CIMA

Subject F2

Advanced Financial Reporting

Study Text

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Introduction

This document references IFRS® Standards and IAS® Standards, which are authored by the International Accounting Standards Board (the Board), and published in the 2016 IFRS Standards Red Book.

How to use the Materials

These official CIMA learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your objective tests.

The product range contains a number of features to help you in the study process. They include:

- a detailed explanation of all syllabus areas
- extensive 'practical' materials
- generous question practice, together with full solutions.

This Study Text has been designed with the needs of home study and distance learning candidates in mind. Such students require very full coverage of the syllabus topics, and also the facility to undertake extensive question practice. However, the Study Text is also ideal for fully taught courses.

The main body of the text is divided into a number of chapters, each of which is organised on the following pattern:

- **Detailed learning outcomes.** These describe the knowledge expected after your studies of the chapter are complete. You should assimilate these before beginning detailed work on the chapter, so that you can appreciate where your studies are leading.
- **Step-by-step topic coverage.** This is the heart of each chapter, containing detailed explanatory text supported where appropriate by worked examples and exercises. You should work carefully through this section, ensuring that you understand the material being explained and can tackle the examples and exercises successfully. Remember that in many cases knowledge is cumulative: if you fail to digest earlier material thoroughly, you may struggle to understand later chapters.
- **Activities.** Some chapters are illustrated by more practical elements, such as comments and questions designed to stimulate discussion.
- **Question practice.** The text contains three styles of question:
  - Exam-style objective test questions (OTQs).
  - 'Integration' questions – these test your ability to understand topics within a wider context. This is particularly important with calculations where OTQs may focus on just one element but an integration question tackles the full calculation, just as you would be expected to do in the workplace.

– ‘Case’ style questions – these test your ability to analyse and discuss issues in greater depth, particularly focusing on scenarios that are less clear cut than in the objective tests, and thus provide excellent practice for developing the skills needed for success in the Management Level Case Study Examination.

- **Solutions.** Avoid the temptation merely to ‘audit’ the solutions provided. It is an illusion to think that this provides the same benefits as you would gain from a serious attempt of your own. However, if you are struggling to get started on a question you should read the introductory guidance provided at the beginning of the solution, where provided, and then make your own attempt before referring back to the full solution.

If you work conscientiously through this Official CIMA Study Text according to the guidelines above you will be giving yourself an excellent chance of success in your objective tests. Good luck with your studies!

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details, or follow the link to the feedback form in MyKaplan.

Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Icon explanations

Definition – These sections explain important areas of knowledge which must be understood and reproduced in an assessment environment.

Key point – Identifies topics which are key to success and are often examined.

Supplementary reading – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an assessment question. **Reference to this text is vital when self-studying.**

Test your understanding – Following key points and definitions are exercises which give the opportunity to assess the understanding of these core areas.

Illustration – To help develop an understanding of particular topics. The illustrative examples are useful in preparing for the Test your understanding exercises.

Exclamation mark – This symbol signifies a topic which can be more difficult to understand. When reviewing these areas, care should be taken.

New – Identifies topics that are brand new in subjects that build on, and therefore also contain, learning covered in earlier subjects.

Tutorial note – Included to explain some of the technical points in more detail.

Study technique

Passing exams is partly a matter of intellectual ability, but however accomplished you are in that respect you can improve your chances significantly by the use of appropriate study and revision techniques. In this section we briefly outline some tips for effective study during the earlier stages of your approach to the objective tests. We also mention some techniques that you will find useful at the revision stage.

Planning

To begin with, formal planning is essential to get the best return from the time you spend studying. Estimate how much time in total you are going to need for each subject you are studying. Remember that you need to allow time for revision as well as for initial study of the material.

With your study material before you, decide which chapters you are going to study in each week, and which weeks you will devote to revision and final question practice.

Prepare a written schedule summarising the above and stick to it!

It is essential to know your syllabus. As your studies progress you will become more familiar with how long it takes to cover topics in sufficient depth. Your timetable may need to be adapted to allocate enough time for the whole syllabus.

Students are advised to refer to the examination blueprints (see page P.13 for further information) and the CIMA website, www.cimaglobal.com, to ensure they are up-to-date.

The amount of space allocated to a topic in the Study Text is not a very good guide as to how long it will take you. The syllabus weighting is the better guide as to how long you should spend on a syllabus topic.

Tips for effective studying

(1) Aim to find a quiet and undisturbed location for your study, and plan as far as possible to use the same period of time each day. Getting into a routine helps to avoid wasting time. Make sure that you have all the materials you need before you begin so as to minimise interruptions.

(2) Store all your materials in one place, so that you do not waste time searching for items every time you want to begin studying. If you have to pack everything away after each study period, keep your study materials in a box, or even a suitcase, which will not be disturbed until the next time.

(3) Limit distractions. To make the most effective use of your study periods you should be able to apply total concentration, so turn off all entertainment equipment, set your phones to message mode, and put up your 'do not disturb' sign.

(4) Your timetable will tell you which topic to study. However, before diving in and becoming engrossed in the finer points, make sure you have an overall picture of all the areas that need to be covered by the end of that session. After an hour, allow yourself a short break and move away from your Study Text. With experience, you will learn to assess the pace you need to work at. Each study session should focus on component learning outcomes – the basis for all questions.

(5) Work carefully through a chapter, making notes as you go. When you have covered a suitable amount of material, vary the pattern by attempting a practice question. When you have finished your attempt, make notes of any mistakes you made, or any areas that you failed to cover or covered more briefly. Be aware that all component learning outcomes will be tested in each examination.

(6) Make notes as you study, and discover the techniques that work best for you. Your notes may be in the form of lists, bullet points, diagrams, summaries, 'mind maps', or the written word, but remember that you will need to refer back to them at a later date, so they must be intelligible. If you are on a taught course, make sure you highlight any issues you would like to follow up with your lecturer.

(7) Organise your notes. Make sure that all your notes, calculations etc. can be effectively filed and easily retrieved later.

