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Redeemable Debt

- If the amount the investor buys the bond for is different from the amount that will be repaid by the company when the bond is repaid (redeemed), this difference will also form part of the investor's return. The investor will earn a return from:
 - the interest paid and
 - the difference between the price paid for the bond and the amount the company repays
- To calculate return to the investor, need to calculate the overall rate of return on the bond

Example:

BOND	
Term:	3 years
Nominal (Par) amount:	£100
Coupon rate:	5%
Redemption:	at par

Action	Year	£
Bond purchased by investor	0	(£90)
Interest paid by company	1	£5
Interest paid by company	2	£5
Interest paid & bond redeemed	3	£105
Return (RATE/IRR function)		8.9%

- The return to the investor of 8.9% is made up of:
 - £5 interest payments and
 - £10 difference between price paid for the bond and amount company repays
- Cost to the company = Return to investor (minus tax saving)
 - The cost to the company (Kd) is 6.7% ($8.9\% \times 0.75$) because the company can treat the payments made to the investor as a tax-deductible expense to reduce tax payments (25% tax rate assumed)

EXAM TECHNIQUE GUIDANCE

If asked to advise on best source of finance in an exam question:

- always ensure that you consider **the specific scenario** in the question
- calculate cost of each alternative (IRR/RATE function for debt)
- calculate number of bonds/shares to be issued in order to raise required amount of finance
- compare price to be paid per bond/share by investor
- consider cash flow (regular interest payments v premium on redemption / variable v fixed interest)
- consider period of each alternative with life of asset/project which it is financing
- FX risk
 - foreign currency loans/interest expense will hedge foreign currency assets/income
 - an FX loss on assets/income will be offset by an FX gain on loans/interest (and vice versa)
- Interest rate risk
 - variable debt: cash flow risk if rates increase
 - fixed rate debt: fair value risk if rates decrease
- calculate company's gearing to see if gearing is high or low compared to industry averages
- calculate company's interest cover to see if it is high or low compared to industry averages
- calculate company's EPS to see impact of additional interest payments
- only mention theories if specifically asked

Points to make if applicable to the scenario:

Debt issue:

- Introducing debt when gearing is nil or low will reduce WACC and increase share price
- Adding more debt when gearing is high will increase WACC and therefore reduce share price
- Tax savings on interest will only apply if company has sufficient profits
- Debt will require interest payments so will reduce shareholder profits (EPS)
- Debt finance may require security - check SFP to see if sufficient PPE is available
- Existing debt may have restrictive covenants preventing more debt
- Check SFP to see if there are other ways to raise finance e.g. sell unused assets

Share issue:

- A new share issue is not appropriate if company only requires a small amount of finance
- A new issue will cause an initial decline EPS (same earnings, more shares)
- A new share issue may be underwritten by investment bank to ensure all shares are bought
- Check SFP to see if retained earnings (and cash) available as this is cheapest source of equity as has no issue costs
- An unlisted company will find it harder to raise new equity
- Existing shareholders will have their ownership/control diluted
- Unlike interest payments, dividends do not have to be paid so equity more suitable for uncertain projects

MASTER PLAN

TOPIC	VIDEO CLASSES	QUESTIONS	ICAEW Workbook
<p style="color: blue;">Investment Appraisal</p>	<p>FM: Investment Appraisal</p> <p>SBM: Investment Appraisal</p> <p>SBM: Statistics</p> <p>SBM: July 2022</p> <p>SBM: 2022 Live Class Recording</p>	<p>J14 Q2(1) Landex</p> <p>J15 Q1 (1) Commex Cables - Video Course</p> <p>J16 Q1 (Exhibit 4) (1) Kiera Healy – Video Course</p> <p>N16 Q1 (1) Wooster</p> <p>N18 Q1 (2) Ketch – Video Course</p> <p>N19 Q1 (Exhibit 4) SSS</p> <p>A20 Q1 (2) Bristol Batteries – Video Course</p> <p>A20 Q2 (2) International Leisure Attractions – Video Course</p> <p>N21 Q1 (1a,1b) Demm</p> <p>N21 Q1 (2) Demm - Video Course (Statistics)</p> <p>J22 Q1 (1a) Xavi - Video Course (J22)</p> <p>J22 Q2 (4–Proposal 2) LVL - Video Course (J22)</p>	<p>Ch17</p>

Key

Small topic

Medium topic

Large topic

SAMPLE - NOT FOR USE

Futures

- Standardised contracts to buy or sell a notional amount of foreign currency
- Futures contract priced at foreign currency to £ rate e.g. \$1.35/£1
- Futures market will move in line with actual (spot) market:
 - \$ strengthens (\$1.35 to \$1.21): futures price will also strengthen (\$1.35 to \$1.21)
 - Note that futures price may not be the same as spot price

Example:

- Company that needs to buy \$ will sell £ futures (selling £ futures is the same as buying \$)

Scenario 1:

- Spot exchange rates and futures rates move to \$1.21 so company will pay more £ when buying the \$ to pay the supplier
- They will make a gain of \$0.14 on the futures (sold at \$1.35, bought at \$1.21)
- The futures gain will offset their increased cost of buying \$ to pay the supplier

Scenario 2:

- Spot exchange rates and futures rates move to \$1.51 so they will pay less £ when buying the \$ to pay the supplier
- They will make a loss of \$0.16 on the futures (sold at \$1.35, bought at \$1.51)
- The futures loss will offset their reduced cost of buying \$ to pay the supplier

Step 1. What is our exchange rate risk so should we buy or sell futures?

