FINANCIAL RISK MANAGEMENT

CPA PROGRAM SUBJECT OUTLINE

Study guide: Third Edition

High levels of debt exist across the world following the Global Financial Crisis. Combined with slow economic growth this has created a volatile global economic environment. As a result, organisations are vulnerable to financial risk, including funding and liquidity risk, market risk from interest rate, exchange rate or commodity price movements, credit risk and operational risk. The purpose of this subject is to equip you with the necessary skills to assess these financial risks and manage them strategically with the use of financial instruments.

The Financial Risk Management subject extends the governance framework covered in the Ethics and Governance subject, further discusses the process of investment evaluation that is covered in the Strategic Management Accounting subject, and examines some of the practical elements and complexities of hedge accounting in relation to the international financial reporting standards that are covered in the Financial Reporting subject.

On completion of this subject, candidates 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.

Financial Risk Management is an elective subject offered in the CPA Program.

EXAM STRUCTURE

The Financial Risk Management exam generally consists of 100 per cent multiple-choice questions.

SUBJECT CONTENT

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

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

Module 1: Introduction to financial risk management

By the end of this module, you should be able to:

- explain and apply the definition of business risk
- analyse a scenario and apply the framework for managing risk
- explain the impact of the external environment on risk
- explain risk appetite in the context of financial risks
- explain how the risk appetite is established for an organisation and apply this concept to specific scenarios
- explain financial risk and the importance of financial risk to accountants as applied to specific scenarios
- explain and analyse the different nature of financial risks in different organisations and industries
- apply the financial risk concepts of risk appetite, risk identification and risk matrix to a simple example.

Contents

- Introduction to risk
- ERM framework
- Level of sophistication
- Financial risks
- Financial risk in different industry sectors
- The framework for FRM

Module 2: Management of liquidity, debt and equity

At the end of this module, you should be able to:

- explain and apply the concepts of cash flow and working capital management
- discuss how capital structures are determined using a simplified structure of debt, equity and preference shares
- calculate the cost of debt, ordinary shares (equity) and preference shares and explain the capital asset pricing model (CAPM)
- calculate and use the before- and after-tax weighted average cost of capital (WACC).

Contents:

Part A: Cash flow management

- Liquidity management
- Cash management
- Cash disbursements
- Free cash flow
- Stress testing

Part B: Working capital management

- Strategies to manage working capital
- Measuring working capital requirements
- Funding risk and credit risk assessment

Part C: Cost of capital and capital structure

- Qualitative factors
- Weighted average cost of capital
- Weighted average cost of capital with taxes

Module 3: Financing and evaluating investments

At the end of this module, you should be able to:

- explain the various forms of short-term and intermediate-term financing
- explain the various forms of long-term debt and equity financing
- explain and analyse various business types and identify appropriate sources of funding
- analyse and discuss an organisation's ability to access funding
- identify and apply the capital budgeting techniques used in project evaluation
- explain why investment decisions should be analysed using the net present value (NPV) method, and apply it to various investment project scenarios
- analyse and discuss the impact of inflation and the adjusted present value approach on the capital budgeting process.

Part A: Sources of funds for business

- Short- and intermediate-term financing
- Long-term debt financing
- Equity financing
- Debt versus equity—the Global Financial Crisis and European sovereign debt crisis
- Financial risk management and the role of the board of directors
- Summary of financial instruments and products

Part B: Funding for specific types of business structures

- Funding for sole traders and partnerships
- Funding for private companies and other small and medium-sized enterprises

Part C: Capital budgeting techniques

- Accounting rate of return
- Payback period
- Net present value
- Internal rate of return
- Net present value and internal rate of return methods compared

Part D: Additional issues in capital budgeting

- Estimating cash flows
- Inflation and capital budgeting
- Adjusted present value approach
- A word of caution

Module 4: Derivatives

At the end of this module, you should be able to:

- explain what is meant by 'derivatives' and the role of derivatives in financial risk management
- describe the four main classes of derivatives
- explain the basis on which derivatives are priced and valued, and calculate the relevant values
- describe exotic derivatives and hybrids.

Contents:

- The role of derivatives in financial risk management
- Futures
- Forwards
- Swaps
- Options
- Exotic derivatives
- Managing the counterparty component of credit risk

Module 5: Interest rate risk management

At the end of this module you should be able to:

- explain what interest rate risk is
- identify the sources of interest rate risk
- evaluate the implications of interest rate risk management on cash flow
- determine the key drivers that impact on interest rate risk management
- evaluate the effectiveness and appropriateness of techniques to manage interest rate risk.

Contents:

- Background
- Key steps in interest rate risk management

Module 6: Foreign exchange and commodity risk management

At the end of this module you should be able to:

- explain and calculate foreign exchange risk and discuss foreign exchange risk management
- explain and calculate commodity price risk and discuss commodity price risk management
- determine the key drivers that impact on currencies and commodity price risk management
- identify and explain the sources of foreign exchange and commodity price exposures and sensitivities
- analyse appropriate risk management strategies that address foreign exchange rate and commodity price exposures
- select and apply appropriate hedging instruments to formulate strategies to manage foreign exchange and commodity price exposure.

Contents:

- Part A: Foreign exchange risk
- Background to foreign exchange risk management
- Demystifying foreign exchange
- Foreign exchange risk management
- Part B: Commodity risk
- Soft commodities
- Metals
- Energy
- Precious metals
- Weather

Module 7: Accounting for derivatives and hedge relationships

Following on from the three previous modules, which discuss the nature, use and management of derivatives, this module provides the accounting rules for derivatives and hedge relationships as well as the interaction with the accounting for foreign currency transactions. Key areas covered include accounting for embedded derivatives and hedge accounting under IFRS 9.

Contents:

- Part A: Accounting concepts
- IFRS 9 Financial Instruments

Part B: Hedge accounting

- Hedge accounting under IFRS 9
- Eligible hedge instruments
- Eligible hedge items
- Designation
- The nature of risk
- Summary of hedge accounting treatment
- Cash flow hedge
- Fair value hedge
- Complex hedge topics
- Net investments in a foreign operation
- How effectiveness will be assessed and measured
- Hedge documentation requirements
- Foreign currency transactions
- Implementing IFRS 9

Module 8: Controlling risks

At the end of this module you should be able to:

- explain the importance of recognised frameworks for risk management and internal control and apply these to specific scenarios
- explain the regulatory requirements that apply to organisations
- identify and explain the key elements of an effective governance framework for financial risk management
- explain the key controls over financial risks
- evaluate controls over derivatives in a corporate environment
- explain an organisation's financial risk management framework.

Contents:

- Culture of financial risk management
- Risk management framework
- Case study in financial risk control management
- Internal control framework
- Regulations
- Governance framework for financial risk management
- Operational risks
- Accounting disclosure requirements