ACCA

Guide to discursive requirements

September/December 2019

Advanced Financial Management (AFM)

Designed to give you an insight into the discursive requirements of this exam, alongside feedback and observations from the marking team

Think Ahead

Introduction

This article will look at three discursive requirements which can be found in the September/December 2019 Advanced Financial Management (AFM) exam. In each case we will look at an unsatisfactory response, a pass response and a very good response, along with feedback and observations from markers on these responses.

Question 1(c)

The first requirement to be considered is question 1(c), which was worth four marks and is as follows:

Discuss why Okan Co's subsidiary company may be exposed to economic risk (economic exposure) and how it may be managed.

To answer this question, students need to first consider the verb 'discuss' used in the requirement. Discuss means that students should consider whether or not Okan Co's subsidiary is exposed to economic risk, by referring to the scenario set out in the question. In this example, the scenario pertaining to this question part is:

> "One of Okan Co's subsidiary companies in Yasailand, which produces and sells all its products domestically, has still found that it is exposed to economic risk (economic exposure). The directors of the subsidiary believe that this is because Yasailand's government has maintained comparatively higher interest rates, even though the inflation in Yasailand is now under control"

The question requirement sets out the following issues to be addressed:

- What is economic risk?
- Can Okan Co's subsidiary which only trade domestically be exposed to economic risk?
- Can economic risk be managed?
- In what ways can Okan Co's subsidiary company manage its economic risk?

To earn full marks for this question part, an answer will need to address at least three out of the four issues.

The marking scheme indicates two sub parts for marks; up to 3 marks for explaining economic risk faced by Okan Co's subsidiary, and up to 2 marks for discussing about how its economic risk can be managed, with a maximum of 4 marks for this question part.

Below are three examples of how candidates answered this question part, along with an indication of how many marks each example would be awarded.

Question 1(c) candidate one:

The Okan Co's subsidiary exposure to economic risk is that the reason for the company to borrow in a fixed rate. It will suffer from borrowing at floating rate, if the interest rate moves unfavourably.

The ways to manage the risks are hedging, diversifying and mitigation. Hedging includes forward, futures, options and swaps to make the outcome more certain.

Diversifying is effectively to prevent from putting all your eggs in one basket.
Holding a portfolio of investments with varying degrees can reduce the overall risk of the business.

Mitigation involves putting control procedures to prevent investment whose risk is beyond the shareholders required.

Feedback:

The candidate's answer did not address the sub two parts. For the first sub part, there was no explanation of what economic risk is. The candidate's answer hinted at hedging interest rate risk by borrowing at fixed interest rate. Interest rate risk is not economic risk. Therefore, no marks awarded for the first sub part.

For the second sub part, the answer does not explain how economic risk can be managed. Instead it describes how risks in general can be managed. There was no indication the candidate understood that economic risk is of a long-term nature. Also, the answer did not discuss whether or not Okan Co's subsidiary should manage its economic risk and the difficulties in doing so. Therefore, no marks were awarded for the second sub part.

Overall, the candidate did not explain what economic risk is, discuss why Okan Co's subsidiary might be exposed to it and how this subsidiary can manage its economic risk. Time and effort were spent answering this question part without gaining any marks.

The following observations should also be noted here:

1) Answers should relate to Okan Co's subsidiary in order for marks to be earned.

2) Writing about issues that are irrelevant to the question asked, waste time and earn no marks.

This response is unsatisfactory and would receive 0 out of 4 marks available.

Question 1(c) candidate two:

Economic risk arises when the exchange rate fluctuates and impacts the foreign investment's cash flow, thus causing volatility to the value of the investment.

Yasailand maintains higher interest rates while the inflation is under control. This may lead to a fluctuation in the value of Yasailand's currency (exchange rate) and for interest rate and will subsequently impact the value of Okan's investments in Yasailand.

To manage the risk, Okan's subsidiaries in Yasailand can consider diversifying its sales and procurements abroad, so that the currency fluctuation can be mitigated.

Okan can also consider diversifying its investments into more geographical locations with various currencies.

Feedback:

For the first sub part, the candidate's answer point to economic risk due to fluctuations in exchange rates and interest rates, affecting an investment's cash flow and hence its value, is worth one mark, although the answer did not specifically refer to Okan's subsidiary.

