CIMA F3 Course Notes

Chapter 1

Formulating a financial strategy

1. Financial vs non-financial objectives

Strategy

A strategy is a plan of action designed to achieve a goal or objective. The aim of a strategy is to gain some kind of competitive advantage or to help to exploit future opportunities.

A strategic plan tends to be an overall guide to the way forward rather than a detailed step by step approach due to the tendency of the real world to be uncertain. In the example of a chess game, a 'strategy' provides the over-riding approach that the player will take to win the game, but the exact set of moves they undertake will vary depending on the opponent's moves.

In business a strategy will focused towards achieving objectives, which can be both financial and non-financial.

Financial objectives

Maximising shareholder wealth

In private sector organisations there is an over-riding objective ensure shareholder's wealth isincreased through paying dividends and increasing the value of the shareholder's equity (for instance through a higher share price).

Public sector - Value for money

Public sector organisations do not aim for profitability. Instead their focus is of the 3E's of value:

Effectiveness – achieving the goals of the organisation (e.g. education in a school)

Efficiency – using resources as efficiently and productively as possible(e.g. best use of school teachers and schools)

Economy – gaining resources at the lowest cost (e.g. buying books at the lowest possible cost)

Each of the 3E's needs to be balanced to achieve the best overall result within the limited funds available.

Providing a surplus

Achieving a surplus (e.g. additional cash in the bank) is a key element of financial risk reduction, as it allows for businesses to survive periods of financial difficulty while the economy or business is turned back into profit. Crucially it provides cash for times when cashflow is short.

Non-financial objectives

Financial objectives need to balance against non-financial objectives of a business which can include:

- Employee welfare
- Customer service
- Ethics
- Increases in market share
- Being competitive
- Health and safety
- Environmental issues
- Good supplier relationships
- Putting up barriers to entry to the market

Sensitivity of the attainment of financial objectives to changes in economic factors

The attainment of financial objectives is dependent on major economic influences:

- Interest rates;
- Inflation rates;
- Exchange rates.

Effect of interest rates

The following effects occur when interest rates rise:

- Market value of interest bearing securities falls;
- Companies reduce total debt finance;

- Companies raise new debt finance by short-term borrowings;
- Companies with surplus cash switch into interest bearing securities e.g. bonds.

Effect of inflation

The following effects occur when inflation rate rises:

- Increase in production costs;
- Increase in selling prices;
- Increase in interest rates to dampen demand;
- Decrease in foreign exchange rates (via purchasing power parity);
- Decrease in demand as a result of higher prices or uncertainty.

Effect of exchange rates

The following effects occur when exchange rates rise:

- Increase costs of exports;
- Decrease costs of imports;
- Increase in the value of investments in the UK.

Exchange rate policies can be in the form of fixed, floating or managed float.

2. Sustainability and integrated reporting

Limitations of financial statements in reflecting non-financial capital base

The IASB's Framework states that the objective of financial statements is:

> *'to provide **information** about the financial position, performance and changes in financial position of an entity that is **useful to a wide range of users** in making **economic decisions** '.*

The following lists some of the reasons why the overall objective has not been met and hence the drivers for change:

- **Information overload** - annual reports of entities have become complex and comprehensive due to the growth of standards and disclosure. A simpler approach or alternative format is required to extract useful information.

- **Backward looking** – the financial statements report on transactions that have already taken place. In order to make economic decisions, users require forward looking information. Past performance may not be a guide to future performance.

- **Difficulty in forecasting** – Forecasting is difficult and incorrect forecasts can be translated as management incompetence with an impact on share price and hence investment. They are also costly.

- **Accounting scandals and governance** – The response to recent accounting scandals has made reporting complicated and detailed. For example, Enron and WorldCom scandals have led to an increase of regulation (Sarbanes-Oxley Act) and hence disclosure. Rooting out weaknesses in Boards has resulted in legislation and voluntary codes promoting good corporate governance with the effect of increased disclosure.

