



FINANCIAL MANAGEMENT – WRITTEN WARNING!

In an article in the July 2013 edition of VITAL, the Professional Level Financial Management (FM) examining team explained the differences between the old FM paper and the new one that is first examined at the September 2013 session. The examining team have no intention of changing the balance between the numerical and discursive aspects that existed in the old version of the paper where on average the split was 60:40 numerical/discursive. However, individual papers may vary from this average depending on the nature of the material tested.

Historically, students have consistently performed well on the numerical aspects of FM. However, in recent sittings there has been a marked decline in performance on the discursive aspects, leading to a fall in the pass rate below its long-term average (June 2013: 73.6%; March 2013: 78.8%; December 2012: 80.1%).

The purpose of this article is to highlight the main causes of the decline so that future students can improve their performance on the discursive aspects. The examining team have identified four key reasons for poor performance.

Firstly, students often fail to apply their knowledge in the circumstances described in the question. For example, question 1 in the June 2013 paper required candidates to deal with the acquisition of one business by another using NPV. Requirement (c) was as follows:

Explain what is meant by the term 'real options' and suggest two real options that might be relevant to Brixham's purchase of Cabin. **(6 marks)**

Breaking this requirement down, there is a pure knowledge aspect – what is meant by 'real options' – and then an application of real option knowledge *to the specific scenario*. Most (but certainly not all) students addressed the knowledge aspect but then proceeded to blindly regurgitate material from the study manual that was simply inappropriate *for the circumstances described*. Frequent references to 'the project' in students' answers gave away the fact that they were not considering the specific acquisition scenario but real options in the context of project appraisal generally, so that suggesting there was an option to delay by one, two or three years was just plain wrong.

Secondly, students often fail to answer the question set. Question 2 in the December 2012 paper concerned the WACC and requirements (b) and (c) were as follows:

Discuss the underlying assumptions and weaknesses of the approach you have employed in calculating the cost of equity in part (a). **(8 marks)**

Discuss any reservations you may have regarding the use of the WACC as a discount factor in appraising Liteform's potential investment projects next year. **(5 marks)**

The majority of students answered part (b) as if it read 'calculating the WACC' rather than what it actually said which was 'calculating the cost of equity' so there was a vast amount in their answers to (b) on keeping the gearing constant, having the same systematic business risk and not having project specific finance that scored nothing, rather than an answer based on the dividend valuation model. Unfortunately, what they had written as their answer to (b) was in fact relevant to answering (c)! The sensible ones repeated their answer to (b) thus ensuring they scored some marks, but many wrote very little for (c) and scored, in most cases, nothing.

Thirdly, many students fail to break the requirements down and fully answer all aspects, thus losing what are often very easy marks. Question 3 in the June 2013 paper was again on WACC and part (c) was as follows:

Critically evaluate the suggestions of the finance director, the managing director and the production director, in respect of both the method of financing and the cost of capital. **(11 marks)**

A well-structured answer would recognise that there are 3 directors each commenting on 2 things (method and cost), so there would be 6 parts to the answer. Many of the weaker answers simply dived straight in having seen there was debt and adopted the 'write all I know about M&M' approach (coming back to the first point about applying knowledge).

Finally, there is a lack of knowledge on the part of some students. All of the material in the study manual is examinable and small requirements testing knowledge should be expected e.g. part (b) of question 1 in June 2013:

Distinguish between the terms 'uncertainty' and 'risk' in the context of investment decision-making and describe how the directors of Brixham might adjust the calculations made in part (a) from calculations made under conditions of uncertainty to calculations made under conditions of risk. **(6 marks)**

Students would be well advised to take note of the above when preparing for future sittings of the FM paper.