Progression

There are two elements of progression that we can measure: how quickly students move through individual topics within a subject; and how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

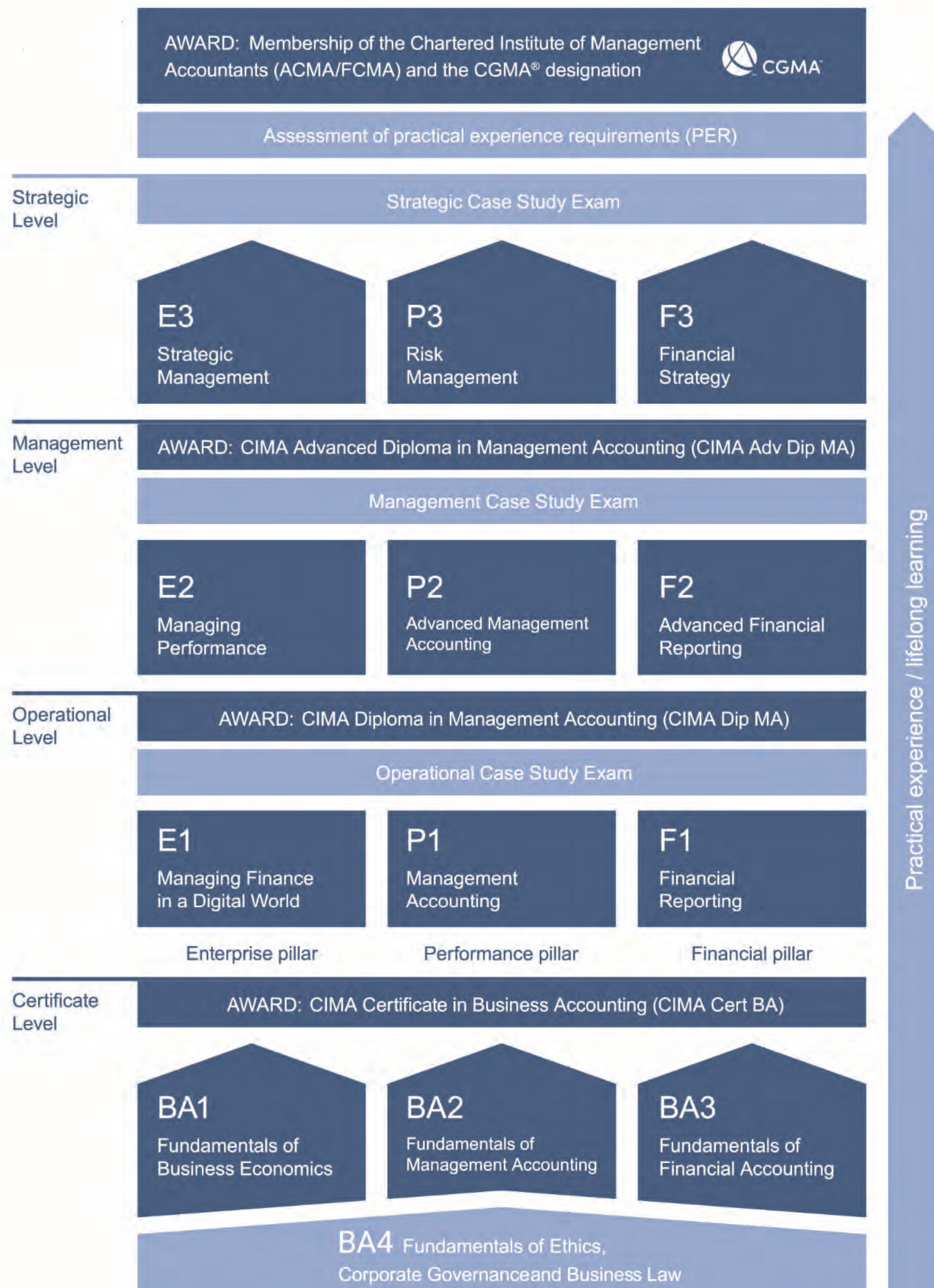
A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. For example, F2 *Advanced financial reporting* builds on your knowledge of financial accounting from F1 *Financial reporting* and BA3 *Fundamentals of financial accounting* and lays the foundations for long term financing and weighted average cost of capital usage within F3 *Financial strategy*.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress. Make sure you carefully review the 2019 CIMA syllabus transition rules and seek appropriate advice if you are unsure about your progression through the qualification.



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Objective test

Objective test questions require you to choose or provide a response to a question whose correct answer is predetermined.

The most common types of objective test question you will see are:

- Multiple choice, where you have to choose the correct answer(s) from a list of possible answers. This could either be numbers or text.
- Multiple choice with more choices and answers, for example, choosing two correct answers from a list of eight possible answers. This could either be numbers or text.
- Single numeric entry, where you give your numeric answer, for example, profit is $10,000.
- Multiple entry, where you give several numeric answers.
- True/false questions, where you state whether a statement is true or false.
- Matching pairs of text, for example, matching a technical term with the correct definition.
- Other types could be matching text with graphs and labelling graphs/diagrams.

In every chapter of this Study Text we have introduced these types of questions, but obviously we have had to label answers A, B, C etc. rather than using click boxes. For convenience, we have retained quite a few questions where an initial scenario leads to a number of sub-questions. There will be no questions of this type in the objective tests.

Guidance re CIMA on-screen calculator

As part of the CIMA objective test software, candidates are now provided with a calculator. This calculator is on-screen and is available for the duration of the assessment. The calculator is available in each of the objective tests and is accessed by clicking the calculator button in the top left hand corner of the screen at any time during the assessment. Candidates are permitted to utilise personal calculators as long as they are an approved CIMA model. Authorised CIMA models are listed here: https://www.cimaglobal.com/Studying/study-and-resources/.

All candidates must complete a 15-minute exam tutorial before the assessment begins and will have the opportunity to familiarise themselves with the calculator and practise using it. The exam tutorial is also available online via the CIMA website.

Candidates may practise using the calculator by accessing the online exam tutorial.

Fundamentals of objective tests

The objective tests are 90-minute assessments comprising 60 compulsory questions, with one or more parts. There will be no choice and all questions should be attempted. All elements of a question must be answered correctly for the question to be marked correctly. All questions are equally weighted.

CIMA syllabus 2019 – Structure of subjects and learning outcomes

Details regarding the content of the new CIMA syllabus can be located within the CIMA 2019 professional syllabus document.

Each subject within the syllabus is divided into a number of broad syllabus topics. The topics contain one or more lead learning outcomes, related component learning outcomes and indicative knowledge content.

A learning outcome has two main purposes:

(a) To define the skill or ability that a well prepared candidate should be able to exhibit in the examination.

(b) To demonstrate the approach likely to be taken in examination questions.