- Company that needs to buy \$ will sell £ futures now (selling £ futures = buying \$)
- Company that needs to sell \$ will buy £ futures now (buying £ futures = selling \$)

Step 2. Calculate number of contracts needed to offset actual payment

$$\text{Number of futures contracts} = \frac{\text{Foreign currency payment (e.g. \$1m)}}{\text{Futures rate (e.g. \$1.35)}} = \text{£ equivalent} \frac{\text{£ equivalent}}{\text{Contract size (e.g. £62.5k)}}$$

Step 3. Calculate gain/loss on futures

Gain/loss per \$ movement x number of contracts x contract size

- The gain /loss is calculated in \$ so needs to be converted in £ at spot rate

Step 4. Calculate actual £ payment/receipt in the spot market

Step 5. Calculate net amount

- The gain/loss on the futures will offset the actual payment/receipt

Advantages	Disadvantages
Secondary market for futures	Can't benefit from upside risk
Low transactions costs	Not available in every currency
Don't need to know exact date of payment or receipt	Standardised futures contracts so can't hedge exact amount
	Futures movement may not be the same as actual market (basis risk)

Fair Value Hedge

- A hedge to reduce exposure from **changes in Fair Value (FV)** of a **recognised asset/liability** or **unrecognised firm commitment** (binding agreement)

Hedged Item	Hedging Instrument
FV of inventory owned (or to be purchased under firm commitment)	Commodity future
FV of equity held as an investment	Option to sell shares (put option*)
FV of loan/bond asset (FV=discounted CFs)	Interest rate swap (fixed to variable)
FV of loan/bond liability (FV=discounted CFs)	Interest rate swap (fixed to variable)

*intrinsic value of option is hedging instrument; time value of option recorded in OCI

- Hedged item remeasured to FV to offset FV movement on derivative

	Hedged Item	Hedging Instrument	Net P&L Impact
Without Hedge Accounting	Inventory: remeasured only if NRV < Cost Firm commitment: not recognised Equity: FVPL or FVOCI Loan/Bond asset: FVPL/OCI or Amortised cost Loan/Bond liability: Amortised cost	FVPL	Gain/loss on derivative if item not FVPL
With Hedge Accounting	FVPL (Firm commitment recognised as asset/liability)	FVPL (FVOCI if hedging equity classified as FVOCI)	Ineffective element of hedge

Cash Flow (CF) Hedge

Hedged Item	Hedging Instrument

	Hedged Item	Hedging Instrument	Net P&L Impact
Without Hedge Accounting			
With Hedge Accounting			

†ineffective element of hedge: movement in hedging instrument > movement in hedged item

PERFORMANCE ANALYSIS (P&L)

REVENUE			
NUMBER		REASON	TREND/FURTHER ANALYSIS
Total Revenue	v PY*	All streams growing/declining	Best performing stream
Revenue by Stream	v Budget*	Commercial reason from exam scenario (market growth/decline/new product/advertising/competitors)	Growth rate accelerating/slowing
Revenue Mix by Stream	v Other streams		Decline accelerating/slowing/stabilising
	v Competitor	Price change and/or volume change (demand (in)elastic to price change)	Specific customer/product causing change: Revenue per Customer/Product/Employee
	v Market		Expected to continue / Strategic position
Net Asset Turnover: <u>Revenue</u> / Equity + Net Debt	v PY	Share issue	Growth rate accelerating/slowing
Revenue generated from resources	v Budget	Debt issue	Decline accelerating/slowing/stabilising
	v Other streams	Asset revaluation	Specific customer/product causing change
	v Competitor		Expected to continue / Strategic position
	v Market		
	v Other industry		

†Revenue Streams: Region/Division/Store/Product/Service

*Consider changing basis of comparison to ensure like-for-like comparison (volume/period)

REVENUE

Overall revenue has increased (decreased) impressively (disappointingly) by £x (x%) to £2023 due to growth in all revenue streams†. Stream A is the best performing stream. This is a strong performance compared to market growth of x%.

Stream† A revenue has increased (decreased) impressively (disappointingly) by £x (x%) to £2023 due to **reason** (reason from exam scenario / price change and/or volume change).

Comment on the **trend** (growth rate accelerating) / **further analysis** of numbers (specific customer or product causing increase or decrease) / significant movements / future impact.

Stream† B revenue has increased (decreased) impressively (disappointingly) by £x (x%) to £2023 due to **reason** (reason from exam scenario / price change and/or volume change).

Comment on the **trend** (growth rate accelerating) / **further analysis** of numbers (specific customer or product causing increase or decrease) / significant movements / future impact.