- **Corporate social reporting** – the current thinking (stakeholder view) is that organisations have a social responsibility insofar as impact on future generations (e.g. pollution, carbon emissions), public responsibility (e.g. safety, charity etc.) and provision of opportunity for less advantaged groups (e.g. employment). This requires visibility in the form of reporting.

- **Stakeholder needs** – There are varied users of financial statements (not just investors) and different requirements (not just financial). Users require more narrative and outlook as well as reporting on environmental and social activities of organisations. The ubiquitous internet has seen the promulgation of 'Big Data' and more visualisation and analysis of financial and non-financial data.

  Specifically, companies are attracting environmentally conscious investors. Regulators and pressure groups are also using environmental and social information to manage and monitor the effectiveness of their performance.

Increasing the scope of financial reporting

As seen in the last section, while the financial information has a high degree of importance, stakeholders are interested in other aspects of an entity's performance. For instance, its future prospects, management of the business, its social responsibility and environment policy.

All of this is reported in several ways:

- **Operating and financial review (OFR)** - this assesses the results of the period and discusses the future prospects of the business. This is an Accounting Standard Board's (ASB) standard known as RS1. It is a Reporting Statement of Best Practise.

- **Environmental report** - this reports on the business's environmental responsibilities and the effects of its activities on its environment.

- **Social report** - the aim of social reporting is to measure and disclose the social impact of a business's activities.

- **Sustainability report** - the environmental and social reporting can be combined into a single report on sustainability. The **Global reporting initiative (GRI)** is a set of guidelines regarding sustainability reporting i.e. the environmental, social and economic aspects of performance. Applying these guidelines is voluntary.

The **additional reporting and disclosures** play a role in increasing the **transparency**. This allows better evaluation of the entity's financial performance, position and strategy. Greater transparency builds **confidence** in the information that is made available to **investors** and other **stakeholders** who may be interested in both financial and non-financial information.

Principles and scope of reporting social and environmental issues

Aims

Environmental reporting aims to disclose an organisation's corporate environmental responsibilities and how its' activities effects its environment. The aim of social reporting is to measure and disclose the social impact of a business's activities.

Scope

Social accounting and reporting covers both financial and non-financial aspects of reporting. It is a large scope potentially covers many aspects which may include reporting on both environmental and social aspects.

Environmental aspects

- The entity's **policy** towards the environment;

- The formal systems used to manage **environmental risks**;

- The **perception** of the entity of environmental risks from its operations;

- The measurement and reporting of the impacts of an entity's activities on the natural environment;
- The expected value of **future obligations** related to rectification of environmental damage;
- The degree to which it can recover from an **environmental disaster** and the financial impacts of such an event;
- The impact of government **environment legislation**;
- Details of any **infringement** of environment legislation or regulation;
- The details of any **environmental legal issues** the entity is involved in.

Social aspects

- The measurement and reporting on the **value of human assets** in an entity;
- The reporting of **policies** and **measurements** relating to the workforce, for example policies and statistics relating to employment of disabled people; ethnic groups; gender diversity.
- The reporting on an entity's **intellectual capital**;
- The details of an entity's **policies on ethical issues**.

Note. This is not an exhaustive list of potential social reporting issues.

Sustainability and the Global Reporting Initiative (GRI)

Sustainability

Sustainability is a method of conducting business to enable **future generations** to be able to meet their **needs**. Organisations frequently produce a sustainability report which details their actions and policies towards the environment and society.

Goal and scope

The Global Reporting Initiative (GRI), launched in 1997, is a multi-stakeholder, international not-for-profit organisation. Its mission is to develop and distribute globally applicable Sustainability Reporting Guidelines for voluntary use by organisations.

In June 2000, the GRI issued its first set of reporting guidelines. Version 4 is now the latest updated guidelines. Applying these guidelines is voluntary.

The guidelines cover the economic, environmental and social activities of a business entity.