The learning outcomes are part of a hierarchy of learning objectives. The verbs used at the beginning of each learning outcome relate to a specific learning objective, e.g.

Calculate the break-even point, profit target, margin of safety and profit/volume ratio for a single product or service.

The verb '**calculate**' indicates a level three learning objective. The following tables list the verbs that appear in the syllabus learning outcomes and examination questions.

The examination blueprints and representative task statements

CIMA have also published examination blueprints giving learners clear expectations regarding what is expected of them.

The blueprint is structured as follows:

- Exam content sections (reflecting the syllabus document)
- Lead and component outcomes (reflecting the syllabus document)
- Representative task statements.

A representative task statement is a plain English description of what a CIMA finance professional should know and be able to do.

The content and skill level determine the language and verbs used in the representative task.

CIMA will test up to the level of the task statement in the objective tests (an objective test question on a particular topic could be set at a lower level than the task statement in the blueprint).

The format of the objective test blueprints follows that of the published syllabus for the 2019 CIMA Professional Qualification.

Weightings for content sections are also included in the individual subject blueprints.

CIMA VERB HIERARCHY

CIMA place great importance on the definition of verbs in structuring objective tests. It is therefore crucial that you understand the verbs in order to appreciate the depth and breadth of a topic and the level of skill required. The objective tests will focus on levels one, two and three of the CIMA hierarchy of verbs. However, they will also test levels four and five, especially at the management and strategic levels.

Skill level	Verbs used	Definition
Level 5 Evaluation How you are expected to use your learning to evaluate, make decisions or recommendations	Advise	Counsel, inform or notify
	Assess	Evaluate or estimate the nature, ability or quality of
	Evaluate	Appraise or assess the value of
	Recommend	Propose a course of action
	Review	Assess and evaluate in order, to change if necessary
Level 4 Analysis How you are expected to analyse the detail of what you have learned	Align	Arrange in an orderly way
	Analyse	Examine in detail the structure of
	Communicate	Share or exchange information
	Compare and contrast	Show the similarities and/or differences between
	Develop	Grow and expand a concept
	Discuss	Examine in detail by argument
	Examine	Inspect thoroughly
	Interpret	Translate into intelligible or familiar terms
	Monitor	Observe and check the progress of
	Prioritise	Place in order of priority or sequence for action
	Produce	Create or bring into existence
Level 3 Application How you are expected to apply your knowledge	Apply	Put to practical use
	Calculate	Ascertain or reckon mathematically
	Conduct	Organise and carry out
	Demonstrate	Prove with certainty or exhibit by practical means
	Prepare	Make or get ready for use
	Reconcile	Make or prove consistent/compatible

Skill level	Verbs used	Definition
Level 2 Comprehension What you are expected to understand	Describe	Communicate the key features of
	Distinguish	Highlight the differences between
	Explain	Make clear or intelligible/state the meaning or purpose of
	Identify	Recognise, establish or select after consideration
	Illustrate	Use an example to describe or explain something
Level 1 Knowledge What you are expected to know	List	Make a list of
	State	Express, fully or clearly, the details/facts of
	Define	Give the exact meaning of
	Outline	Give a summary of

Information concerning formulae and tables will be provided via the CIMA website, www.cimaglobal.com.

SYLLABUS GRIDS

F2: Advanced Financial Reporting

Analysing and communicating insights about the performance of the organisation

Content weighting

Content area		Weighting
A	Financing capital projects	15%
B	Financial reporting standards	25%
C	Group accounts	25%
D	Integrated reporting	10%
E	Analysing financial statements	25%
		100%

F2A: Financing capital projects

For selected strategic (capital investment) projects to be implemented, funds must be sourced at the right cost and at the right time. This is a key role of the finance function and shows how it enables the organisation to create value. This section looks at the sources and types of funds and how much they cost.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Compare and contrast types and sources of long-term funds.	Compare and contrast: a. Long-term debt b. Equity finance c. Markets for long-term funds	• Characteristics of different types of shares and long-term debts • Ordinary and preference shares • Bonds and other types of long-term debt • Operations of stock and bond markets • Issuance of shares and bonds • Role of advisors	What are the types of funds that can be used to finance medium to long-term projects? What are their unique and shared profiles and under what conditions are they suitable for organisations seeking long-term funds? What is the impact of these funds on the risk profile of organisations? Where can these funds be sourced? What are the criteria that organisations must fulfil to access funds from these sources?
2. Calculate cost of long-term funds.	Calculate: a. Cost of equity b. Cost of debt c. Weighted average cost of capital	• Cost of equity using dividend valuation model (with or without growth in dividends) • Post-tax cost of bank borrowing • Yield to maturity of bonds and post-tax cost of bonds • Post-tax costs of convertible bonds up to and including conversion	What is the cost of each type of funds? What is the cost of the total funds used by the organisation to fund its projects? How can the organisation minimise the cost of funds whilst ensuring the availability of adequate funds at the right time and at the same time maintaining an appropriate risk profile?

F2B: Financial reporting standards

The finance function is responsible for narrating how organisations create and preserve value. Different types of narratives are used for different audiences. Financial reporting is used for external stakeholders. This section examines the building blocks for constructing the narratives in the financial statements. It covers the key financial reporting standards on which the financial statements will be based.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Explain relevant financial reporting standards for revenue, leases, financial instruments, intangible assets and provisions.	Explain the financial reporting standards for: a. Revenue b. Leases c. Provisions d. Financial instruments e. Intangible assets f. Income taxes g. Effect of changes in foreign currency rates	• IFRS 15 – Revenue from Contracts with Customers • IFRS 16 – Leases • IAS 37 – Provisions, Contingent Liabilities and Contingent Assets • IFRS 9 – Financial Instruments • IAS 32 – Financial Instruments: Presentation • IAS 38 – Intangible Assets • IAS 12 – Income Taxes • IAS 21 – Effect of Changes in on Foreign Exchange Rates	How should important elements of the financial statement be treated in the books? What principles should underpin these? How do financial reporting standards help to ensure this? Using financial reporting standards terminology this part will be looking at issues in recognition and measurement. The most important issues will be considered here.
2. Explain relevant financial reporting standards for group accounts.	a. Explain the financial reporting standards for the key areas of group accounts	• IAS 1 – Presentation of Financial Statements • IAS 27 – Separate Financial Statements • IAS 28 – Investment in Associates and Joint Ventures • IFRS 3 – Business Combinations I• FRS 5 – Non-current Assets Held for Sale or Discontinued Operations • IFRS 10 – Consolidated Financial Statements • IFRS 11 – Joint Arrangements	What are the key principles that should govern the preparation of group accounts? How are they reflected in financial reporting standards? The approach should focus on the aspects of group accounts that are essential for discussions with the rest of the business. Therefore, the emphasis should be on awareness creation and basic understanding of the technical elements.

