

# Paper 4

## Risk management

### AIMS

The aims of this syllabus are:

- To develop an understanding of the main frameworks and techniques concerning the management of financial risk and operating risk;
- To achieve a sound appreciation of the theory and practical aspects of corporate governance;
- To develop an understanding of the key issues surrounding the capital structure and dividend policies of businesses.

### OBJECTIVES

On completion of this syllabus, candidates should be able to:

- Explain the nature of risk and the benefits of risk management;
- Identify the main processes of risk management;
- Explain the importance of aligning risk management processes to the culture and values of a business;
- Identify the main forms of both financial and operating risk and describe the techniques that may be used to manage exposure to these types of risk;
- Discuss the frameworks of corporate governance regulations and the key issues relating to these frameworks;
- Explain the role of the board of directors and discuss the main issues relating to its composition, responsibilities and functioning;
- Identify and discuss the main social, environmental and ethical issues that businesses must confront;
- Explain the effect of dividend policy on shareholder wealth and discuss the factors influencing the dividend policy of a business;
- Explain the effect of capital structure on shareholder wealth and calculate the cost of capital of a business.

### SYLLABUS CONTENT

#### 1 Managing risk

(the risk element comprises 50% of the syllabus)

- a the nature of risk
- b risk concepts (exposure, volatility, severity, probability etc)

- c the benefits of risk management
- d the framework for risk management (including the COSO ERP framework)

#### 2 Risk management processes

- a risk identification and awareness
- b risk measurement and assessment
- c risk response and control
- d risk monitoring and reporting

#### 3 Risk and corporate characteristics

- a risk appetite and policy
- b risk culture and corporate values
- c risk management and the implications for organisational structure

#### 4 Managing financial risk

- a the nature of financial risk
- b the main forms of financial risk (foreign exchange risk, interest rate risk, gearing risk etc)
- c the main techniques to manage financial risk (portfolio analysis, scenario analysis, stress testing, swaps, futures contracts, options etc)

#### 5 Managing operational risk

- a the nature of operational risk
- b the main forms of operational risk (process risk, people risk, systems risk, event risk, business risk)
- c risk management processes (risk policies, risk identification and assessment, risk mitigation and control)
- d the nature and scope of corporate governance
- e concepts and theories of corporate governance
- f models of corporate governance (including international comparisons)

#### 6 The framework of corporate governance regulations

(the corporate governance element comprises 30% of the syllabus)

- a the role and nature of the regulatory framework
- b voluntary codes
- c financial reporting requirements
- d auditing and statutory requirements
- e issues relating to the regulatory framework

**7 The board of directors**

- a the role and composition of the board of directors
- b theories of boards
- c appraising the performance of the board of directors
- d the role of non-executive directors
- e nomination, appointment and remuneration issues
- f the nature and role of board committees
- g issues relating to the role, responsibilities and functioning of the board

**8 Corporate citizenship**

- a the nature of corporate social responsibility
- b social and environmental issues in corporate governance
- c ethical concepts and issues in corporate governance

**9 Dividend policy**

(the financial management element covers 20% of the syllabus)

- a dividend policy and shareholder wealth (MM v traditional school)
- b the importance of dividends in practice
- c factors determining the level of dividends
- d dividend policy and management attitudes
- e alternatives to cash dividends

**10 Cost of capital and capital structure**

- a cost of different elements of capital (inc. a basic understanding of CAPM)
- b weighted average cost of capital and NPV analysis
- c gearing and the evaluation of capital structure decisions
- d factors affecting the level of gearing
- e the capital structure debate

**KEY AREAS OF THE SYLLABUS**

- Risk planning and the processes for managing risks, including financial and operational risk
- Key factors and characteristics driving an organisation's attitude towards, and propensity for, accepting risk
- The framework for corporate governance including the role and nature of regulatory and voluntary codes, including corporate governance processes and constitution
- The nature of corporate citizenship and corporate social responsibility

- Dividend policy and the impact of the cost of capital and capital structure on corporate value

**RELEVANT TEXTS**

A Buckley **Multinational finance** FT Prentice-Hall

G Arnold **Corporate Financial Management** FT Pitman

RA Brealey, SC Myers, AJ Marcus **Fundamentals of Corporate Finance** McGraw Hill

J. Davidson Frame **Managing Risk in Organisations** Jossey Bass

J. Lam **Enterprise Risk Management** Wiley

RAG Monks, N Minow **International Corporate Governance**

J Charkam **Keeping Good Company** OUP

RI Tricker **Corporate Governance** Dartmouth

**Websites**

[www.oecd.org/maintopic](http://www.oecd.org/maintopic)

[www.iaa.org.uk/knowledgecentre](http://www.iaa.org.uk/knowledgecentre)

[www.corpgov.net](http://www.corpgov.net)

[www.encycogov.com](http://www.encycogov.com)

**STUDY GUIDE****1–2 Managing risks**

- Explain the nature of risk and discuss the ways in which the key risks affecting a business may be identified
- Describe the attitudes to risk that may exist and discuss the relationship between risk and expected returns
- Discuss the main benefits to be derived from implementing risk management processes
- Identify and explain key risk concepts (including exposure, volatility, severity and probability) and discuss the tools and techniques that may be used to assess the impact of risks on the business
- Identify the main responses to risk (including risk avoidance, risk retention, risk reduction and risk transfer) and discuss the factors that determine the choice of an appropriate response
- Explain the relationship between risk management policies and the risk appetite and values of the business

