A RISKY BUSINESS

In the first part of a new three-part series, Matt Holden outlines what you'll need to know for 'sources of finance' decision making questions

The onset of the credit crisis in 2008 allowed 'sources of finance' to take on huge relevance for aspiring finance professionals. For me, the credit crisis transported the subject from the study manual to every day life. I continue to derive great enjoyment from lecturing on sources of finance. Not out of some macabre enjoyment of failing capitalism, but in the hope that our memories of the disastrous financial decision making, by those officials who simply should have known better, are not too short! We shall see.

Despite the far-reaching implications of the subject and individuals' personal viewpoints, there remains the need to be able to pass the exam in front of you, in the time allowed. Being accountancy exams, this inevitably involves some use of numbers. Speaking to the examiners themselves, you learn quickly that the unsuccessful candidate is often the one that is reticent to use the numbers given to them in the question. This remains true for sources of finance questions. When invited to comment on the board's decision between debt and equity finance, the examiner will, more often than not, present you with an income statement and SOFP – the key to success is using them.

The most difficult issue I have found is 'where to start?' and then, once started, 'how far to go?'. The key, of course, is to keep it simple, but still discover the main elements of the story that will allow you to form an opinion. When faced with sources of finance dilemmas, I believe it is essential you are confident with the key ratios, namely:

Financial gearing (debt/equity) – as a % (high gearing suggests high financial risk). The examiner may expect you to use debt/(debt + equity) and/or use market values rather than SOFP values. They will indicate this either explicitly or by how they calculate the comparative.

Interest cover (PBIT/Interest) – number of times PBIT covers the current level of finance charges (an indication of comfort with which interest commitments can be met but also the link between financial and business risk – see subsequent article in next issue).

Operational gearing (Operational fixed costs/Total operational costs) – as a % (high gearing means high proportion of operating costs (NB: not finance costs) that are fixed which suggests high business risk. Indicates PBIT sensitivity to changes in sales volume).

Key definitions

You'll also need to know key definitions, namely:

Financial risk: Variability of profit after tax caused by the level of finance charges as a result of the level of debt finance in the capital structure (ultimately putting pressure on shareholder dividends).

Business Risk: Variability of profit before interest and tax (profit from operations) as a result of the type of industry/sector/business we operate within.

With regard to ratios, students need to practice them so that in the exam itself, there is no hesitation as to what numbers to look for. Confidence in the calculation allows you to demonstrate confidence in your opinion. You must be sure of not only how to calculate ratios but what they claim to demonstrate.

With definitions, learn them – remember the reader needs you to provide a context before applying it to the specifics of the question. Look at past papers and appreciate how the theory is applied to the scenario given. Notice the specifics that the examiner uses in the suggested solutions – this is where the high marks are.

In the next issue of PQ magazine I will provide illustrations of how these issues are typically examined in practice. PQ

• Matt Holden, Reed Business School

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