F2C: Group accounts

Organisations sometimes acquire or merge with other organisations to improve their strategic performance, position and prospects. The performance and position of combined operations are reported through group accounts. This section covers the application of the relevant financial reporting standards to prepare group accounts. The topics covered are those that are essential to conducting conversations with different parts of the business about the performance of the group and its component parts.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Prepare group accounts based on IFRS.	Prepare the following based on financial reporting standards: a. Consolidated statement of financial position b. Consolidated statement of comprehensive income c. Consolidated statement of changes in equity d. Consolidated statement of cash flows	• IAS 1 – Presentation of Financial Statements • IAS 27 – Separate Financial Statements • IAS 28 – Investment in Associates and Joint Ventures • IFRS 3 – Business Combinations • IFRS 5 – Non-current Assets Held for Sale or Discontinued Operations • IFRS 10 – Consolidated Financial Statements • IFRS 11 – Joint Arrangements	This is about the preparation of basic group accounts applying the financial reporting standards learned in the previous section. Basic understanding of the technical issues is required. Thus, it should cover the rules of consolidation, goodwill, foreign subsidiaries, minority interests and associated companies. These should be placed in the context of the organisation's strategy as executed through mergers and acquisitions and the setting up of subsidiaries. In addition, it can be linked to the performance management of responsibility centres.
2. Discuss additional disclosure issues related to the group accounts.	Discuss disclosure requirements related to: a. Transaction between related parties b. Earnings per share	• IAS 24 – Related Party Disclosures • IAS 33 – Earnings Per Share	What other issues should be disclosed outside the financial statements? Why? Again, the focus is on building awareness and basic understanding of the technical issues in order to equip finance professionals to conduct meaningful discussions with the rest of the organisation about the performance, position and potential of the organisation.

F2D: Integrated reporting

In a multi-stakeholder world, there has been a call for broader forms of reporting to cover wider audiences and issues of concern to them. The International Integrated Reporting Framework developed by the International Integrated Reporting Council (IIRC) is one of the most influential frameworks that seeks to fulfil this role. This section introduces candidates to the Framework and its components.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Discuss the International <IR> Framework activities.	a. Describe the role of the International Integrated Reporting Council. b. Explain integrated thinking. c. Discuss the International <IR> Framework.	• Context of integrated reporting • International Integrated Reporting Council • Integrated thinking • International <IR> Framework • Benefits and limitations of the Framework	This section looks at the International <IR> Framework as a means of addressing the need for wider forms of reporting in a multi-stakeholder world. It introduces the role of the IIRC and uses the concept of integrated thinking as the foundational concept of the International <IR> Framework. It also discusses the Framework, its benefits and limitations.
2. Explain the Six Capitals of Integrated Reporting.	Explain the measurement and disclosure issues of: a. Financial capital b. Manufactured capital c. Intellectual capital d. Human capital e. Social and relationship capital f. Natural capital	• Definition of the six capitals • Measurement and disclosure issues relating to the six capitals	The six capitals are a key part of the International <IR> Framework. This section defines the six capitals and explains the measurement and disclosure issues relating to them.

F2E: Analysing financial statements

The analyses of financial statements enable organisations to explain their performance and to compare their performance and prospects over time and against others. It can show how vulnerable they and their business models are to disruption. This section shows how these analyses are conducted and their limitations.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Analyse financial statements of organisations.	Analyse financial statements to provide insight on: a. Performance b. Position c. Adaptability d. Prospects	• Ratio analysis • Interpretation of ratios • Reporting of ratios along the dimensions of the Gartner Data Analytics maturity model – descriptive, diagnostic, predictive and prescriptive • Link to organisation's business model	The financial statements narrate how organisations create and preserve value using financial numbers. Analyses of financial statements allows finance professionals to go beyond the numbers and put the narrative into everyday business language to facilitate discussions and collaboration with the rest of the organisation. The analysis could be based on the Gartner Data Analytics model which presents information as descriptive, diagnostic, predictive and prescriptive. Thus, it will cover hindsight, insight and foresight into the organisation's performance, position, resilience (or adaptability) and prospects. The analyses can be linked to the organisation's business model.
2. Recommend actions based on insights from the interpretation of financial statements.	a. Recommend actions	• Linkages between different areas of performance • Predictive and prescriptive ratios • Impact of recommendations on wider organisational ecosystem	Draw logical conclusions from the analysis. The focus is mainly predictive and prescriptive areas of data analytics. The recommendations should also be organisation wide and must encompass the ecosystem. A link with the business model framework in E2 is essential.
3. Discuss the limitations of the tools used for interpreting financial statements.	Discuss: a. Data limitations b. Limitations of ratio analysis	• Quality and type of data used • Comparability – both in segment and internationally	What are the limitations of the data and techniques used in the analyses of financial statements? How do they affect the recommendations? How could they be overcome?

Chapter

1

Long term finance

Chapter learning objectives

Lead	Component
A1: Compare and contrast types and sources of long term funds	Compare and contrast: (a) Long-term debt (b) Equity finance (c) Markets for long-term funds

1 Session content

2 Introduction

Syllabus area F2A 'Financing capital projects' is covered in the first two chapters of this text. Financing capital projects makes up 15% of the syllabus. It consists of two main areas – sources of long term finance (Chapter 1) and the cost of long-term funds (Chapter 2).

Sources of long term finance

If a company has a large cash surplus, it may be able to afford to undertake new investment projects without having to resort to external sources of finance.

However, if external funds are required, the company might raise finance from the following sources:

1 The capital markets:

   – new share issues, for example by companies acquiring a stock market listing for the first time

   – rights issues

   – issues of marketable debt.

   A company must be quoted/listed on a recognised stock exchange in order to be able to raise finance from the capital markets.

2 Bank borrowings – long-term loans or short-term loans, including bank facilities such as revolving credit facilities (RCFs) and money market lines.

3 Government and similar sources.

In general, finance can be raised from Equity or Debt sources.

3 Equity finance

Equity is another name for shares or ownership rights in a business.

