Financial Risk Management

CPA Program subject outline

Fourth edition

The global business environment is ever changing, and as a result, organisations are exposed and vulnerable to a growing array of financial risks. These include financial risk, such as funding and liquidity risk, market risk from changes in interest rates, exchange rate or commodity price movements, credit risk and operational risk, and increasingly to the financial impacts of climate risk. The purpose of this subject is to equip candidates with the necessary skills to assess these financial risks and manage them strategically with the use of financial instruments.

Financial Risk Management is an elective subject offered in the CPA Program and is related to content in several of the compulsory subjects, including *Ethics and Governance*, *Financial Reporting* and *Strategic Management Accounting*.

Exam structure

The *Financial Risk Management* exam is comprised of multiple-choice questions.

General objectives

On completion of this subject, you should be able to:

- understand risk and a risk management framework
- identify the types of financial risk faced by an organisation
- apply a practical approach to assessing, monitoring and managing an organisation's financial risk
- understand the funding, liquidity, interest rate, foreign exchange, commodity price, credit and operational risk faced by organisations
- advise an organisation on the procurement and management of funding and the allocation to competing long-term investments
- understand the nature and characteristics of derivatives
- advise an organisation on the types of financial instruments that could be used to best manage an organisation's financial risk
- demonstrate the practical elements of accounting for derivatives for both embedded derivatives and derivatives used for hedging purposes
- explain responsibilities for financial risk and regulatory requirements, and the control framework for managing both financial and operational risks.

Subject content

The "weighting" column in the following table provides an indication of the emphasis placed on each module in the exam, while the 'recommended proportion of study time' column is a guide for you to allocate your study time for each module.

Module	Recommended proportion of study time (%)	Weighting (%)
1. Introduction to Financial Risk Management	10	10
2. Management of liquidity, debt and equity	10	10
3. Financing and evaluating investments	14	14
4. Derivatives	10	10
5. Interest rate risk management	14	14
6. Foreign exchange and commodity price risk management	14	14
7. Accounting for derivatives and hedge relationships	14	14
8. Controlling risks	14	14
	100	100

Module descriptions

The subject is divided into five modules. A brief outline of each module is provided below.

Module 1: Introduction to Financial Risk Management

Module 1 provides definitions of risk and financial risk, and explores one prominent risk management standard, including the principles, elements and the financial risk management process that it espouses. Contemporary and historic factors affecting the external business environment are discussed in relation to their impact on financial objectives and a comprehensive case study is presented to illustrate the financial risk management process. The treasury functions and risk exposures of a corporate and financial institution are compared and contrasted. This module also contains an overview of statistical terms such as ‘standard deviation’ and ‘normal distribution’.

Module 2: Management of liquidity, debt and equity

This module provides a detailed explanation of some of the techniques used in the management of financial exposures. Part A examines the management of cash, including ratios to measure liquidity, application of surplus funds and the calculation of free cash flow. Part B presents strategies to manage working capital, covers calculating the cash conversion cycle and presents a case study on how a bank might assess an application for a loan. Part C discusses capital structures, the cost of debt and equity, introduces the capital asset pricing model and how to calculate the weighted average cost of capital both before and after tax.

Module 3: Financing and evaluating investments

Module 3 focuses on the evaluation of long-term investments undertaken by companies and the debt and equity funding alternatives available to them. Part A examines the various sources of equity and debt funding available to businesses with a view to using the appropriate source for the identified need. Part B considers the sources of funding available to sole traders and partnerships. Part C discusses alternative methods of project evaluation techniques, including accounting rate of return, payback period, net present value and internal rate of return. Part D includes a discussion on estimating cash flows, the impact of inflation on capital budgeting and an additional project evaluation technique known as ‘adjusted present value’.

Module 4: Derivatives

This module discusses the concept of derivative instruments, which are financial instruments that ‘derive’ their value from underlying financial instruments, commodities or benchmarks. The four main classes of financial derivatives are examined — forwards, futures, swaps and options. For each type of financial derivative, associated terminology, trading process and use cases are covered. The module then outlines the fundamentals of pricing these key derivatives. Exotic derivatives are briefly discussed as is credit value adjustment. The content in this module provides background knowledge for module 5 and module 6.

Module 5: Interest rate risk management

This module begins with an examination of the factors that drive interest rates and the sources of interest rate risk. Additional factors that need to be considered when managing interest rate risk, including the time value of money and inflation are addressed. The following section then applies the steps in the financial risk management process to managing interest rate risk with a discussion on techniques, including offsets, embedded options, price adjustment clauses, interest rate swaps and interest rate options. The module concludes with a case study on an organisation that failed to manage interest rate risk.

Module 6: Foreign exchange and commodity risk management

Module 6 focuses on the use of derivatives to manage foreign exchange (FX) and commodity price risk. Part A covers foreign exchange risk management. This includes FX terminology, the financial risk management process for FX risks, and case studies that illustrate the tools available to importers and exporters to manage FX risk. Part B covers commodity price risk. The part begins with examples of the categories into which the various types of commodities are grouped, discusses contango and backwardation, and then examines the tools available to manage risk for several types of commodities. Part B concludes with a case study that highlights the importance of managing the situation where a business with commodity exposures is affected by currency movements.

Module 7: Accounting for derivatives and hedge relationships

This module covers the complex area of accounting for derivates and hedging. Part A uses the relevant IFRS standards to discuss the classification and accounting approach for derivatives and embedded derivates. Part B focuses on the more practical aspects of hedge accounting and explores the various types of hedge and accounting treatment, effectiveness assessments and documentation requirements with respect to inception, subsequent years and termination. The module concludes with the more complex topic of net investments in a foreign operation and several comprehensive case studies.

Module 8: Controlling risks

Module 8 examines the complex and ever-evolving governance associated with financial risk management. This includes the importance of corporate culture and how this influences behaviour throughout the organisation and internal control systems that should prevent, deter or detect problematic behaviour. The module then discusses how businesses must interpret and apply legislation, regulation, regulatory guidance and accounting and sustainability standards (the regulatory framework); some of which are jurisdiction dependant, and act accordingly and/or make disclosures consistent with their requirements.

The module explores the ASX *Corporate Governance Principles and Recommendations*, Australian Securities and Investments Commission (ASIC), the Australian Transaction Reports and Analysis Centre (AUSTRAC), *Corporations Act 2001* (Cwlth), APES 325 *Risk Management for Firms* and IFRS 7 *Financial Instruments – Disclosures*, and IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures*.