GRI framework stages

The Framework (www.globalreporting.org) sets out a series of key stages that are involved in the sustainability reporting process:

Stage	Aim	Purpose
Define report content	Guidance	Application of the principles of materiality, stakeholder inclusiveness, sustainability context and completeness.
Ensuring report quality	Principles	Based on balance, comparability, accuracy, timeliness, reliability and clarity.
Setting report boundary	Guidance	Determining the range of entities for inclusion in the report.
Profile	Disclosure	Framework of the sustainability report. It has 5 sections: strategy & analysis; org profile; report parameter; governance; commitments and Stakeholder engagement (see below).
Disclosure of management approach	Disclosure	Approach to managing sustainability risks and opportunities in terms of economic, environmental and social aspects.
Performance indicator disclosures	Disclosure	Comparable information on a number of indicators separated into categories i.e. economic, environmental and social.

Sustainability report content

The 'Profile' stage identifies the base content that should appear in a sustainability report, which can be briefly summarized as follows:

#	Report content	Detail of GRI requirements
1	Strategy and Analysis	CEO statement explaining relevance of sustainability to the business strategy. As well as a description of the high-level, strategic view of the organisation's key impacts on sustainability and vice versa.

2	Organisational Profile	The organisation's structure including products, location of operations and markets.
3	Report Parameters	The reporting period, materiality, report boundaries (e.g. countries) and exclusions, data measurement techniques and a GRI Content Index.
4	Governance, Commitments and Engagement	Governance structure of the organisation (e.g. internal codes and their application), commitments to external initiatives and stakeholder engagement (e.g. list of groups, approach and key topics).
5	Management Approach and Performance Indicators	Organised by economic, environmental, and social categories. Each category includes a Disclosure on Management Approach (i.e. goals, policy and responsibility) and a corresponding set of core and additional performance Indicators (see below).

Performance indicators in the GRI framework

The GRI suggests that entities report performance indicators so that users can **monitor their performance** from economic, environmental and social perspectives. Examples of such performance indicators may be:

- **Economic** – the impact of the entity on local, national and global economies, for example, proportion of spending with local suppliers, proportion of local workforce employed by entity, level of taxes paid;

- **Environmental** - for example, % of recycled material used in production, levels of gas emissions, levels of organic ingredients used in products, level of water used;

- **Social** - for example, breakdown of workforce by ethnic background, policies in respect of working hours, benefits provided to employees such as healthcare, gym membership, and level of fines for non-compliance with legal requirements.

International Integrated Reporting Committee (IIRC)

What is the purpose of the IIRC?

The IIRC is being set up to respond to the need for a **concise, clear, comprehensive and comparable** integrated reporting **framework** structured around the organization's strategic objectives, its governance and business model and **integrating key financial and non-financial information**.

The **objectives** for an integrated reporting framework are to:

- support the information **needs of long-term investors**, by showing the broader and longer-term impacts of decision-making;
- reflect the **interconnectivity** between environmental, social, governance and financial factors in decisions that affect long-term performance and condition, making clear the link between economic value and sustainability;
- provide the required **framework for environmental and social factors** to be taken into account systematically in reporting and decision-making;
- **rebalance performance metrics** away from the unnecessary emphasis on short-term financial performance; and
- **align reporting** to the **information used by management** to run the business on a day-to-day basis.

What is the role of the IIRC?

Presently, various standard-setters and regulatory bodies are responsible for individual elements of reporting. **No single body** has the **oversight** or authority to **pull together these different elements** that are essential to the presentation of an **integrated picture** of an organization and the impact of environmental and social factors on its performance. In addition, globalisation means that an **accounting and reporting framework** needs to be **developed on an international basis**. At present, there is a likelihood that, as individual regulators react to the risks faced, multiple standards will emerge.

The **role** of the IIRC is to:

- **raise awareness** of this issue and develop a consensus among governments, listing authorities, accounting bodies, standard setters, business and investors for the ideal way to address it;
- develop an **overarching integrated reporting framework** setting out the scope of integrated reporting and its main components;
- **identify priority areas** where additional work is required and create a plan for development;
- **consider whether standards** in this area should be **mandatory or voluntary** and facilitate collaboration between standard-setters and

convergence in the standards needed to underpin integrated reporting;

- **promote the adoption of integrated reporting** by all the relevant regulators and report preparers.