Important terminology

Share – a fixed identifiable unit of capital in an entity which normally has a fixed nominal value, which may be quite different from its market value.

Shareholders receive returns from their investment in shares in the form of dividends, and also capital growth in the share price.

Ordinary shares

Ordinary shares (sometimes also referred to as 'equity shares') pay dividends at the discretion of the entity's directors. The ordinary shareholders of a company are the owners of the company and they have the right to attend meetings and vote on any important matters.

On a winding-up of a company, the ordinary shareholders are subordinate to all other finance providers (i.e. they receive their money last, if there is any left after all other finance providers have been paid).

Preference shares

Preference shares are shares that pay a fixed dividend, which is paid in preference to (before) ordinary share dividends, hence the name.

Also, on a winding-up of a company, the preference shareholders are subordinate to all the debt holders and creditors, but receive their payout before ordinary shareholders.

More details on preference shares

Comparison of preference shares with debt and with ordinary shares

Preference shares pay a fixed proportion of the share's nominal value each year as a dividend. This is why they are often considered to behave in a way which is more similar to debt finance (fixed annual returns) rather than ordinary shares (variable dividend at the discretion of the directors).

However, unlike interest on debt finance, preference share dividends are paid out of post-tax profits, so there is no tax benefit to a company of paying preference share dividends.

Also, there are certain circumstances (e.g. where a company has insufficient distributable profits) when the company will be given permission to not pay its preference share dividends in a year. This is not the case with debt interest, which is an obligation every year, whether or not the company can afford to make the payment.

The lack of tax relief on dividends mentioned above explains why preference shares are relatively unattractive to companies compared with bank borrowings and other forms of fixed rate security such as bonds.

However, they do have some appeal to risk-averse investors looking for a relatively reliable income stream.

Different types of preference shares

There are four types of preference shares:

- cumulative preference shares, for which dividends must be rolled forward if the company is unable to pay the dividend i.e. if a dividend is not paid in year 1, that dividend has to be paid in year 2 along with the 'normal' dividend for year 2
- non-cumulative preference shares, for which missed dividends do not have to be paid later. There is no roll forward of dividends
- participating preference shares, which give the holder fixed dividends plus extra earnings based on certain conditions (in a similar way to ordinary shares)
- convertible preference shares, which can be exchanged for a specified number of ordinary shares on some given future date.

Also, note that some preference shares are redeemable, meaning that holders will be repaid their capital (usually at par) a pre-determined future date.

Example of convertible preference shares

Convertible preference shares are fixed-income securities that the investor can choose to turn into a certain number of ordinary shares after a predetermined time span or on a specific date.

The fixed-income component offers a steady income stream and some protection of the investor's capital. However, the option to convert these securities into ordinary shares gives the investor the opportunity to gain from a rise in the share price.

Convertibles are particularly attractive to those investors who want to participate in the rise of hot growth companies while being insulated from a drop in price should the ordinary share price growth not live up to expectations.

If a company were to issue some 5% $10 nominal value preference shares, convertible to ordinary shares in five years' time, the investor would receive a fixed amount of $0.50 each year for the first five years.

In five years' time though, the investor would have the choice to keep the preference shares or convert to a number of ordinary shares. The conversion ratio would have been set when the preference shares were first issued. For example it could be 3, i.e. each preference share could be converted into 3 ordinary shares.

In this example, the investor would be keen to convert if the ordinary shares on the conversion date were worth more than $3.33 ($10/3).

For example, if the ordinary share price growth has been impressive and the shares are actually worth $4.50 each on the conversion date, the investor could trade a single preference share (value $10) for 3 ordinary shares worth $13.50 in total.

The shares in a listed, or quoted, company will be traded on a capital market.

Capital markets

Capital markets (or stock markets) must fulfil both primary and secondary functions.

Primary function:

The primary function of a stock market is to enable companies to raise new finance (either equity or debt). Through the stock market, a company can communicate with a large pool of potential investors, so it is much easier for a company to raise finance in this way, rather than contacting investors individually.

Note that in the UK, a company must be a plc before it is allowed to raise finance from the public on the stock market.

Secondary function:

The secondary function of a stock market is to enable investors to sell their investments to other investors. A listed company's shares are therefore more marketable than an unlisted company's, which means that they tend to be more attractive to investors.

Listed v private companies

Private vs public companies

A limited company may be 'private' or 'public'. A private limited company's disclosure requirements are lighter, but for this reason its shares may not be offered to the general public (and therefore cannot be traded on a public stock exchange). This is the major distinguishing feature between a private limited company and a public limited company. Most companies, particularly small companies, are private.

Private limited company (Ltd in UK terminology)

A private company limited by shares, usually called a private limited company, has shareholders with limited liability and its shares may not be offered to the general public, unlike those of a public limited company (see details below).

'Limited by shares' means that the company has shareholders, and that the liability of the shareholders to creditors of the company is limited to the capital originally invested, i.e. the nominal value of the shares and any premium paid in return for the issue of the shares by the company. A shareholder's personal assets are thereby protected in the event of the company's insolvency, but money invested in the company will be lost.

The company will have "Ltd" after its name to indicate its status as a private company.

Public limited company (plc in UK terminology)

A public limited company is a limited liability company that may sell shares to the public. It can be either an unlisted company, or a listed company on the stock exchange. The company will have "plc" after its name to indicate its status as a public limited company.

A stock exchange listing

When an entity obtains a listing (or quotation) for its shares on a stock exchange this is referred to as a flotation or an Initial Public Offering (IPO).

Advantages of a listing

- Once listed, the market will provide a more accurate valuation of the entity than had been previously possible.
- Creates a mechanism for buying and selling shares in the future at will.

- Raise profile of entity, which may have an impact on revenues, credibility with suppliers and long-term providers of finance.
- Raise capital for future investment.
- Makes employee share schemes more accessible.

Disadvantages of a listing

- Costly for a small entity (flotation, underwriting costs, etc.)
- Making enough shares available to allow a market, and hence loss of at least some control of the original owners.
- Reporting requirements are more onerous.
- Stock exchange rules for obtaining a quotation can be stringent.

UK capital markets

There are two important capital markets in the UK:

- the full Stock Exchange – a market for larger companies. Entry costs are high and scrutiny is very high for companies listed on the 'full list', but the profile of a Stock Exchange listed company's shares is very high, so the shares are extremely marketable
- the Alternative Investment Market (AIM) – a market for smaller companies, with lower associated costs and less stringent entry criteria.