### **3–4 Risk management processes**

- Identify and discuss the main elements of a risk management process (including risk identification and awareness, risk management and assessment, risk response and control, and risk monitoring and reporting)
- Describe the factors that need to be taken into account in order to successfully implement risk management processes
- Outline a framework for risk management (eg the COSO ERP framework)
- Discuss the possible implications for the organisational structure of business that is seeking to implement risk management policies and frameworks
- Discuss ways in which the 'ownership' of risk management may be spread and describe the responsibilities of key individuals and groups (including the board of directors, the audit committee, the risk management group, the chief risk officer and line managers) in managing risks

### **5–6 Managing operating risk**

- Distinguish between operating risk and financial risk and identify the main forms of risk falling within each category
- Discuss the main forms of operating risk (process risk, people risk, systems risk, event risk and business risk)
- Provide examples of each form of operating risk and develop action plans for dealing with them
- Explain the importance of reviewing operational risk management procedures

### **7–8 Assessing and managing financial risk**

- Demonstrate an understanding of key methods of assessing and managing financial risk including:
  - sensitivity analysis
  - scenario analysis
  - simulation
  - expected value and the use of probabilities
  - expected value/variance criterion
  - basic portfolio analysis (using a two-asset portfolio) and make appropriate calculations
- Discuss Value at Risk and stress testing as methods of assessing financial risk

### **9–12 Financial risk and international trading**

- Discuss the problems associated with foreign exchange transactions
- Explain the main elements of exchange rate risk (transaction risk, economic risk and translation risk)
- Discuss the main methods of dealing with transaction risk (including doing nothing, netting, trading in the home currency, using foreign bank accounts, forward contracts, money market hedges, and currency options and futures)
- Undertake simple calculations to show how hedging methods deal with transaction risk
- Discuss the main methods of dealing with translation risk
- Discuss the main methods of dealing with economic risk (including currency swaps)

### **13 Financial risk and interest rate risk management**

- Explain the problem of interest rate risk
- Demonstrate an understanding of the main methods of dealing with interest rate risk including forwards rate agreements, interest rate guarantees, options and swaps
- Undertake simple calculations to show how hedging methods can deal with interest rate risk

### **14–16 Cost of capital**

- Define the concept of the cost of capital and explain its importance in decision making
- Discuss the differences in the cost of debt and equity and the methods used to determine the cost of each element of capital (including a basic discussion of CAPM)
- Calculate the cost of each element of capital and the weighted average cost of capital (WACC)
- Discuss the practical problems associated with establishing the cost of each element of capital and describe the assumptions underpinning the use of WACC as an appropriate discount rate in investment appraisal
- Explain the concept of gearing and demonstrate how gearing may be used to evaluate capital structure decisions
- Discuss the factors that may influence the level of gearing in practice
- Describe the traditional and MM (including an adjustment for taxes) views on capital structure and outline the assumptions underlying these views

- Explain the relationship between capital structure and business value

### **17–18 Dividend policy**

- Explain the relationship between dividend policy and shareholder wealth (including a discussion of the MM v traditional school debate)
- Discuss the notion of cash dividends as a residual
- Identify and discuss the factors determining the level of cash dividends
- Explain the importance of cash dividends in practice (clientele effect, signalling and agency problems)
- Discuss the main alternatives to cash dividends (scrip dividends and share repurchase)
- Discuss management attitudes towards dividend policy (including a discussion of the Lintner study)

### **19–20 The nature of corporate governance**

- Discuss the nature, role and scope of corporate governance
- Identify and discuss the main factors that have led to the development of corporate governance procedures
- Explain the main theoretical approaches to corporate governance (agency, stewardship and stakeholder theories)
- Explain the relationship between corporate governance and risk management
- Discuss alternative models of corporate governance (including a brief outline of governance procedures in the US, Japan, France and Germany)

### **21–22 The framework of corporate governance regulations**

- Discuss the role and nature of the Combined Code and briefly review its genesis
- Describe the main elements of the Combined Code
- Evaluate the arguments for and against the use of voluntary codes rather than statutory codes of corporate governance
- Demonstrate an understanding of the role of internal control and internal audit in effective corporate governance
- Demonstrate an understanding of the role of external audit in effective corporate governance and discuss the relationship between the internal and external auditors
- Discuss the ways in which corporate governance matters are reported to shareholders and other stakeholders

- Identify and discuss key issues relating to the corporate governance framework and to the role of external auditors

### **23–25 The functioning of the board of directors**

- Explain the roles (including the strategic, control and institutional roles) and legal responsibilities of the board of directors
- Describe the composition of the board of directors and explain the role of the chairman in the effective functioning of the board
- Explain the roles and responsibilities of executive and non-executive directors
- Discuss key issues relating to the effectiveness of non-executive directors and to their relations with executive directors
- Discuss key issues relating to the nomination, appointment and remuneration of directors
- Discuss the role and responsibilities of key board committees (including the audit, nominations and remuneration committees)
- Explain the relationship of the board with shareholders and with managers and discuss the problems and issues that may arise in managing these relationships

### **26 Appraising and rewarding the board of directors**

- Evaluate methods that may be used to appraise the performance of the board of directors and of individual directors (including the use of financial measures based on accounting profit, economic profit and market values)
- Evaluate the main methods of remunerating and rewarding directors (including stock options and bonus schemes)

### **27 Corporate citizenship**

- Explain the concept of the corporate citizenship and the different perspectives of the role of the corporation in society
- Describe and discuss the ways in which social and environmental factors may affect corporate governance decisions
- Explain the role of ethics in corporate governance and key ethical issues that the board of directors might face

### **28 Revision**