

ACA MASTERS

SBM OPEN BOOK NOTES

These notes summarise the key Financial Management, Financial Reporting and Assurance issues for the most frequently examined parts of the SBM syllabus and therefore serve as a useful and time-effective reference in the exam. The notes also include calculation proformas and reminders.

The Exam Technique Guidance section provides specific advice as to how to approach each type of exam question in the SBM exam. Our SBM masterclasses demonstrate how to apply these techniques to recent exam questions.

Always remember to tailor your answer to the specific scenario. Nothing annoys the examiner more than a student who tries to dump a pre-prepared list of points.

Exam Technique Guidance (p1)

FM technical:

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FR technical:

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Data Analysis Questions

- Calculate basic % movements and ratios
 - Performance: revenue increase, revenue mix, profit margin, profit mix, ROCE
 - Position: Liquidity (cash, receivables, payables and inventory)
 - Position: Financing (interest cover, gearing)
- Each mini-paragraph in your answer should include:
 - number up / down with reason from scenario
 - further insight (underlying cause, growth trend, future impact)
e.g. revenue increased by 32% to £150k due to the sales promotion discounting products. However, selling at a lower price will negatively impact profit margins
- Use information from the narrative to explain movements
e.g. operating profit margin has improved to 21% as the majority of production costs are fixed so the revenue growth has fed through to operating profit
- Combine financial and non-financial information to provide further insight
e.g. revenue per product sold, revenue per customer enquiry, selling costs per staff member
- Identify missing information or unrealistic assumptions
- Conclude and recommend on way forward

FR-Based Questions

- Very brief abstract (relevant rules from relevant IFRS standards)
- Application (apply standard to the specific scenario)
- Numbers for financial statements
- Future impact on financial statements
- Identify missing information or unrealistic assumptions

Common scenarios

Business acquisition:

- Trade and asset acquisition (e.g. branch or division) - new assets acquired
- Share acquisition - consolidate if control acquired (assets at FV, GW calculated)

Business disposal:

- Trade and asset disposal (e.g. branch or division) - profit or loss on asset disposal and consider if IFRS5 discontinued operation
- Share disposal - group profit or loss on disposal of sub and consider if IFRS5 discontinued operation

Overseas business:

- Trade and assets overseas (e.g. overseas branch or division) - only retranslate monetary assets and liabilities with gain/loss in P&L
- Subsidiary overseas - retranslate all assets and liabilities for group accounts with gain/loss in OCI

Distressed business:

- Going concern issues, asset impairments, restructuring provisions

Bond Pricing

- When a company issues a bond, they are borrowing money from investors
- A bond gives the investor the right to receive interest and a repayment (redemption) amount from the company
- The return earned by the investor includes the interest paid on the bond (coupon rate):

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

Action	Year	£	DF 5%	PV £	DF 20%	PV £
Bond purchased	T0	(£100)	1	(£100)	1	(£100)
Interest paid	T1-3	£5	2.723	13.62	2.106	10.53
Bond repaid	T3	£100	0.864	86.40	0.579	57.90
				0.02		-31.57
		0.05	0.02		0.15	5% return
				31.59		

- If the amount the investor buys the bond for is different from the amount they are eventually repaid, this difference will also form part of the investor's return:

Bond:	3 years
Nominal amount:	£100
Coupon rate:	5%
Redemption:	at par

Action	Year	£	DF 5%	PV £	DF 20%	PV £
Bond purchased	T0	(£90)	1	(£90.00)	1	(£90.00)
Interest paid	T1-3	£5	2.723	£13.62	2.106	£10.53
Bond repaid	T3	£100	0.864	£86.40	0.579	£57.90
				£10.02		(£21.57)
		0.05	10.02		0.15	9.76% return
				31.59		

- Rather than using IRR, examiners appear happy for investor return to be estimated as:
- Interest payment £5/£90 = 5.6% pa
- Redemption premium £100/£90 = 11% over 4 years = 3.6%pa*
- Total pa = 9.2%

*3.6% per annum amount for 11% over 4 years calculated as $1.11^{0.33} (1/\text{number of years})$

- Even though the two bonds (above) pay an equal amount of interest (coupon rate) and the same redemption amount, the investor's return will be influenced by how much they are willing to pay for the bond
- If we know the return that investors require (Gross Redemption Yield) and the terms of the bond, then we can calculate the price of a bond
- This will tell us how many bonds the company needs to issue to raise a certain amount of finance

If investors require an 10% return (Gross Redemption Yield):

Bond:	3 years
Nominal amount:	£100
Coupon rate:	5%
Redemption:	at par

Action	Year	£	DF 10%	PV £
Interest paid	T1-3	£5	2.487	£12.44
Bond repaid	T3	£100	0.751	£75.13
Bond price				<u>£87.57</u>