3. The three key decisions of financial strategy

A financial strategy is one key element of a business strategy as a whole. It has three key constituents

Financing decisions

Businesses need funding to invest in capital (e.g. equipment, machinery, buildings etc), to pay expenses and working capital (e.g. salaries, inventories, utilities etc).

Financing decisions relate to the decisions about where this money comes from, and is primarily about balancing:

- equity (i.e. from owners/shareholders)
- debt (from lenders such as banks)
- retained earnings.

Investment decisions

Once raised the money needs to be invested, and investment decisions help the organisation decide where to invest this money to repay debt (and interest payments) and achieve a good rate of return for shareholders.

Strategic options are generated as part of the business strategy setting process. As part of the evaluation of the strategic options, investment decisions can be made using techniques such as:

- Net present value (NPV)
- Internal rate of return (IRR)
- Payback period
- Return on capital employed (ROCE)

Dividend decisions

Assuming investments were well made, funds can be returned to shareholders in the form of dividend payments.

The directors have to balance the payment of dividends with retention of cash in the business to allow for future investment and growth.

Matching investment and financing characteristics

One key link between these strategies is to ensure that investments and financing characteristics are linked. For example:

- Long term funding (e.g. equity or long term debt) for long term projects (as returns will not be available in the short term to pay short term interests payments or to pay back a shorter term loan)
- Use of leasing for short term equipment use
- Overdrafts for short term cashflow shortages due to flexibility.

4. Dividend policy

What is dividend policy?

Dividends are the payments made to shareholders which give them a return on their investment. Dividend policy is concerned with deciding on taking a decision between:

- paying cash dividend
- paying dividends in the form of shares
- retaining earnings in the business for investment with the aim of increasing the value of the business (e.g. the share price) and ultimately paying an increased dividend at a later stage

A dividend policy is a general statement about how dividends will be paid. For example, companies in large growth markets may have a dividend policy of earnings retention and no dividends as they need to cash to invest in the business and believe shareholders returns are maximised through business growth. Conversely a large listed company may pay a set dividend each year growing at a consistent rate (irrelevant of actual earnings levels) as a signal of stability and to attract investors who want consistent returns.

Considerations when making dividend policy

Key considerations when setting dividend policy are:

- **shareholder expectations** and desire for dividends (do they want high dividends and low investment or low dividends and increased investment (and hence higher share prices)
- impact of dividends paid on **share price**
- **availability of good investments** if capital is retained in the business

- degree of **risk in new investments** in which retained earnings are invested

- the choice of **debt vs equity** finance an the weighted average cost of capital (WACC) [see later]

- **cashflow availability** e.g. to pay dividends

- the **need for cash** in other parts of the business (if cash is used to to pay dividends it can not be used elsewhere)

- whether there are any restrictions in terms of debt finance (**restrictive covenants**)

There are two schools of thought about the importance of dividend policy, one argues that it is highly relevant to shareholders, the other that it is irrelevant.

Irrelevance of dividend policy

Modigliani and Miller suggest that dividend policy is irrelevant. Instead the focus should be on investment decisions. If there’s a good investment to be made that delivers good returns (i.e. a positive NPV – see later) then that investment should be made. The amount of dividends paid is simply the residual amount left after all viable investments have been made. This is called the **theory of residuals -** dividends are residuals from the profits less funding of proposed investments.

In summary the dividend decision should be made as follows:

- evaluate the available investment opportunities to determine capital expenditures needed.

- evaluating the amount of equity finance that would be needed for the investment to ensure the optimum debt/equity finance mix (see WACC later).

- use retained earnings to finance the equity element of investments (retained earnings are preferable to raising new equity capital as it is cheaper since there are no floatation costs).

