



**ACCA Advanced Financial Management
(AFM)**

**Platinum Super Revision Questions Pack
2025**

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Q1: Sunset Co – (IRM)

Syllabus coverage:

- FRA (Forward rate agreement)
- Interest rate futures
- Interest rate options on futures
- OTC interest rate options (Interest rate guarantee/IRG)
- Interest rate collars
- Asset securitization - Interest rate Swaps
- Interest Rate Swaps pricing

Question:

Sunset Co, a large listed company based in Europe, is expecting to borrow €22,000,000 in four months' time on 1 May 20x3. It expects to make a full repayment of the borrowed amount nine months from now.

Assume it is 1 January 20x3 now. Currently there is some uncertainty in the markets, with higher than normal rates of inflation, but an expectation that the inflation level may soon come down.

To manage interest rate risks, Sunset Co has already used the internal hedging techniques including smoothing (maintain a balance between fixed and floating rate debts), and matching (match interest bearing assets with liabilities against the common referenced interest rate).

However, Sunset Co want to use external hedging techniques to hedge against the interest rate risks.

The company can borrow at LIBOR plus 80 basis points and LIBOR is currently 3.3%.

FRA:

Bank has offered the following FRA rates:

- 4-9: 3.9% - 4.1%
-

Futures:

Three month Euro futures, €1,000,000 contract, tick size 0.01% and tick value €25

The following information and quotes from an appropriate exchange are provided on Euro futures

Options (Exchange):

Options on three month Euro futures, €1,000,000 contract, tick size 0.01% and tick value €25. Option premiums are in annual %.

Calls			Strike	Puts		
March	June	September		March	June	September
0.279	0.391	0.446	96.00	0.006	0.163	0.276
0.012	0.090	0.263	96.50	0.196	0.581	0.754

OTC interest rate options (Interest rate guarantee/IRG)

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Asset securitization - Swaps:

Non-executive director proposes that it should raise funds by means of a securitisation process,

Required:

a. Suppose interest rate expects to rise by 0.5%, suggest the hedging strategy for the €22,000,000 loan using:

1. FRA (Forward rate agreement)
2. Interest rate futures
3. Interest rate options on futures
4. OTC interest rate options (Interest rate guarantee/IRG)
5. Interest rate collars
6. Asset securitization - Interest rate Swaps

b. Evaluate the above proposal.

c. One of the Sunset Co's subsidiaries obtains the yield curve in its country, and it also wants to perform the interest rate Swap, as it wants to pay fixed interest rate, but it currently pays LIBOR rate. Therefore, it needs to receive LIBOR rate and pay fixed rate per the Swap agreement.

Here is the yield curve information:

Years	1	2	3
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Required: Forear?

d.

The bank has found a possible counterparty for a swap with Sunset Co's subsidiary.

The counterparty can borrow at an annual floating rate of base rate plus 130 basis points, or a fixed rate of 4.8%.

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Required: Show the hedge outcome using interest rate swap.

Answer:

a.

1. FRA:

	€
Consider (borrow) $(3.3\% + 0.5\%) + (80/100\%) \times €22,000,000 \times 5/12$	(421,667)
Profit or loss with the bank: Actual LIBOR = 3.8% FRA (4-9) = 4.1% Lose $0.3\% \times €22,000,000 \times 5/12$	(27,500)
Actual borrow	(449,167)
Effective cost = Effective cost/Amount/5 x12 $= €449,167 / €22,000,000 / (5/12)$	4.76%

2. Interest rate futures:

	€
Consider (borrow) $(3.3\% + 0.5\%) + (80/100\%) \times €22,000,000 \times 5/12$	(421,667)
Profit or loss from futures market(W1)	12,950
Actual borrow	(408,717)
Effective cost = Effective cost/Amount/5 x12 $= €408,717 / €22,000,000 / (5/12)$	4.46%

W1: Profit or loss from futures contract:

Ticks (P/L per futures contract (W2) (already in %) / (0.01%): $0.14\% / 0.01\% = 14$ ticks)

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$96.16 - 96.02 = 0.14$ or $96.16 - 96.02 = 14$ ticks (when calculate ticks)

W3: Number of contracts

No of contracts = $\frac{\text{Amount}}{\text{Contract Size}} \times \text{Duration}$
Contract Size 3

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3. Interest rate options on futures:

Option exercise prices	96		96.5
Premium: (PTN) Premium: 16.3 and 58.1 Tick value: €25 Number of contracts: 37	€(15,076)		€(53,743)

Effective % (Cost/Amount/Time)	€436,745/€22m/(5/12) =4.76%		€431,010/€22m/(5/12) =4.7%
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4. OTC interest rate options (Interest rate guarantee/IRG)

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5. Collar hedge:

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6. Asset securitisation – Interest rate Swaps:

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b. Comments:

Summary of the above hedging methods:

Options	FRA	Futures	Options	IRG	Collars
Effective cost	4.76%	4.46%	4.76% or 4.7%	4.99%	4.67%

Result: Interest rate futures could be chosen because it costs less compared to other options.

Evaluation:

FRA:

- It creates perfect hedge as this is the OTC contract.
- However, Sunset co can not benefit from the favourable interest rate movement as this is a binding contract.

Futures:

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Tutorial note for professional marks:

- Analysis and Evaluation – 0 marks for poor calculations; 1 mark for OK calculations; 2 marks for good calculations (usually 70% correct)
- Comment calculation result – 1 mark from Analysis and Evaluation; 1 Technical mark.
- Commercial Acumen mark – 1 mark for mentioning about collateral, margin requirement, flexibility in Swaps.
- Scepticism – 1 mark for analysing pros and cons of each financial instrument.

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Q5: Reconstruction, Changes in Risk

Syllabus coverage:

- WACC calculation when there is a change in risk profile
- Degear, regear
- Demerger
- Market capitalization
- Demerger comments
- Free cash flows valuation

Situation 1: Company AB - Changes in risks because of merger

Company A and B are in different industries where company A wants to acquire company B.

Company A's information:

- Non-current assets = \$100m
- To fund company B's acquisition, an additional \$50m is required, and the \$50m is the size of company B.
- Debt: Equity ratio = 3:7
- Asset beta = 0.54
- Equity Beta = 0.72
- Tax rate is 20%

Cost of debt information:

From Statement of financial position:	
	\$m
....

Company A's four-year bonds have a A credit rating, there is the table of credit spreads shown in basis points, and this can be used to determine the cost of debt:

Rating	1 year	2 years	3 years	5 years
AA	5	8	17	21
...				

Company B's information: Asset beta = 1.31

It is assumed that the proportion of the book value of non-current assets gives a fair representation

Required:

1. Determine the Weighted Average Cost of Capital (WACC) if company A and B are merged. (9 Marks)
2. Comment on the results of the calculations. (2 Marks)

Answer:

1.

WACC (A):

Sources of finance	Value	Cost	Value x Cost
Equity	7	$K_e = R_f + \text{Beta}(E) \times (R_m - R_f) = 3\% + 0.72 \times 4.8\% = 6.4\%$	0.452
....		

After M&A:

Combined Asset beta = 67% x 0.54 (A's Asset Beta) + 33% x 1.31 (B's Asset Beta) = 0.79

Equity beta = $0.79 / (7/9.4) = 1.06$

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2. Comments:

If company B is acquired, there is an increase in WACC from 5.35% to 8.84%.

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Tutorial note: the following points could also be awarded marks:

- Assumed $K_d(1-T)$ unchanged
- Assumptions in any of the above factors change, potential loss in shareholders value

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