Examiner's report

Financial Management (FM)
December 2018

The examining team share their observations from the marking process to highlight strengths and weaknesses in candidates' performance, and to offer constructive advice for future candidates.

General comments

The Financial Management exam is offered in both computer-based (CBE) and paper-based (PBE) formats. The structure is the same in both formats, but the CBE exam delivery model means that candidates do not all receive the same set of questions.

- Section A objective test questions – we focus on two specific questions that caused difficulty in this sitting of the exam
- Section B case-based objective test questions – here we look at the strengths and weaknesses in specific syllabus areas
- Section C constructed response questions - here we provide commentary around some of the main themes that have affected candidates' performance in this section of the exam, identifying common knowledge gaps and offering guidance on where exam technique could be improved, including in the use of the CBE functionality in answering these questions.

Congratulations to those candidates who were successful in this examination diet. If you were not successful, I hope that you will study the content of this report carefully as part of your preparation for your next attempt.

Performance in the December 2018 examination diet was generally satisfactory and there were some very good individual performances. That said, it is disappointing to see that there are some candidates who are inadequately prepared for this level of Financial Management examination. As has been stated in previous examiner's reports, candidates preparing for this examination need to study the whole of the syllabus in order to be able to cope with the type of questions set in this test of Financial Management skills.

This is especially true of Section C of this examination, where candidates are expected to demonstrate in depth knowledge through the performance of detailed calculations and the discussion and explanation of Financial Management concepts as applied to the given scenarios. In order to be able to do this, candidates need to have prepared well for the examination through dedicated study and question practice, and then be ready to apply this knowledge to the Section C questions.

In general, candidates were well prepared in some areas of the syllabus, in particular those that have featured regularly such as performing the discounted cash flow in relation to an investment project, but less able to demonstrate knowledge in others such as 'Specific investment decisions' and 'Finance for small and medium sized entities (SMEs)'.

Section A

The objective test questions in Section A aim for a broad coverage of the syllabus, and so all areas of the syllabus need to be carefully studied. Candidates preparing for the examination are therefore advised to work through as many practice objective test questions as possible, reviewing carefully to see how correct answers are derived in any areas where they have uncertainty.

The following questions are reviewed with the aim of giving future candidates an indication of the types of questions asked and guidance on dealing with such exam questions.

Example 1 is numerical and tests valuation of debt.

Example 2 is a question testing knowledge of value for money measures.

Example 1

Black Co has in issue 5% irredeemable loan notes, nominal value of $100 per loan note, on which interest is shortly to be paid. Black Co has a before-tax cost of debt of 10% and corporation tax is 30%.

What is the current market value of one loan note?

A $55
B $50
C $76
D $40

The correct answer is $55

A 5% irredeemable debenture pays interest of $100 x 5% = $5 annually.
Ex-interest market value = $5 / 0.1 = $50.
Therefore the cum interest market value is: $50 + $5 = $55.

Choosing $50 is incorrect as the market price is cum interest so interest about to be paid needs to be added.

Example 2

ARP is a charity providing transport for people visiting hospitals.

Which of the following performance measures would BEST fit with efficiency in a value for money review?

A Percentage of members who re-use the service
B Cost per journey to hospital
C A comparison of actual operating expenses against the budget
D Number of communities served

The correct answer is B.

Cost per journey to hospital is a measure of efficiency.

Percentage of members who re-use the service is a measure of effectiveness.

A comparison of actual operating expenses against the budget is an economy measure.

Number of communities served is an effectiveness measure.

<u>Section B</u>

Similarly to Section A, questions can come from any area of the syllabus, reinforcing the need for candidates to study the whole syllabus.

General comments

Candidates should read the question carefully and follow the instructions on how to answer the question, for example if a question asks the candidate to select two correct statements, then marks can only be awarded if two statements have been selected. There is no partial marking, so an answer which only selects one statement will be awarded no marks. A candidate who selects three statements will also receive no marks.

In addition, when answering a number entry question, candidates must ensure they are entering their answer in the correct format as stated in the requirement. If there is no format specified, answers may be given as an integer or to one or two decimal places. The exam system is configured to allow any correct answer, under these formats, to be awarded the available marks.

Issues that were noted under specific syllabus areas are as set out below.

Working capital

A number of candidates made errors relating to the effect on a company's profitability and liquidity from changing its working capital funding policy.

There were also a number of candidates who were unable to identify which action would result in a company reducing its cash operating cycle.

Business finance

Some issues were noted in a question relating to the assumptions of the dividend growth model.

There were also a couple of common misconceptions about equity finance, including the idea that equity reserves represent cash that is available for a company to invest.