- If there is a surplus after the financing then there is distribution of dividends.

The value of the firm will not depend on the dividends paid out therefore, but, instead, the availability of good (i.e. positive NPV) investments. The dividend policy of such a kind is a passive one, and doesn't influence market price. The dividends will also fluctuate every year because of different investment opportunities every year. However, it doesn't affect the shareholders as they get compensated in the form of future capital gains.

Relevance of dividend policy

While the 'theory of residuals' make good sense in theory, in the real world dividends policy often does make short terms impacts on dividend policy, and there and so arguments can be made for its relevance.

The key arguments are as follows:

Information content of dividends - signalling

Dividend announcements convey information to investors regarding the firm's future prospects. Studies have shown that stock prices tend to increase when an increase in dividends is announced and tend to decrease when a decrease or omission is announced due to the **information content of dividends**.

Shareholders perceive that when managers lack confidence in the firm's ability to generate cash flows in the future they may keep dividends constant, or possibly even reduce the amount of dividends paid out. Conversely, managers that have access to information that indicates very good future prospects for the firm (e.g. a full order book) are more likely to increase dividends. Investors use this knowledge about managers' behaviour to inform their decision to buy or sell the firm's stock, bidding the price up in the case of a positive dividend surprise, or selling it down when dividends do not meet expectations.

This, in turn, may influence the dividend decision as managers know that stock holders closely watch dividend announcements looking for good or bad news. As managers tend to avoid sending a negative signal to the market about the future prospects of their firm, this also tends to lead to a dividend policy of a steady, gradually increasing payment.

Dividends reduce shareholder uncertainty

Payment of regular dividends reduce uncertainty of the shareholders and increases their perception of security. Under dividend irrelevancy policy dividends will fluctuate which will not be popular for some real-world investors.

Dividend clientele

A particular pattern of dividend payments may suit one type of shareholder more than another. A retiree may prefer to invest in a firm that provides a consistently high dividend yield, whereas a person with a high income from employment may prefer to avoid dividends due to their high marginal tax rate on income.

If clienteles exist for particular patterns of dividend payments, a firm may be able to maximise its stock price and minimise its cost of capital by catering to a particular clientele. This model may help to explain the relatively consistent dividend policies followed by many listed companies.

Conclusion

In the real world it can be argued that dividend policy is relevant, and in reality most large companies tend to retain stable dividend payout levels where possible, to keep their shareholders (or "clientele") happy, avoid shareholder uncertainty and to ensure the right "signal" is given to the market.

Alternative to cash dividend and their impact on shareholder wealth and entity performance measures

When an entity earns income, it can choose to distribute that income to shareholders by way of a **cash dividend**. Alternatively, it can make a **scrip dividend** i.e. offer additional shares that are worth the same or make a **share repurchase** i.e. return capital to investors by buying back its own stock.

Scrip dividend

A stock dividend (aka bonus issue) is a **dividend paid in additional shares** of stock rather than in cash. It is done on a pro-rata basis and expressed in percentage terms. For example, on a 100% stock dividend, the holder of 1 share will get additional 1 share.

A stock dividend **does not change a shareholder's proportionate ownership**. The shareholder does not receive cash, and there are no tax consequences. Thus, each shareholder will own more shares, but his or her slice of the firm's "pie" remains the same and each share is worth less. There is however, a saving on commission that would have been paid if the shares were bought on the open market.

The stock dividend is **issued from reserves**. Once reserves are capitalised in this way, they are reclassified as **undistributable**. The company's share capital increases permanently. Increase in the number of stocks accompanied with decrease in stock price improves affordability. It leads to **improvement in float and liquidity** of the stock. The traded volume of the stock increases as a cumulative effect.

There is **no economic effect** and the issue **does not affect financial ratios**. Also dividends have **no impact on a company's capital structure**. The market values of equity and debt remain unchanged.

Share buyback

A share repurchase (aka share buyback) is the transaction in which the stock issuer **buys back its shares from investors**. Once repurchased, the shares become **treasury shares (or treasury stock)**.