For the second sub part, one mark was awarded for explaining that to manage economic risk, Okan's subsidiaries in Yasailand can consider diversifying its sales and procurements abroad to mitigate currency fluctuations. Diversifying its investments into more geographical locations with various currencies is restating the point made earlier, so no extra mark was awarded.

A marginal pass (2 out of 4 marks) was awarded for this question part.

Question 1(c) candidate three:

Economic risk refers to the long-term loss of value suffered by a company due to a depreciation of its currency. The central bank of the country has held the interest rates high despite lower level levels of inflation which may lead to an appreciation in the value of the domestic currency. This will lead to an increase in the value of the domestic currency relative to foreign currencies. This will make foreign goods cheaper compared to local goods which will reduce domestic sales for Okan Co's subsidiary in the country.

Economic risk is very difficult to manage given its long-term nature. One of the ways would be for the company to outsource production to foreign countries with weaker currencies to cut its own costs.

Feedback:

The candidate is awarded:

- 2 marks for describing well why Okan Co is exposed to economic risk
- 1 mark for identifying economic risk is long term and so, is very difficult to manage
- 1 mark for suggesting a way to manage economic risk

The answer is awarded the full 4 marks as this is the maximum available for this question part.

The following observations should also be noted here:

1) Provided that the question part's aims are appropriately addressed, it is possible to gain full marks without writing a lot or discussing in much detail as shown in the published solution.

2) Well developed arguments or points can be awarded 2 marks.

Question 1(d)

The next requirement we shall look at is question 1 (d) which was worth six marks, and is as follows:

Discuss how each category of risk, in terms of severity and frequency, may be managed.

In the context of this question, ‘discuss’ meant to write about the management of risk when it was categorised according to the severity and frequency of the risk occurring. Candidates were encouraged to think of each category separately, as the list of categories was provided.

In their discussion, candidates needed to justify how each category of risk would be managed by demonstrating their undertaking of the category and using this to contextualise the recommended action(s). Stronger responses explained the risk category and then demonstrated how the risk management action recommended could be justified. Weaker responses did not go much beyond explaining the categories or the risk management actions. The very weakest responses lacked explanatory depth, as well as meaningful justification and contextualisation.

The examples below explain this in more detail.

Question 1(d) candidate one:

There is mainly the TARA approach to manage risk.

1. Severe and frequent: Terminate
2. Not severe but frequent: Treat it with appropriate measures
3. Severe but not frequent: Transfer
4. Neither severe nor frequent: Tolerate

Feedback

One mark was awarded for awareness of the action that could be taken for each category, but there was little else in this response where any additional marks could be awarded. On a fundamental level, although it is acceptable for answers to discursive elements within the AFM paper to be given in bullet points, the answers should nevertheless be in complete sentences and not just as few or one-word answers. Requirement 1(d) had six marks allocated to it, and in terms of the time-effort required, this indicates that a normal response should take 10 to 11 minutes of concentrated, articulated discussion dedicated to it. The above response falls significantly short of that. There is a lack of explanatory narrative and no discursive justifications.

It is recommended that candidates spend time and effort commensurate to the mark allocation for each part of each question. At this level, in order to demonstrate knowledge and skills, candidates need to provide responses with explanatory and discursive depth.

This response is unsatisfactory and would receive 1 out of 6 marks available.

Question 1(d) candidate two:

Severe and frequent. Given that the action or decision will have a negative impact which is severe and occurs frequently, then maybe the company should just avoid the situation completely. This is just not worth taking and the company must not take it. Because it is going to be too harmful and therefore avoiding is the best.

Not severe but frequent. This is low impact but happens a lot. This can be managed through money market hedges, derivatives and diversification of projects. It is important to plan for these risks and take action. Planning is very important for a company and managers must spend a lot of time doing this, because good planning is necessary for a company to be successful and better than the competition and maximise its share price.

Not frequent, but severe. It is so important that these risks are transferred because then the company will be successful, better than the competition and maximise its share price. Here money market hedges, over-the-counter derivatives and insurance is the best. The company must do this otherwise the shareholders and stakeholders will not be happy. They must be kept happy so that a company can be successful, and its share price is maximised.

Not severe and not frequent. This is of no concern to the company and can be ignored completely. No hedging is necessary because hedging costs money and these types of risks will not really be harmful to the company at all. So, no need to spend money and lower the share price.