The operation of stock exchanges

Prices of shares on the stock exchange are determined by the forces of supply and demand in the market. For example, if a company performs well, its shares become attractive to investors. This creates demand which drives up the price of the shares.

Conversely, investors who hold shares in an underperforming company will try to sell those shares, creating supply in the market. This drives down the price of the shares.

The role of advisors in a share issue

Investment banks usually take the lead role in share issues and will advise on:

- the appointment of other specialists (e.g. lawyers)
- stock exchange requirements
- forms of any new capital to be made available
- the number of shares to be issued and the issue price
- arrangements for underwriting
- publishing the offer.

Stockbrokers provide advice on the various methods of obtaining a listing. They may work with investment banks on identifying institutional investors, but usually they are involved with smaller issues and placings.

Institutional investors have little direct involvement other than as investors, agreeing to buy a certain number of shares. They may also be used by the entity and its advisors to provide an indication of the likely take up and acceptable offer price for the shares. Once the shares are in issue institutional investors have a major influence on the evaluation and the market for the shares. Pension funds are examples of institutional investors.

Registrars to an issue will provide administrative functions such as collecting and processing applications from potential investors, monitoring payments due and made to and from investors and providing advice and information regarding share issues to stock exchanges, investors and issuing entities.

Public and Investor relations will work with the entity to ensure communications regarding the share issue are transparent, informative and are understandable to those investing. If successful, the work of public and investor relations could improve the uptake of the share issue and increase the market value of the issued shares.

Reporting accountants will provide advice regarding the impact on the financial statements of any potential shares issues. They must consider the wider ramifications upon the economic decisions of the users of the financial statements caused by the potential share issues e.g. implications on loan covenants.

Underwriters are financial institutions that help corporations raising finance by taking on the risk associated with a new issues and attempting to promote the new share issue to 3rd party investors. The underwriters take on the risks associated with the share issues but retain part of the proceeds from raising the finance.

4 Methods of issuing new shares

The three most commonly used methods of issuing new shares are:

- an IPO (initial public offering) or flotation
- a placing
- a rights issue (see section 5).

An IPO is suitable when an entity seeks a listing on a stock market for the first time.

Placings and rights issues are relevant for entities that already list their shares on a stock market and are seeking further financing through a new share issues.

Initial public offering (IPO)

IPOs occur when a company seeks to be listed on a stock market for the first time. These offers may be of completely new shares or they may derive from the transfer to the public of some or all of the shares already held privately.

Shares are offered for sale to investors, through an issuing house. The offer could be made:

- at a fixed price set by the company
- in a tender offer.

For a tender offer, investors are invited to tender for new shares at their own suggested price. All shares being offered are sold at the best price that would generate the required finance.

Further information on tenders and IPO's

Tender offers

A tender offer is an alternative to a fixed price offer. Under a tender offer, subscribers tender for the shares at, or above, a minimum fixed price. Once all offers have been received from prospective investors, the company sets a "strike price" and allocates shares to all bidders who have offered the strike price or more. The strike price is set to make sure that the company raises the required amount of finance from the share issue.

Once the strike price has been set, all bidders who offered the strike price or more are allocated shares, and they all pay the strike price irrespective of what the original bid was.

Example of a tender offer

Bragg Co needs to raise $20m to invest in a new project. The company has asked investors for tender offers and the following offers have been received:

Maximum price offered ($ per share)	No of shares requested at this price (in millions)
2.0	5.0
2.2	4.1
2.4	1.9
2.6	3.2

The strike will be set at the highest possible level that generates the required amount of finance. This is to make sure that the company does not issue more shares than it has to. This ensures that the dilution of the existing shareholders' holding is kept to a minimum. If Bragg Co sets the strike price at $2.60, only 3.2 million shares will be issued, raising $8.32m in total ($2.60 × 3.2m). This is not acceptable since $20m is needed.

If Bragg Co sets the strike price at $2.40, 5.1m shares will be issued (being 1.9m to the people who bid $2.40 and 3.2m to the people who bid $2.60). Therefore the total finance raised will be $2.40 × 5.1m = $12.24m. Again, not sufficient.

If Bragg Co sets the strike price at $2.20, 9.2m shares will be issued (being 4.1m to the people who bid $2.20, 1.9m to the people who bid $2.40 and 3.2m to the people who bid $2.60). Therefore, the total finance raised will be $2.20 × 9.2m = $20.24m. This is now enough to satisfy Bragg Co's financing requirements.

Hence, to ensure that $20m is raised from the tender offer, the strike price would be set at $2.20 and any investor who bid $2.20 or more would be allocated shares at the strike price of $2.20.

Placing

Shares are placed directly with certain investors (normally institutions) on a pre-arranged basis.

In this type of issue the shares are not offered to the public, but the issuing house will arrange for the shares to be issued to its institutional clients. This method is very popular, being cheaper and quicker to arrange than most other methods. However, it does not normally lead to a very active market for the shares after flotation.

5 Rights issues

A rights issue is where new shares are offered for sale to existing shareholders, in proportion to the size of their shareholding.

The right to buy new shares ahead of outside investors is known as the 'pre-emption rights' of shareholders. Note that the purpose of pre-emption rights is to ensure that shareholders have an opportunity to prevent their stake being diluted by new issues. Pre-emption rights are protected by law, and can only be waived with the consent of shareholders.

Rights issues are cheaper to organise than a public share issue.

An issue price must be set which is:

- low enough to secure acceptance of shareholders, but
- not too low, so as to avoid excessive dilution of the earnings per share.

Rights issues – further detail

Definition

A rights issue may be defined as:

- Raising of new capital by giving existing shareholders the right to subscribe to new shares in proportion to their current holdings. These shares are usually issued at a discount to market price.

Explanation

In a rights issue, the entity sets out to raise additional funds from its existing shareholders.

It does this by giving them the opportunity to purchase additional shares. These shares are normally offered at a price lower than the current share price quoted. The entity cannot offer an unlimited supply at this lower price, otherwise the market price would fall to this value. Accordingly the offer they make to the existing shareholders is limited. For example they may offer one new share for every four held.