The repurchase of an entity's shares are based on the following **reasons**:

- return of **surplus cash** to investors;
- to reduce the entity's **cost of capital**;
- to enhance **earnings per share** in the hope of also increasing market price per share;
- to prevent, or reduce the likelihood of, unwelcome **takeover bids**;
- to **adjust the gearing** of the entity to a higher level, closer to the entity's optimal capital structure;
- to reduce the amount of cash needed to pay **future dividends**.

The impact of a share repurchase on **shareholder value** is that there is a **reduction of assets and equity** by the amount of the repurchase.

5. External constraints on financial strategy

There are a range of external factors that impact our 3 key financial strategy decisions (investment, funding and dividends). These include:

Economic factors – impacts the availability of good investments, interest rates (on debt), inflation (impacting discount rates for investment appraisal), and exchange rates relating to funds and investments in foreign currencies.

Funding – availability of finance in the market. E.g. high up to 2007 and low thereafter due to the credit crunch.

Regulatory bodies - Regulated industries (e.g. utility companies, rail, telecoms, banks) can have restrictions imposed on them such as limitations on prices and service levels (affecting investment decisions) and cash reserves (affecting funding decisions).

Investor relations and strategy – shareholders and shareholder perceptions affect what investments can be made, availability of funds and levels of dividend expected.

Regulation on business combinations – Most countries have legislation to stop monopolies being formed through business combinations, limiting investment decisions or merging with a cash rich company as a method of funding future operations

Political factors – affects availability of funds for public sector companies, or private sector companies undertaking public sector contracts. Grant availability is also an issue.

6. External influences on financial strategy

Lender's assessment of creditworthiness

An entity's **creditworthiness** is defined as the **extent** to which the entity is deemed to be **credit worthy**. This helps **mitigate default risk** on the provision of **debt finance** i.e. the risk a borrower does not repay the debt obligation. A lender assesses creditworthiness in a number of ways:

- Business plans;
- Liquidity ratios;
- Cash forecasts;
- Credit rating;
- Quality of management.

Business plans

The amount an entity aims to borrow is normally supported by a business plan. A lender will scrutinise the business plan of an entity with the aim of establishing credit worthiness. The **lender's review** is focused on a number of financial and non-financial areas of the business plan, namely:

- **Management experience** – **Competency and commitment** is gauged by the education and experience of the management team.
- **Market analysis** – The industry, competitors and customers for the given product or service will highlight the **opportunities and threats**;
- **Assets** – A list of the assets owned by the entity will serve as **security for any loan** provided;
- **Debt to equity split** – A **low** debt to equity ratio or one **within the limits for the industry** will improve the chance of securing debt funding.

Liquidity ratios

Liquidity ratios can be used by lenders to assess credit worthiness. They measure the firm's **ability to liquidate short-term assets** to meet short-term obligations. Examples include **current ratio** (= current assets / current liabilities) and **quick ratio** (= current assets less stock / current liabilities).

Cash forecasts

The **primary mechanism to repay debt** is cash flow. Hence an analysis of cash forecasts is critical to understanding an entity's capacity to pay. The entity's cash flow statement reports the entity's cash inflows and receipts. These cash flows are classified as follows:

- **Cash flow from operating activities (CFO)** which include the cash effects of transactions affecting the entity's net income;

- **Cash flow from investing activities (CFI)** which are cash effects of acquisition or disposal of long terms assets and certain investments;
- **Cash flow from financing activities (CFF)** which are cash impacts on the capital structure, for example, issuing or repaying debt and issuing or repurchasing stock.

Comparing CFO with net income is a good gauge for credit worthiness. If CFO is significantly and consistently larger than net income, then the entity is financially strong. This would mean that it will be able to repay debt from a lender. If the margin between CFO and net income is small, then there is a high risk of default. Also, the sum of CFO, CFI and CFF gives the **net increase in cash for the year**. This is the cash remaining after all obligations have been paid. This could be used to pay any new loan and therefore is another credit worthiness indicator for lenders.

