extent to which value is lost due to the separation of ownership from control is referred to as agency costs.

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Problems that give rise to these costs

- Effort
- Horizon
- Differential Risk Premium
- Asset use

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The effort problem

- Managers shirk their responsibilities by not putting in the same amount of effort they would if they owned the company
- It has been found that stock price declines when an executive accepts a board seat on another firm

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Horizon Problem

- Executives see themselves as spending a limited time in their current position.
- Executives prefer projects that come to fruition before they move on.
- For example, Managers nearing retirement will not invest in R&D expenditure that will yield benefits after they have retired. They may feel that they bear the cost and do not reap the benefits of such expenditure.

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Horizon continued

- However, this may not always be a problem because the capital market tends to value R&D positively.
- It can be a problem where product development cycles are long or secrecy is important. The market may not recognise a project as profitable and the manager may suffer before it comes to fruition

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Differential Risk Preference

- Shareholders are normally diversified but managers have ALL their human capital tied up in the company
- Managers risk preferences are closer to those of bankers than equity shareholders in that they have limited upside potential.

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Consequences of Differential Risk Preferences

- Avoiding risky projects which have positive NPVs
- Conglomerate diversification
- Leverage reduced to below optimal level.
- Underinvestment to avoid raising capital and the external scrutiny involved.

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Asset Use Problem

- Perks
- Increasing size rather than value
- Managers exhibit bias in the selection of investments to create barriers against their own dismissal.
- Over investment if access to excess funds or free cash flow.

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Controls on Agency Costs: Corporate Governance Mechanisms

- Management Stock Ownership
- Management Compensation Contracts
- Ownership Structure: Outside Blockholders (Concentrated Ownership)
- Board of Directors
- Managerial Labour Market
- The Market for Corporate Control (Takeovers and LBOs)
- Leverage
- Audit and Financial Reporting

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Corporate Governance

- Corporate governance is set of control mechanisms that is specially designed to monitor and ratify managerial decisions and to ensure the efficient operation of a corporation on the behalf of its shareholders
  - Reduce monitoring and bonding costs
  - Attempt to reduce information asymmetry

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Important features of corporate governance

- Adequate and appropriate system of internal controls in place
- No single individual should have too much power in a company.
- Relationship between company's management, the board of directors, shareholders and other stakeholders

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Important features of corporate governance

- Company managed in best interests of shareholders and other stakeholders
- Encourages transparency and accountability

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Management Stock Ownership

- Improvement is not monotonic. A point can be reached where more ownership just entrenches management.
- MBOs or LBOs improve performance

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Ownership Structure: Outside Blockholders

- Diffuse external shareholders: free rider problem
- Large block holders will have more incentives to monitor management
- However, some block holders may have other business ties which will mitigate against their incentive to monitor management.
- Also the problem of "Tunnelling"

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Compensation

- Salary – compensation based largely on a fixed salary can aggravate the differential risk problem
- Stock options – value increases with risk of business so mitigates differential risk problem
- Performance related bonuses
  - Rely on accounting measures which are not always good indicators of value creation.
  - Open to manipulation

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The Board of Directors

- Independent boards monitor management on behalf of shareholders
  - Authority to hire and fire top management
  - Sets management's compensation

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The managerial labour market

- Ineffective managers will not be employed elsewhere if a firm fails due to their incompetence
- Effective managers will be more marketable and have better career prospects

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The market for corporate control

- The stock market will reflect actual and/or anticipated poor managerial performance in a low stock price making the company vulnerable to a hostile take-over and the consequent loss of the managers' jobs.
- Entrenchment can mitigate against the effectiveness of this market.

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Debt

- Leverage reduces managers ability to create financial slack by imposing a fixed charge each year.
- Bondholders or lenders also monitor management.
- Interest and dividend payments reduce internally generated funds and force managers to raise capital which brings them under the scrutiny of the capital markets.

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Accounting and Corporate Governance

- Financial Reporting is a bonding cost incurred by the company to reduce the information asymmetry problem in agency theory. The cost of producing the accounts and having them independently audited is a bonding cost (Jensen & Meckling 1976).
- The audited accounts are the only information produced by the company's management for its shareholders that are verified by an independent third party.

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Accounting as a product of the governance process

- Financial reporting is regulated through the legal system
- Formation of Accounting rules delegated to the accounting profession
- Reports are verified by an external auditor
- The board appoints an audit committee to oversee this aspect of its duties.
- Voluntary disclosure of accounting information; governance; cost of capital

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Explicit Use of Accounting information in governance

- Managerial compensation contracts
- Debt covenants and contracts – (grid-pricing)

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Implicit use of Accounting in corporate governance

- How the market interprets accounting information – e.g. discretionary accruals.
- Litigation and accounting information.
- The board uses accounting information as in input into firing decisions.

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Corporate Governance Influences Accounting

- Earnings management is declining in the quality of corporate governance.

How are the issues above examined in SCF?

- The SCF examination is in the form of a case study.
- There are usually managers, shareholders and accountants in this case study.
- There will be agency conflicts
- There may be some information on corporate governance remedies (or attempts at remedies).

Open Book Examination

- You don't have time to learn things in an open book examination. The books are just to verify facts that you know, but need to check.
- You will need to devote your time to reading the case study and the questions.
- You must answer the questions asked (no marks for answering what is not asked or transcribing things from a book)

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Application of Knowledge

- Up to now the emphasis has been on testing your knowledge.
- An open book examination tests if you can apply knowledge.
- The case study is written in an attempt to reflect some potential situations that may occur in practice.
- You have to grapple with the problems set regarding the case study.

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One Possible Approach

- Read the case study
- Read the questions
- Read the questions again
- Read the case study again with a view to gathering the information to address the questions.
- Highlight or Mark parts of the case study that pertain to particular questions

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Question 1

- This is a compulsory question and there are half of the marks of the paper allocated to it.
- Now read it carefully again.
- Plan your approach to answering Q1
- Read the case study once more before beginning your answer.

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