Financial Management

FRIDAY 2 FEBRUARY 2018 - SESSION NOTES

The slides used, and the ensuing discussion, are reproduced below.

The examining team highlighted a key weakness in the performance of students at the most recent sitting (December 2017) and previous sittings where similar questions had been asked – the practical application of finance – with the following 3 slides.

Debt v equity

- As we have said at the last 3 conferences, if we want M&M 58, 63 etc the requirement will state 'making reference to relevant theories' (also applies to dividend policy)
- Otherwise we require a practical answer
- Students are generally dreadful at this (paper based exams and CBE)

Debt v equity – example from D17 paper

☐ An analyst has calculated the gearing ratios (measured as debt/equity by market values) and interest cover for companies that operate in Peel's market sector as follows:

	Maximum	Minimum	Average
Gearing ratio	135%	80%	100%
Interest cover	3	2	2.4

2.3 Determine whether the £200 million finance required should be raised from either debt or equity sources. You should discuss the likely reaction of both shareholders and the financial markets, and make reference to the gearing and interest cover data provided and give advice to Debbie on which source of finance should be used. **(12 marks)**

Debt v equity – example from D17 paper cont'd

- Gearing is defined – MV not BV; D/E not D/D+E
- So if you change either (or both!) you will be making totally nonsensical comparisons with the market gearing ratio data
- Interest cover is PBIT/I, anything else produces nonsense
- Requirement explicitly asks for reference to market sector data
- Requirement does not say 'making reference to relevant theories'
- 12 marks requires some detail not a couple of paragraphs (see CBE later – strategically avoiding these application requirements?)

The examining team emphasised that follow through marks can only be awarded where it is clear that the student knows what they are doing – not using the gearing definition provided would result in no marks being awarded as apples are being compared with oranges! As the question did not ask for theory no marks were awarded for it – no matter how much was written on it as it was not required.

Many students completely ignored the requirement to refer to the market data provided so scored well less than half the marks available – often only 2 or 3 for general debt v equity issues eg issue costs etc.

Many students wrote very little and clearly did not spend the 18 minutes that should have been allocated to this requirement. This may be because of time pressure eg typing out formulae for other requirements. A high level of familiarity with the CBE software would alleviate this – lots of practice is essential.

Tutors agreed that students find this type of analysis difficult and suggested that students needed some kind of checklist to help with finance questions. The examining team introduced the next couple of slides.

2018 study manual

- Chapter 8 is now solely on valuations
- Finance material moved back into chapter 6
- New section in chapter 6: 'The examining team's guide to answering financing questions'
- FAT PRICE

FAT PRICE

- **F**inancial risk
- **A**nalysis and discussion
- **T**heory
- **P**ractical gearing
- **R**atios
- **I**ndustry averages
- **C**onclusion
- **E**asy marks

Students are *strongly* urged to read through this approach in chapter 6 of the study manual ahead of future sittings of the FM exam and take particular note of when theory is and isn't required along with definitions of key ratios when they are provided in the question,for example gearing. Students should also ensure that they know how to calculate ratios such as interest cover.

The examining team also stated that students should not forget to give a conclusion.

The discussion then moved on to the impact of CBE on teaching etc with the following slide.

CBE

- Tutor and student experience so far (eg teaching students to use CBE v teaching actual FM content, slower with typing out formulae etc?, how much practice?, mocks on CBE?)
- Avoid application? (Sept and Dec 17 exams showed major weaknesses in written application answers – see D17 part 2.3 debt v equity earlier – do students make a conscious decision to avoid these parts or do them last if time is an issue?)
- Presentation of answers (see separate pack for examples to discuss)
- Data hidden in cells can't be marked and no workings = no marks

The examining team and the tutors were in total agreement that practice with the software is essential. However tutors pointed out that courses were of the same length as pre-CBE courses, therefore practice with the software has to be carried out alongside the usual course content.

The examining team showed the tutors some examples of good and bad presentation. However they made the point that they are not marking presentation, but seeking to help students prepare their answers in a more efficient way.

The examining team emphasised that workings must be shown if marks are to be awarded – it is not enough to say 'using the formula above the answer is…' without showing any numbers in the formula at all and that typing out formulae provided on the formulae sheet is a waste of time – the relevant numbers themselves should be typed out and entered into the formulae.

Tutors asked about rounding. The examining team said that they wanted evidence that students knew what they were doing rather than whether something should be rounded to 2 or 3 decimal places to get the marks (NB foreign exchange rates need to be to 4 dp and not rounded however).

The meeting then discussed good and bad presentation using some examples of student answers from December. Examples of good presentation are provided on the ICAEW website.

The examining team said that students should consider carefully the use of the text boxes in column A - these can often be used to produce an answer more efficiently than trying to use the spreadsheet cells in the other columns eg cost of equity, degearing/regearing betas or forex. The spreadsheet cells lend themselves to other calculations more naturally eg NPV, cost of redeemable debt. Leaving a gap between lines/paragraphs in a text box helps with ease of reading for a marker. Widening columns so a marker has to scroll across back and forth to try to read a text box is not helpful. Using a separate text box for each individual line of a written answer is not helpful – they can all go in a single text box. Again practice will help with these issues.