Credit rating

Default risk can also be assessed via **credit ratings** supplied by nationally recognised **ratings agencies (Standard & Poor's, Moody's, and Fitch)**. The higher the credit rating, the lower the chance an entity will default on debt. The ratings agencies are paid by the entity that is seeking a credit rating for itself. A **high credit rating** will **reduce the interest charged** on a loan supplied by a lender. For **individuals** (e.g. company directors), credit ratings are derived from the record of **credit history** maintained by **credit-reporting agencies (e.g. Equifax and Experian)**.

Quality of management

The lender's assessment of management quality can be done by analysing the management's **integrity and commitment** to repay the loan. Their **relevant business qualifications** and their **operating track record** will ensure that the entity can react to unexpected events and avoid the risk of payment default.

The entity's **corporate governance structure** is an important aspect of gauging the quality of management. Corporate governance is the set of internal controls, processes and procedures by which an entity is managed. **Good corporate governance** practices ensure that: the board adheres to a **code of practise**; is **independent** of management; and the entity and the managers **act lawfully, ethically and in the shareholder's interests**.

Developing financial strategy in the context of regulatory requirements

The **role** of a regulatory body is to **balance the interests of various stakeholders**. Customer needs are protected by limiting monopoly power and thus reducing returns to shareholders. However prices still need to be high enough to promote shareholder investment. The regulatory body is involved in **price control, profit control, promotion of competition and**

ensuring quality and safety. Examples of regulators are as follows: Oftel (telecommunications), Ofcom (media) and Ofwat (water).

Regulation maybe **enforced via** the following methods: **legislation, licences and industry codes of practice**. Examples of legislation include the Companies Acts, health and safety regulations, laws relating to consumer protection and consumer rights, laws relating to contract and agency, employment law and laws relating to protection of the environment.

Taxation regulation ensures that **sufficient tax is paid** to governments by entities. However, **most large multinational enterprises avoid or pay low levels tax** by using **tax havens**. A tax haven is a country that offers foreign individuals or businesses little or no tax liability in a politically and economically stable environment. They tend to provide little or no financial information to foreign tax authorities.

7. International operations

Funding issues when operating internationally include:

Political – the political situation in each market operated needs to be considered e.g. grant availability, interest rate levels set by government

Economic – impact of interest rates, inflation rates, exchange rates and funding availability in each market operated.

Legal – Each country has its own law and regulation which must be abided by in each new market entered e.g. rules over obtaining finance

Banks and banking system – Each local market will tend to have it's own banks and banking system, which will affect sources and terms of finance.

Suppliers – New relationships will need to be built with new suppliers who may give credit terms as a source of low cost finance.

8. Hedging instruments (IAS 39)

Hedging is entered into to **reduce risk and volatility**. There will be an item that needs to be hedged and a hedging instrument. The hedging instrument will counteract any gain or loss arising on the item being hedged.

IAS 39 permits hedge accounting if the following **two conditions** are met:

- **Arrangement** must be designated as a hedge at the inception. There must be formal documentation which identifies:
    - hedged item
    - hedge instrument

- nature of risk that is to be hedged
- how the entity will assess the hedging instrument's effectiveness.

- **Hedge** is expected to be **highly effective** and its effectiveness is capable of reliable measurement.

There are **three types** of hedging arrangement:

- **fair value** hedge
- **cash-flow** hedge
- net investment in a **foreign operation**.

Fair value hedge

In a fair value hedge, the risk being hedged is the **change in the fair value** of an asset or liability, which is already recognised in the financial statements. This is driven primarily by a **change in market price**.

Hedge accounting requires both the **hedged item and the hedging instrument** to be measured at **fair value** at each year end. The **changes** in fair value of both the hedged item and hedging instrument are **recognised in the income statement** and will off-set each other.