- Each bond with a nominal amount of £100 will be issued to investors for £87.57
- These bonds are issued at 87.57% of their nominal amount i.e. issued at a discount
- To raise £100k of finance, the company will need to issue bonds with a total nominal value of $\frac{£100k}{87.57\%} = £114,194$
- This is 1,142 bonds with a nominal amount of £100

Financial Reporting

- The £100k will be a financial liability on the SFP measured under amortised cost (IFRS9)
- The P&L expense will be the effective interest rate of 10% (£100k @10%)
- The cash interest paid will be £5,710 (114,200 @5%)
- The effective interest rate includes the interest payment and the 'premium' on redemption
- The effective interest rate is the IRR of the bond

EXAM TIP

- To calculate how many bonds a company needs to issue to raise a certain amount of finance, we need to know the terms of the bond (period, coupon rate and redemption amount) and the return % required by investors
- To calculate the return required by investors, we can calculate the return on a similar bond for a similar company
- Always comment that the return required by investors won't be identical if:
 - The industry of the other company is different as this will cause business risk to be different
 - Gearing structure of the other company is different as this will cause financial risk to be different
 - The bond period is different

Financial Liability: Obligation to pay cash or financial asset to another party

- Loans / Bonds payable
- Preference shares with fixed dividend
- Redeemable preference shares
- Trade payables
- Derivatives

Classification and Measurement

IFRS9					
Liabilities	Type of financial liability	e.g.	Measurement	Transaction costs	FV Gains/losses
FVTPL	Held for short term trading	Derivatives	FV every year	expense	P&L
Amortised cost	Everything else	Bonds, Loans, Payables	Amortised cost	capitalise	N/A

Amortised cost

	b/f	Interest	Cash payment	c/f
Yr1	x	x	(x)	x
Yr2	x	x	(x)	x
Yr3	x	x	(x)	x

Fair Value calculation

	Cash payment	Discount factor	PV	
Yr 1	x	x	x	
Yr 2	x	x		b/f in amortised cost table
			x	X

- Initially measured at FV which is calculated using the effective interest rate method (PV of future payments that will be made). This is not always the nominal (par / face) value:

Cr Liability, Dr Cash

- Capitalise any 'transaction costs' e.g. broker fees:

Dr Liability, Cr Cash

- Subsequent measurement is on an 'Amortised cost' basis (above)
- The effective interest rate will ensure that the initial liability recognised is increased up to the actual amount payable at each payment date. This increase in the liability is recorded as a Finance Expense in P&L:

Cr Liability, Dr Interest Expense

- Cash interest paid is not recorded in the P&L as we have already accrued the effective interest:

Dr Liability, Dr Cash

Futures

- Standardised contracts which pay or receive a notional amount of interest (not actual interest payments)
- Futures contracts are priced at (100-interest rate)

	Today	Scenario 1	Scenario 2
Interest rate (%)	100	100	100
Futures price	98	97	99

Example:

- Borrowers will be concerned that interest rates will rise so they sell futures at 98

Scenario 1:

- Interest rates rise to 3% and they have to pay 1% more interest to the lender
- They will have made a gain of 1% on the futures (sold at 98, bought at 97)
- This will offset their additional interest expense

Scenario 2:

- Interest rates fall to 1% and they pay 1% less interest to the lender
 - They will have made a loss of 1% on the futures (sold at 98, bought at 99)
 - This will offset their interest saving
- Lenders will be concerned that rates will fall so they buy futures to be able to sell at a profit if rates do fall
 - Futures contracts are standardised and are not tailored to the company's circumstances
 - Therefore, need to calculate how many contracts are needed to hedge the loan

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

- Think about how the futures price is calculated (100-interest rate)
- A borrower's risk is that interest rates rise so they try to make a gain on futures by selling them now and buying when interest rates rise / future price falls
- A lender's risk is that rates fall so they try to make a gain on futures by buying them now and selling when interest rates fall / future price rises

Step 2. Calculate number of contracts needed to offset loan

$$\text{Number of futures contracts} = \frac{\text{Amount of actual loan or deposit}}{\text{Futures contract size}} \times \frac{\text{Length of loan}}{3 \text{ months}}$$

Step 3. Calculate gain / loss on futures

$$\% \text{ increase in futures} \times \text{number of contracts} \times \text{contract size} \times 3/12$$

Step 4. Calculate actual interest paid on the actual loan

Step 5. Calculate net amount and effective interest rate

The gain / loss on the futures will offset the additional / reduced actual interest expense

Advantages	Disadvantages
Lower cost than forwards and options	Futures movement may not be the same as actual market (basis risk)
Can hedge large amounts	Contracts are standardised so can't hedge exact amount of loan