Feedback

This response contained both elements of explanation and of justification, and it did provide a basic discussion for all categories. However, it was let down by rudimentary and unnecessary repetition, moving away from the core requirements of the question and sometimes providing incorrect recommendations for the action the company might take. It is also likely that the candidate in this case took longer than the 10 – 11 minutes that they should have, when responding to this question part. The excess time devoted here would mean that the candidate would have less time available to answer other questions.

It is recommended that candidates manage their time carefully. This should be done by answering the question set and not resorting to repetition or by going off-topic. Candidates should respond to nothing else but the question set.

A marginal pass (3 out of 6 marks) was awarded for this question part.

Question 1(d) candidate three:

Severe and frequent: Projects or investments with these risks should be avoided if possible. This is because the probability of such risks occurring is high and the impact is so severe that the survival of company could be threatened. Such projects could be highly profitable, and the company should monitor them to see if the risk profile changes in the future, so that they can be accepted.

Not severe but frequent: These types of risks which occur frequently but do not have a big negative impact, should be monitored so that they do not become severe. Where possible, plans and systems put into place to reduce their frequency.

Severe but not frequent: Risks which do not occur often but when they do, their impact is severe, like in the case of natural disasters, need a double approach. Insurance should be used to transfer these risks out of the company, but also the company should try to make plans to reduce the impact or severity of the risks. Such as keeping file copies using 'cloud computing' to protect against natural disasters.

Neither severe nor frequent. These risks should be accepted and monitored to ensure that they do not change. No immediate action may be necessary. And companies need to accept some risks in order to generate sufficient returns.

Feedback

This answer provided excellent coverage of the different parts to the question. The main points made are clear and succinct and there no time was wasted on making comments which were not asked for.

Each category and subsequent action were explained and then justified well by linking the reason(s) for the action to the risk category. There was a clear flow within each category, and this demonstrated that the candidate understood the topic area and the requirements of the question fully.

The answer is awarded the full 6 marks, the maximum available for this question part.

Question 3(a)

The last of the three requirements we will look at is question 3(a) which was worth eight marks, and is as follows:

Discuss possible sources of financial synergy arising from Kerrin Co's acquisition of Danton Co and comment on the finance director's concern that synergy is often overestimated, including any steps which could be taken by Kerrin Co's board to address this problem.

The marks available indicate this is a substantive requirement with credit split across a detailed examination of the following issues:

- sources of financial synergy arising from Kerrin Co's acquisition of Danton Co (4 – 5 marks),
- reasons why synergy is often overestimated in practice, and (2 – 3 marks)
- ways of avoiding the overestimation problem (1 – 2 marks).

The best responses considered all three aspects of this requirement.

The following section provides feedback from markers for a range of responses, including recommendations for improvement where appropriate.

Question 3(a) candidate one:

The potential for synergy provides a motive for Kerrin Co's acquisition of Danton Co. Where synergy exists, the acquisition creates shareholder value in a way that would not have been possible if the two companies operated independently. There are a number of possible sources of synergy including revenue, cost and financial synergy.

Revenue synergy exists if the acquisition is expected to increase the revenue of the combined company. This could arise from increased market power due to the elimination of a competitor as well as marketing synergies such as the effective exploitation of cross-selling opportunities.

The potential for cost synergy arises from the existence of economies of scale. As the production volume increases, the average cost per unit falls since overheads are spread over an increased level of activity. The larger company may also be capable of negotiating bulk discounts with suppliers. In addition, the takeover may generate cost savings by removing duplicate functions such as certain head office costs.

Financial synergy includes the fact that the larger group may be able to negotiate competitive interest rates with their bank and other sources of debt.

There is a possibility that synergy may be overestimated if it isn't valued correctly so the directors should be excessively prudent when making their assumptions about the impact of the acquisition.

Feedback:

The approach adopted by this candidate was a relatively frequent occurrence with many candidates ignoring the requirement and wasting time on detailed descriptions of cost and revenue synergies even though these were not asked for and attracted no marks. Many candidates compounded this error by ignoring the other parts of the requirement on the overestimation issue.

This response improves upon that low benchmark by including a valid comment on financial synergy although this only appears towards the end of their response. However, the final paragraph fails to identify a reason for the overestimation issue and the recommendation that the board should be "excessively prudent" would underestimate synergy and lead to its own problems. For this reason, no marks were awarded for that final paragraph.

