ACA MASTERS

Financial Management: Learning Materials 2020

These notes summarise the key technical content and include calculation proformas and exam tips for the most frequently examined parts of the syllabus.

Our online masterclasses demonstrate exactly how to answer each type of FM exam question in order to score prize-winning marks.

Contents:

SUMMARY		
	Debt	**Equity**
Cost to company	Lower Debtholders require less return than shareholders because they are taking less risk Tax deduction is available for interest payments making cost of debt even lower (assuming that company has sufficient taxable profits)	Higher Shareholders require more return than debtholders because they are taking more risk
Risk for company	Higher Interest payments and capital repayments must be made as they are legally enforceable Debtholders may also have security over assets	Lower Dividends do not have to be paid and shareholders do not have right to their money back
Issue costs	Lower than new equity share issues and easy to arrange	High for new shares and complex to arrange (only suitable for a large expansion) Nil for retained earnings
Company ownership and control	No impact	New shares dilute existing ownership
Profit (earnings) impact	Interest reduces profit	No impact

EXAM TIP

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

- always ensure that you consider **the specific scenario** in the question
- 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 additional interest payments have on profits
- only mention theories if specifically asked

Examples of 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 balance sheet to see if sufficient PPE is available
- Existing debt may have restrictive covenants preventing more debt
- Check balance sheet to see if there are other ways to raise finance e.g. sell unused assets
- A variable interest rate exposes the firm to interest rate risk

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 an investment bank to ensure all shares are bought
- Check balance sheet to see if retained earnings (and cash) available as this is cheapest source of equity finance as has no issue costs
- An unlisted company will find it harder to raise new equity
- A family business will not want their ownership diluted
- Unlike interest payments on debt, dividends do not have to be paid so equity more suitable for uncertain projects

Foreign Exchange Risk

- A business may be exposed to foreign exchange risk:
- Future payments in a foreign currency to overseas suppliers **(transaction risk)**
- Future receipts in a foreign currency from overseas customers **(transaction risk)**
- Loss of international competitiveness due exchange rates moving unfavourably e.g. causing cost of inputs to increase, value of revenues to fall **(economic risk)**
- Overseas operations lose value when translated back to company's reporting currency for financial statements **(translation risk)**

Foreign Currency Basics

- The bank will have a buy and a sell rate. The bank makes it profit by buying and selling at different rates so the **customer** (the company) will always get the **least favourable rate**

Exchange rate ($/£) 1.30 - 1.50		
If buying $10k dollars	£7,692	£6,667
Use the least favourable (costs us more)	**£7,692**	
If selling $10k dollars	£7,692	£6,667
Use the least favourable (we receive less)		**£6,667**

- This is the spot rate: the rate available to buy and sell currency now
- If a company needs to pay a supplier in a foreign currency in the future, there is a risk that the foreign currency will strengthen so that the payment costs more in the company's home currency
- If a company will receive payment in a foreign currency in the future, there is a risk that the foreign currency will weaken so that the receipt is less in the company's home currency
- Currencies are expressed relative to one another:
- if a currency strengthens (appreciates) then the other currency is weakening (depreciating)
- if you are buying a currency, you are selling another currency

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/£
- Futures market will move in line with actual (spot) market so if $ strengthens (e.g. from $1.35 to $1.21), the futures price will also see $ strengthen (e.g. from $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 has to 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 have to 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 interest rate 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

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

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)