Selection of an issue price

In theory, there is no upper limit to an issue price but in practice it would never be set higher than the prevailing market price (MPS) of the shares, otherwise shareholders will not be prepared to buy as they could have purchased more shares at the existing market price anyway. Indeed, the issue price is normally set at a discount on MPS. This discount is usually in the region of 20%. In theory, there is no lower limit to an issue price but in practice it can never be lower than the nominal value of the shares. Subject to these practical limitations, any price may be selected within these values. However, as the issue price selected is reduced, the quantity of shares that has to be issued to raise a required sum will be increased.

Selection of an issue quantity

It is normal for the issue price to be selected first and then the quantity of shares to be issued. The effect of the additional shares on earnings per share and dividend cover should be considered (these ratios will be covered later). The selected additional issue quantity will then be related to the existing share quantity for the issue terms to be calculated. The proportion is normally stated in its simplest form, for example, 1 for 4, meaning that shareholders may subscribe to purchase one new share for every four they currently hold.

Market price after issue

- After the announcement of a rights issue there is a tendency for share prices to fall.
- The temporary fall is due to uncertainty about:
  - consequences of the issue
  - future profits
  - future dividends.
- After the actual issue the market price will normally fall again because:
  - there are more shares in issue (adverse affect on earnings per share), and
  - new shares were issued at market price discount.

'Cum rights'

When a rights issue is announced, all existing shareholders have the right to subscribe for new shares, and so there are rights ('cum rights') attached to the shares, and the shares are traded 'cum rights'.

'Ex rights'

On the first day of dealings in the newly issued shares, the rights no longer exist and the old shares are now traded 'ex rights' (without rights attached).

Theoretical prices/values

Theoretical 'ex rights' price is the theoretical price that the class of shares will trade at on the first trading day after issue. It is calculated as follows:

$$\frac{(N \times \text{cum rights price}) + \text{Issue price}}{N + 1}$$

N = number of shares required to be held in order to receive one rights issued share (e.g. 1 for 4 rights issue, N = 4).

Illustration 1 – Rights issue

Lauchlan plc has 2m $1 ordinary shares in issue, with a current market value of $5 per share. It offers a 1 for 4 rights issue at $4 per share.

TERP

The cum rights price = $5

Issue price = $4

N = 4

Therefore, TERP = [(4 × $5) + $4]/5 = $4.80

NB. The calculation of TERP would not be a requirement to an exam question within syllabus area F2A1. It is included here for illustration purposes only. However, it will be revisited in chapter 4 EPS and the calculation could be a question as part of syllabus area F2C2.

Implications of a rights issue

(a) From the viewpoint of the shareholders:

- they have the option of buying shares at preferential price
- they have the option of withdrawing cash by selling their rights
- they are able to maintain their existing relative voting position (by exercising the rights).

(b) From the viewpoint of the company:

- it is simple and cheap to implement
- it is usually successful ('fully subscribed')
- it often provides favourable publicity.

6 Debt finance

This is the loan of funds to a business without conferring ownership rights. The key features of debt financing arising from this 'arm's length relationship' are:

- Interest is paid out of pre-tax profits as an expense of the business.
- It carries a risk of default if interest and principal payments are not met.

Security – charges

The lender of funds will normally require some form of security against which the funds are advanced. This means that, in the event of default, the lender will be able to take assets in exchange of the amounts owing. There are two types of 'charge' or security that may be offered/required:

1. **Fixed charge** – The debt is secured against a specific asset, normally land or buildings. This form of security is preferred because, in the event of liquidation, it puts the lender at the 'front of the queue' of creditors.
2. **Floating charge** – The debt is secured against underlying assets that are subject to changes in quantity or value e.g. inventory. The floating charge can cover any other assets that are not already subject to fixed charges. This form of security is not as strong; again it confers a measure of security on liquidation as a 'preferred creditor', meaning the lender is higher in the list of creditors than otherwise.

Covenants

A further means of limiting the risk to the lender is to restrict the actions of the directors through the means of covenants. These are specific requirements or limitations laid down as a condition of taking on debt financing. They may include:

1. **Dividend restrictions** – Limitations on the level of dividends a company is permitted to pay. This is designed to prevent excessive dividend payments which may seriously weaken the company's future cash flows and thereby place the lender at greater risk.
2. **Financial ratios** – Specified levels below which certain ratios may not fall, e.g. debt to net assets ratio, current ratio.
3. **Financial reports** – Regular accounts and financial reports to be provided to the lender to monitor progress.
4. **Issue of further debt** – The amount and type of debt that can be issued may be restricted. Subordinated debt (i.e. debt ranking below the existing unsecured debt) can usually still be issued.

Examples of long term debt finance – terminology

Bank finance

Money market borrowings

The money market consists of financial institutions and dealers in money or credit who wish to either borrow or lend.

The money market is used by participants as a means for borrowing and lending in the short term, from several days to just under a year. This contrasts with the capital market for longer-term funding, for example bonds and equity.

The core of the money market consists of interbank lending – banks borrowing from, and lending to, each other. However, large profit-making entities will also borrow and lend on the money market.

Revolving credit facilities (RCFs)

Under a RCF the borrower may use or withdraw funds up to a pre-approved credit limit. The amount of available credit decreases and increases as funds are borrowed and then repaid.

The borrower makes payments based only on the amount they've actually used or withdrawn, plus interest and the borrower may repay the borrowing over time or in full at any time.

RCFs are very flexible debt financing options, and they enable a company to minimise interest payments because the amount of funds borrowed fluctuates over time and is never more than the company needs.

Often the RCF will be offered by a single bank, or in the case of a large amount of finance required, a syndicate (group) of banks may offer the RCF to reduce the risk to any one lender.

Capital markets

Bonds

A bond is a debt security, in which the issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay interest (the coupon) and/or to repay the principal at a later date. i.e. a bond is a formal contract to repay borrowed money with interest at fixed intervals.

Thus a bond is like a loan: the issuer is the borrower (debtor), the holder is the lender (creditor) and more commonly referred to as the investor, and the coupon is the interest. Bonds provide the borrower with external funds to satisfy long-term funding requirements.

Bonds and shares are both securities which can be traded in the capital markets, but the major difference between the two is that shareholders have an equity stake in the company (i.e. they are owners), whereas bondholders have a creditor stake in the company (i.e. they are lenders). Another difference is that bonds usually have a defined term, or maturity, after which the bond is redeemed, whereas shares may be outstanding indefinitely.

Capital markets – further detail

Issuing debt finance (bonds) in the capital markets enables an entity to borrow a large amount of finance from (potentially) a wide range of potential investors.