A more careful reading of the requirement and scenario would have helped this candidate avoid wasting time by making points not asked for. There is a possibility the candidate correctly interpreted the question but was more comfortable discussing cost and revenue synergies. However, it would have been better to invest time elsewhere where marks might still be gained rather than wasting exam time on topics not being examined. For example, this response also suffers from a lack of balance with insufficient time dedicated to the second part of the requirement on the overestimation issue. It may have been more productive to invest time on this part of the requirement.

This response is unsatisfactory and would receive 1 out of 8 marks available.

Question 3(a) candidate two:

The possible sources of synergy arise from cost savings Kerrin Co will generate when acquiring Danton Co. The cost savings will be legal costs, which would have been facilitated as a result of this acquisition. It may also be possible to save employee costs by imposing redundancies and achieving efficiencies.

Kerrin Co will also be able to utilise its cash reserves to finance Danton Co's investment plans after the acquisition since Danton Co is experiencing difficulties raising funds and Kerrin Co lacks good investment opportunities. Kerrin Co has sufficient cash to support Danton Co's future investment strategy. Combining their resources in this way will mean that both companies are better off in the future since Danton Co's investment plans are no longer constrained, particularly when there is a shortage of funding for new projects.

Kerrin Co will also be able to utilise Danton Co's tax losses and reduce the post-acquisition tax liability through effective loss relief planning. This would apply if Danton Co is unable to relieve its own tax losses but Kerrin Co is profitable and has no alternative options to reduce its own tax liability.

The directors concern that synergy is often overestimated is valid. This can occur if managers are overly optimistic about the outcome of the acquisition, particularly if they feel their professional reputation is at stake depending on whether the deal goes through or not.

This problem can be addressed by assigning a professional expert to conduct a due diligence exercise before the acquisition takes place. The directors should conduct an extensive sensitivity analysis to test the assumptions and ensure synergies are estimated accurately.

Feedback:

This candidate wasted time with a comment on cost synergies that lacked clarity anyway. Although financial synergies are also considered, the candidate writes quite a bit for both examples without adding very much extra value to either and so these attracted just one mark each.

The response ends with a brief discussion on the issue of overestimation, including the recommendation that the directors should conduct due diligence. Both points are valid and were awarded one mark each.

This candidate had the potential to score higher marks with more effective time management and less repetition. Less time spent discussing cost synergies and a more succinct writing style would have freed up time to expand on the financial synergies and overestimation sections.

A marginal pass (4 out of 8 marks) was awarded for this question part.

Question 3(a) candidate three:

The acquisition could create value by combining Kerrin Co's excess cash with Danton Co's investment opportunities to boost post-acquisition growth. Kerrin Co may also be able to exploit Danton Co's tax losses to achieve tax relief much earlier than would otherwise have been the case. It may be possible to negotiate more favourable borrowing rates after the acquisition, particularly if the combined cash flows are less volatile than before.

The problem of overestimation exists if the companies experience integration difficulties after the acquisition. These difficulties could result from cultural differences between Kerrin Co and Danton Co and have the potential to destroy any synergistic benefits. Employees could also be concerned about the potential for job losses and become demoralised and demotivated.

Before the acquisition plan is agreed, Kerrin Co's board would need to consider their integration plans carefully and devise an effective communication strategy to alleviate employees' concerns.

Feedback:

This answer provides excellent coverage of the different parts to the question. The main points made are clear and succinct and there is no time wasted on comments not asked for. One interesting observation is that this response is also considerably shorter and less time intensive than the previous responses but attracted much higher marks.

In the first paragraph, the candidate clearly relates their response back to the scenario rather than providing a generic list and identifies three separate sources of financial synergy, worth one mark each.

The following paragraphs are brief but clearly identify two reasons why synergy may be overestimated and the associated steps that could be taken to address these problems. Both paragraphs are worth two marks each.

This response is awarded 7 out of 8 marks available.

Overall conclusion

This article highlights the need for candidates to ensure that they are addressing the requirement correctly. Bullet points can be used in answers, but any discussion must be written in full sentences in order to obtain marks.

The best answers are not necessarily the longest responses, but instead they are focussed on the specifics of the requirement. Adopting this approach will also help with time management throughout the Advanced Financial Management exam.