High levels of debt exist across the world following the Global Financial Crisis, combined with slow economic growth 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 was 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 were covered in the Financial Reporting subject.

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 AIM

The aim of this subject is to develop an understanding of, and the skills required to apply, appropriate financial risk management strategies to address an organisation’s financial risk.

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
- 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 to manage both financial and operational risks.
SUBJECT CONTENT

The subject is divided into eight modules.

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

<table>
<thead>
<tr>
<th>Module</th>
<th>Recommended proportion of study time (%)</th>
<th>Weighting (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Introduction to financial risk management</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>2. Management of liquidity, debt and equity</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>3. Financing and evaluating investments</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>4. Derivatives</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>5. Interest rate risk management</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>6. Foreign exchange and commodity risk management</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>7. Accounting for derivatives and hedge relationships</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>8. Controlling risks</td>
<td>14</td>
<td>14</td>
</tr>
</tbody>
</table>

A brief outline of each module is provided below.

Module 1: Introduction to financial risk management

Module 1 presents an introduction to the financial risk facing organisations and the risk management process used to address financial risk. Such frameworks are used in many organisations and provide the principles and methodology by which to understand financial risk management. Financial risk management is defined together with an explanation of the important role of accountants in both understanding and managing financial risk. The methodology and concepts introduced in this module will be expanded upon throughout the subject.

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

This module examines the procedures involved in liquidity and working capital and funding management. Also discussed are the cost of capital and the funding mix that is needed to ensure the organisation’s activities are financed at an acceptable cost with a managed level of risk.

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

Module 3: Financing and evaluating investments

Module 3 develops a risk manager’s understanding of capital budgeting techniques and how an organisation should allocate its funds to competing long-term investment opportunities. The various debt and equity markets are explained with reference to organisational funding needs and suitability.

Contents:

Part A: Sources of funds for business
- Short- and intermediate-term financing
- Long-term debt financing
- Equity financing
- Debt versus equity—the GFC and ESDC
- Financial risk management and the role of the board of directors
- Summary of financial instruments and products

Part B: Cost of capital and capital structure
- Funding for sole traders and partnerships
• Funding for private companies and other small to medium-sized enterprises (SMEs)

Part C: Capital budgeting techniques

• Accounting rate of return (ARR)
• Payback period
• Net present value (NPV)
• Internal rate of return (IRR)
• NPV and IRR methods compared

Part D: Derivatives

• Estimating cash flows
• Inflation and capital budgeting
• Adjusted present value (APV) approach
• A word of caution

Module 4: Derivatives

An organisation’s financial risk can be hedged with the use of financial instruments such as forwards, futures, swaps and options. These derivative products can also be used for speculation and arbitrage purposes and therefore alter both the nature and timing of interest rate, foreign exchange and commodity price exposures. This module introduces the main types of derivatives and the associated benefits and constraints of each. The strategic application of these financial instruments to interest rate risk is covered in Module 5, and to foreign exchange and commodity price risk in Module 6.

Contents:

• The role of derivatives in financial risk management
• Futures
• Forwards
• Swaps
• Options
• Exotic derivatives and hybrids
• Managing the counterparty component of credit risk and operational risk

Module 5: Interest rate risk management

Strategic and operational interest rate risk management is a core skill of a corporate risk manager. Volatility in interest rates has resulted in many corporate failures, and management can no longer claim ignorance of the potential cash outflows and losses inherent in exposure to interest rate volatility or of the techniques for its management. Effective interest rate management can protect and improve the value of the organisation. This module explores the fundamental processes of interest rate risk management and its interrelationship with liquidity management and solvency.

Contents:

• Background
• Key steps in interest rate risk management
Module 6: Foreign exchange and commodity risk management

Strategic and operational foreign exchange and commodity risk management is also a core skill of a corporate risk manager. In the increasingly integrated business world, corporations witness tangible volatilities in the currency and commodity markets. The key drivers that affect currencies and commodity prices are examined and the organisation’s exposure determined. Strategic management of these exposures is achieved through the use of financial instruments and effective risk management practice.

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, hedge accounting under IFRS 9.

Contents:

Part A: Accounting concepts

- Key steps in IRRM

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
Module 8: Controlling risks

This module expands on the risk management framework discussed in Module 1 by focusing on the responsibilities within organisations for risk management and controls, regulatory requirements and monitoring expected to manage financial risks. As a key control, the module explores the contents of a financial risk management policy and also considers operational risks associated with a treasury operation and the essential operational controls to be implemented.

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