The bond market can essentially be broken down into three main groups: issuers, underwriters and purchasers.

Issuers

The issuers sell bonds in the capital markets to fund the operations of their organisations. This area of the market is mostly made up of governments, banks and corporations.

The biggest of these issuers is the government, which uses the bond market to help fund a country's operations. Banks are also key issuers in the bond market, and they can range from local banks up to supranational banks such as the European Investment Bank. The final major issuer is corporations, which issue bonds to finance operations.

Underwriters

The underwriting segment of the bond market is traditionally made up of investment banks and other financial institutions that help the issuer to sell the bonds in the market.

In most cases, huge amounts of finance are transacted in one offering. As a result, a lot of work needs to be done to prepare for the offering, such as creating a prospectus and other legal documents. In general, the need for underwriters is greatest for the corporate debt market because there are more risks associated with this type of debt.

The underwriters sometimes place the bonds with specific investors ('bond placement'), or they can attempt to sell the bonds more widely in the market. Alternatively, under a medium term note (MTN) programme, the issuer (via the underwriter) can issue debt securities on a regular and/or continuous basis.

Purchasers

The final players in the bond market are those who buy the bonds. Buyers basically include every group mentioned as well as any other type of investor, including the individual.

Governments play one of the largest roles in the market because they borrow and lend money to other governments and banks. Furthermore, governments often invest in bonds issued by other countries if they have excess reserves of that country's money as a result of trade between countries. For example, Japan is a major holder of U.S. government debt, such as U.S. gilts.

7 Other sources of finance

Retained earnings/existing cash balances

An entity can use its current cash balances to finance new investments.

There is a common misconception that an entity with a large amount of retained earnings in its statement of financial position can fund its new investment projects using these retained earnings. This is not the case.

An entity can only use internal sources of finance to fund new projects if it has enough cash in hand.

The level of retained earnings reflects the amount of profit accumulated over the entity's life. It is not the same as cash.

Sale and leaseback

This means selling good quality fixed assets such as high street buildings and leasing them back over many years (25+). Funds are released without any loss of use of assets.

Any potential capital gain on assets is forgone.

Sale and leaseback is a popular means of funding for retail organisations with substantial high street property e.g. Tesco, Marks and Spencer.

Grants

These are often related to technology, job creation or regional policy. They are of particular importance to small and medium-sized businesses (i.e. unlisted). Their key advantage is that they do not need to be paid back.

Grants can be provided by local governments, national governments, and other larger bodies such as the European Union.

Debt with warrants attached

A warrant is an option to buy shares at a specified point in the future for a specified (exercise) price. Warrants are often issued with a bond as a sweetener to encourage investors to purchase the bonds.

The warrant offers a potential capital gain where the share price may rise above the exercise price.

The holder has the option to buy the share on the exercise date but can also choose to sell the warrant before that date.

Convertible debt

This is similar in effect to attaching a warrant to a debt instrument (as described above) except that the option to convert to shares (the warrant) cannot be detached and traded separately.

With convertible debt, the debt itself can be converted into shares at a predetermined price at a date or range of dates in the future. For example, a $1m loan has an option to convert into 10 new shares for every $100 of loan in 3 years' time.

This has the effect of giving the debt holder a potential capital gain over and above the return from the repayment of the debt. If the value of the shares is greater than value of the debt on the exercise date, then conversion should be made by the investor. If the share value is lower than the debt value, the investor should retain the debt to maturity.

Venture capital

This is finance provided to young, unquoted profit-making entities to help them to expand. It is usually provided in the form of equity finance, but may be a mix of equity and debt.

Venture capitalists generally accept low levels of dividends and expect to make most of their returns as capital gains on exit. A typical exit route is an IPO or flotation, which enables the venture capitalist to sell his stake in the entity on the stock market.

Business angels

Business angels are similar to venture capitalists. Venture capitalists are rarely interested in investing in very small businesses, on the grounds that monitoring progress is uneconomic.

Business angels are wealthy investors who provide equity finance to small businesses.

Test your understanding 1 (further OTQs)

1 ________ preference shares are those for which dividends must be paid in a following year if they are not paid in the current year. ________ preference shares give the holder fixed dividends plus extra earnings based on certain conditions being achieved.

Select the correct words to complete the above sentences, from the following options:

convertible, cumulative, irredeemable, participating, redeemable

2 Capital markets fulfil two functions, one of which is to enable investors to sell investments to other investors.

Is this the primary function or secondary function? Select the correct answer below.

A Primary function.

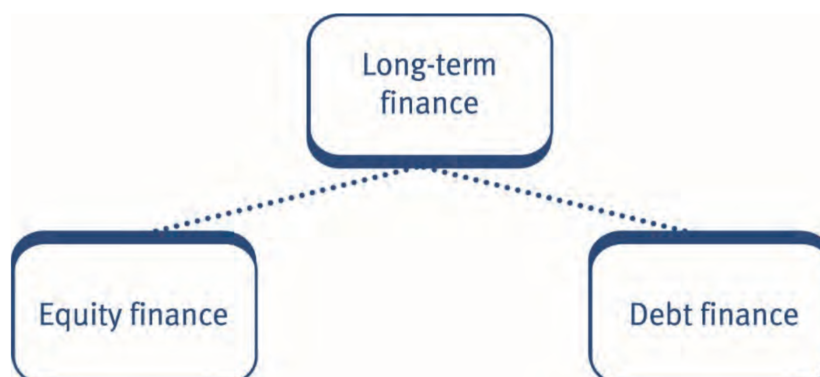
B Secondary function.

3 When fixing security, a lender of funds will prefer a f_______ charge.

Select the correct word to complete the above sentence, from the following options:

fixed, floating

8 Chapter summary



Test your understanding answers

Test your understanding 1 (further OTQs)	
1	**Cumulative** preference share are those for which dividends must be paid in a following year if they are not paid in the current year. **Participating** preference shares give the holder fixed dividends plus extra earnings based on certain conditions being achieved.
2	**B Secondary function** The primary function is to enable companies to raise new finance.
3	When fixing security, a lender of funds will prefer a **fixed** charge. **Note:** a floating charge secures the debt against the underlying assets that are subject to changes in quantity and value whereas a fixed charge is against a specific asset. Therefore a fixed charge is preferable as, in the event of a liquidation, the lender would have a right to the specific asset secured. The fixed charge holder would be paid earlier than a floating charge holder.