Example (fair value hedge)

AB Ltd purchases $105,000 of copper on 1 Dec 20X7. If the price of copper falls, AB Ltd will suffer a loss when they sell the copper. To minimise this risk, it enters into a contract to sell an equivalent volume of copper for $105,000 on 1 Feb 20X8. At the year end of 31 Dec 20X7, the market value of the copper is $95,000. How will the transaction be accounted for?

Solution

The hedged item is the copper. The hedging instrument is the futures contract (a derivative).

At the year end both the hedged item and hedging instrument will be measured at fair value and gains or losses recorded in the income statement.

Hedged item (copper) $95,000

The inventory will be reduced by $10,000 and this loss will be recorded in the income statement.

Hedging instrument (futures contract) $10,000

The entity can sell what is currently worth $95,000 for $105,000. This gain will be recorded in the income statement to off-set the loss of $10,000 described above. Thus, this is a perfect hedge.

Cash-flow hedge

In a cash-flow hedge, the risk being hedged is the c**hange in future cash flows**. The fluctuations are as a result of the change in market price.

The future cash flows will not impact on profits until they occur in the future. Therefore **the gain or loss** on the hedging instrument should not **impact on profits until the future**.

Instead the **gain or loss** on the hedging instrument **is recorded initially in equity** (via reserves) and then **transferred** back to the **income statement** when the **hedged item affects the income statement**.

Net investment in a foreign operation

Here, the risk being hedged is the **change in the value of the investment** due to **movements in exchange rates**. The hedge is treated in a **similar** manner to a **cash-flow hedge**. However, **gains or losses on the derivative** are held in **equity until the transaction occurs** and then is **released to the income statement to match** against the effect of the hedged transaction.

Impact of adoption of hedge accounting on financial statements and on stakeholder assessment

Impact on financial statements

Most hedging instruments are classified as held for trading and as such they are measured at fair value at the entity's year end along. Hedged items are also measured at fair value. Gains or losses in the hedging instrument can be offset against gains or losses in the value of the hedged item.

Impact on stakeholder assessment

In order to use hedge accounting, the hedging relationship should be formally designated at the inception of the hedge. The hedged item, hedging instrument, entity's risk management objective and strategy, and hedged risk should all be documented. This forces risk managers and preparers to focus on the process of risk management.

The sources from which the fair values are derived (for non-exchange traded derivatives) must be acceptable to auditors and available at each reporting date. In terms of the user of the financial statements, they need to be more educated as hedge accounting is complex. They must have an understanding of risk management and its impact on the financial statements.

9. IFRS 7 Financial instrument - disclosure

Objective

IFRS 7 (Financial instrument: disclosures) focus is to detail the disclosure requirements so that users can:

- Enhance understanding of the **significance of financial instruments** to an entity's financial statements;
- **Assess the extent of risks related to the financial statements**.
- **Hedging activities** that help mitigate risk.

Information about the significance of financial instruments

An entity must disclose the **significance** of financial instruments on their financial **position** and **performance**. Disclosures must be made for each class of financial instrument (**based on the IAS 39 classification**).

An entity must disclose **items of income and expenses** as well as **gains and losses**. There must also be separate disclosure of **gains and losses by class** of financial instrument, unless the derivative instrument **qualifies for hedge accounting**. In such cases, the gains and losses of the hedging instrument can be offset against the hedged item.

Information about the nature and extent of risks arising from financial instruments

Entities must disclose information about the **nature and extent of risks** arising from financial instruments, including **qualitative** and **quantitative disclosures**.

Qualitative disclosures

- **Risk exposures** for each class of financial instrument;
- Objectives, policies and procedures for **managing those risks;**
- **Prior period changes** in the above two.

Quantitative disclosures

- **Summary quantitative data** about the above **risk exposures**;
- **Exposure to and management** of the following significant classes of risk: **credit risk** (risk of payment default by counterparty) , **liquidity risk** (risk of entity having difficulty in payment of financial liabilities) and **market risk** (risk that fair value of future cash-flow will fluctuate due to the market e.g. currency, interest or other price risks);

- **Concentration** of risk.