Stream A now accounts for the largest share of revenue (2023% v 2022%) whereas Stream B now has the smallest share (2023% v 2022%).

STATISTICS

Data Bias	
Selection bias	Not representative of whole population
Self-selection bias	Participant chooses to be part of the sample
Observer bias	Researcher is bias
Omitted variable bias	Key variables (potential causes) are not included in data
Cognitive bias	Data is presented in a bias way
Confirmation bias	Focusing on data which supports the user's view
Survivorship bias	Some data already removed

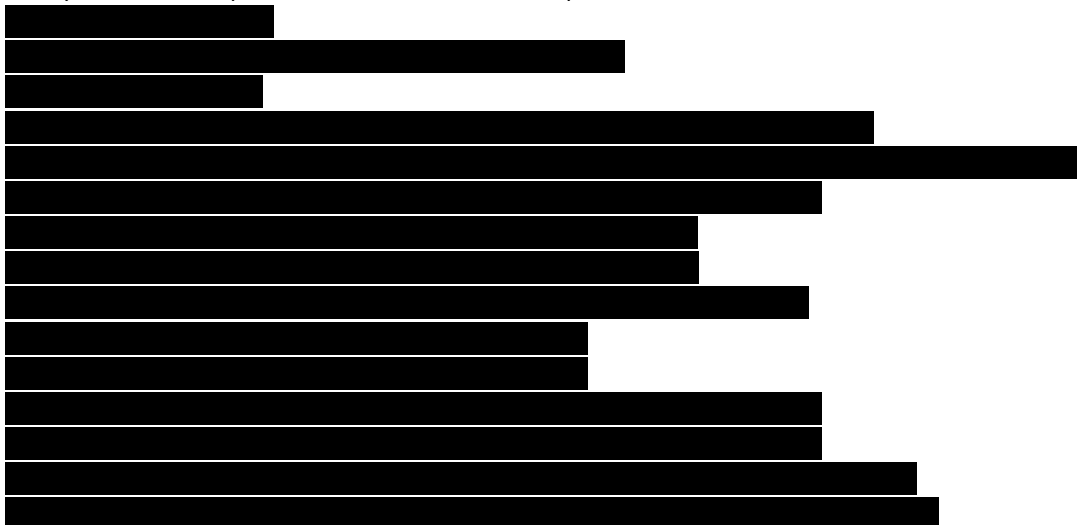
- Mean: average (AVERAGE function)
- Expected value (EV): probability x outcome

Advantages	Disadvantages
Easy to understand and apply	Assumes situation is repeated indefinitely so that average is obtained
	EV might not be one of the possible outcomes
	Probabilities may be bias
	Ignores risk

- Decision Trees: impact of different decisions/variables

Advantages	Disadvantages
Simple to understand	Hard to incorporate lots of different decisions
Considers multiple outcomes/decisions	

- Standard deviation (SD): measure of the amount of variation in a data set (STDEV function)
 - standard deviation = how far possible outcomes are from the mean/EV on average
 - higher standard deviation = higher risk
 - lower standard deviation = less risk
- Co-efficient of variation (CoV): standard deviation divided by the mean/expected value
 - adjusts standard deviation for the size of the data values to enable relative comparison
 - shows how significant the variations are (will be less significant for larger data values/projects)
 - higher co-efficient % = higher risk
 - lower co-efficient % = less risk
 - Cannot be used where data can be negative (e.g. NPV), interval scale (e.g. questionnaires) or where a result of 0 is not meaningful
- Probability distributions: possible values and associated probabilities



Model Answer: November 2020

This answer demonstrates what you could realistically produce within the time limit under exam conditions. The ICAEW answers are too detailed and are not what students are expected to produce.

1.1

Revenue

Farm Vehicles (FV), which account for 50% of EA revenue and only 25% of America (A) revenue, are declining significantly. Need breakdown to see if declining in both EA and A. If this decline continues then it will have bigger impact on EA.

FE, which accounts for 30% in EA and 55% in A, is declining slightly which is also disappointing. Continued decline will have bigger impact on A.

SE, which accounts for 20% in each market, is increasing slightly. If trends continue then this stream will become increasingly important. However, because SE is used for FV and FE, sales could decline if FV and FE continue to decline.

Overall, A accounts for 55% and EA 45% of revenue. This mix will change if trends continue because FV is declining at fastest rate and is EA's main market.

GP

FV GPM is 50% which is the highest of all products. However, GPM is declining. If trend continues this will cause overall GPM to fall and will have a bigger impact on EA because FV accounts for largest share of revenue.

FE GPM is 20% which is lowest of all products. It appears GPM is stable. As FE accounts for largest share AM revenue mix then this is reason why AM GPM overall is lower than EA.

SC GPM is 20%. This is lower than the average GPM for both EA and A so overall GPM will decline if revenue mix continues to shift towards SC.

Conclusion

There is a different revenue mix for each country with A weighted towards FE and EA weighted towards FV.

FV has highest GPM which is why EA has higher GPM overall because revenue/activity focussed there.

However, FV is declining at fastest rate so this will have bigger impact on EA.