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Practice exam questions

AI and finance

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Check your answer to the question on pp. 14–15 of the magazine. This question relates to the AQA specification.

Sample answer

Financial performance, which is a business' ability to manage its assets, liabilities and generate profit and cash, is a key objective for any firm. The use of artificial intelligence (AI) in finance involves using technology and big data to improve forecasting and decision-making. This can have a major impact on a business' financial health by improving profitability, liquidity and solvency. However, the extent of this impact depends on the quality of human leadership and how well the business manages the risks involved.

One way AI can significantly improve financial performance is by helping a business to create more accurate profit forecasts. The article states that AI is the 'perfect tool for creating more accurate forecasts of sales, cash flows and profits'. This helps prevent 'shocks' for investors, like the one at WH Smith where shares fell 40% overnight after profit shortfalls were announced. AI systems can learn from past data and correct flaws in forecasting models that traditional software cannot. Furthermore, AI can act as an early warning system by spotting anomalies, such as a subsidiary speeding up customer payments to artificially boost profits for one year. By providing more reliable forecasts and sniffing out trouble early, AI allows directors to make better strategic decisions, maintain investor confidence, and manage profits more effectively, which is a core part of strong financial performance.

Secondly, AI can massively improve a business' liquidity by enabling more effective cash-flow management. The article correctly points out that with cash flow, 'months matter, and so do weeks and days'. A business that appears profitable on paper can still collapse if it runs out of cash. AI systems can 'interrogate every aspect of a company's finances minute by minute', looking for issues like customers starting to slow down their payments. This allows the finance director to get the early warning needed to chase up payments or arrange short-term finance before a full-blown liquidity crisis hits. By preventing cash shortages, AI helps ensure that the business can meet its short-term debts and continue operating, which is arguably more critical for survival than profit in the immediate term.

On the other hand, AI can also improve long-term financial stability by helping to manage the capital structure of the business. The article uses the examples of Thomas Cook, Carillion and Wilko, which all went into administration due to excess debt levels and poor balance sheet management. A key role for a finance director is to decide how to fund investments without taking on too much risk. AI has the power to constantly run 'what if?' models and scenario-plan the impact of taking on more debt. For example, it could model the effect on gearing ratios if a new investment proves to be a flop or a huge

success. This analytical power helps directors avoid taking risks that could imperil the whole company, leading to a more robust and sustainable balance sheet, which is a sign of excellent long-term financial performance.

However, the importance of AI in improving financial performance is limited by the fact that it is ultimately just a tool that relies on human judgement. The article makes it clear that 'human judgements still need to be made' and that the 'key decisions will have been made by highly paid finance directors, not computer software'. AI provides the data, but it is the leadership team that must interpret it and make the final call. There is also a significant risk that directors could get complacent by trusting the data from a sophisticated AI without questioning it. If the underlying data is flawed or the market changes in an unexpected way, this over-reliance could lead to disastrous decisions. Therefore, the skill and experience of the management team are arguably more important than the technology they use.

In conclusion, the extent to which AI can improve a business' financial performance is very high, but it is not the single most important factor. For a large business, AI offers incredibly powerful ways to improve the accuracy of profit forecasts, the real-time management of cash flow, and the strategic planning of its capital structure, helping to avoid failures like those at WH Smith and Wilko. However, its success is entirely dependent on the quality of human oversight. The article concludes that AI is a 'very useful tool' but cannot do the finance director's job. Factors such as the strategic vision of the leadership team, the corporate culture, and the ability to adapt to external shocks like new competition or a recession are ultimately more important. AI enhances the capabilities of a good finance director, but it cannot compensate for poor human decision-making, which remains the most critical factor for long-term financial success.

Sample examiner comment

25/25 (Level 4 – an excellent response, fully focused on the question)

A depth and range of knowledge and understanding are shown of the different aspects of financial performance, including profitability, liquidity and capital structure. The role of AI within financial management is clearly understood.

Application is applied effectively and consistently throughout the answer. The context from the article is used seamlessly to support each point, with specific references to companies like WH Smith and Thomas Cook to illustrate the arguments being made.

Analysis is well developed, logical and considers a balanced range of issues. The response clearly explains how AI can improve financial performance in distinct areas (forecasting, cash flow, capital structure) before providing a strong and well-reasoned counter-argument regarding the limitations of AI and the importance of human judgement.

The answer makes a clear and well-supported judgment as to the importance of AI in improving financial performance. The conclusion successfully weighs the competing arguments and maintains a sharp focus on answering the specific question asked, leading to a convincing and nuanced final verdict.

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