Business valuation

Price earnings ratio questions caused difficulties for some candidates, one particular recurring issue is that candidates need to use profit after tax and preference dividends, before applying a price earnings multiple to come to the final valuation.

A further issue was noted in a question where the value for the dividend in one year's time was given, but many candidates still inflated this amount to input into the dividend growth model.

A number of students also struggled with identifying which forms of market efficiency were consistent with statements made by a number of directors.

Risk management

It continues to be the case that candidates are not strong on questions which feature derivatives. One specific example in this session was a question testing the characteristics of futures and options.

A further area of confusion appeared in a question which asked for a forecast spot rate in three months' time, with a number of candidates not correctly apportioning the annual interest rates.

A further point causing problems in this area is that some candidates do not seem to understand the terms bid and offer in respect to foreign exchange rates.

Specifically relating to interest rates, a number of candidates were unable to answer a question about the shape of the yield curve.

Section C

This section of the examination is where candidates are required to have deeper knowledge of topics. Whilst there were many reasonable attempts at most parts of questions, especially numerically based requirements, there were too many candidates where responses to discursive questions displayed little or no knowledge.

As previously stated, the CBE exam delivery model means that candidates do not all receive the same set of questions. It is not possible to predict the questions in advance.

Question requirements must be read carefully and answered directly. Candidates writing 'all that they know about the topic' without answering the question will invariably score few marks. Instead, the focus should be on the requirement and relating this to the scenario provided. Question requirements will often make reference to the company in the scenario e.g. 'Discuss THREE ways in which X Co could....'. This means that candidates need to refer to the company's circumstances in order to score the marks on offer

As at previous diets, some candidates are continuing to fail to score marks where a recommendation and/or a comment was required on figures calculated. For instance, if asked whether a company should lease or buy an asset, then it is insufficient for a candidate to simply say ‘Lease the machine’ without any justification for the decision such as ‘Lease the machine as the NPV of leasing is lower than the NPV of outright purchasing’

Finally, in terms of general comments about Section C, it is once again worth restating that, if asked to discuss factors/benefits/reasons, it is not enough to simply list a few words. ACCA’s guidance states that ‘Discuss’ means “Consider and debate/argue about the pros and cons of an issue. Examine in detail by using arguments in favour or against”

Candidates at this diet were presented with Section C questions drawn mainly from the areas of:

- The nature, elements and importance of working capital
- Management of inventories, accounts receivable, accounts payable and cash
- Determining working capital needs and funding strategies
- Investment appraisal techniques
- Allowing for inflation and taxation in Discounted Cash Flow (DCF)
- Adjusting for risk and uncertainty in investment appraisal
- Specific investment decisions
- Sources of and raising business finance
- Sources of finance and their relative costs
- Finance for small and medium sized entities (SMEs)

The nature, elements and importance of working capital

In this part of the syllabus, candidates are expected to identify the objectives of working capital management in terms of liquidity and profitability. In one part-question, asking for a comment on the working capital performance of a company, most candidates could make a suitable comment on the length of the working capital cycle compared to an appropriate benchmark, but developing this by considering the profitability implications of needing to finance such a cycle was not seen very often.

Management of inventories, accounts receivable, accounts payable and cash

This part of the Financial Management syllabus tests the candidates’ abilities in respect of the management of various areas of working capital. Recent questions in this area include Oscar Co (September/December 2018), Pangli Co (March/June 2017) and Nesud Co (September 2016)

One syllabus outcome requires candidates to discuss, apply and evaluate the use of relevant techniques in managing accounts receivable, including offering early settlement discounts. Whilst this was often done well in a question at this diet, common errors included:

- Applying revised trade receivables days to trade receivables rather than to income;
- Not calculating the reduction in finance cost, despite having calculated the reduction in trade receivables;
- Incorrectly basing the cost of discounts on trade receivables rather than on income.

A relatively straightforward mark was available, but not always gained, for a judgement as to whether the discount should be offered.

Also at this diet, candidates were asked to explain the various reasons for holding cash, and to discuss and apply the use of relevant techniques in managing cash, including preparing cash flow forecasts to determine future cash flows and cash balances.

In terms of the latter, namely preparing a cash flow forecast, responses from candidates were of good quality and attracted high marks. Where high marks were not scored it was typically for the following reasons:

- A lack of awareness as to how to present a cash flow forecast shown, for example, by not calculating the closing balances for each month despite having calculated the net cash inflow or outflow;
- Incorrectly including depreciation as a cash flow;
- Ignoring the timing information provided in respect of the cash flows;
- Classifying cash flows incorrectly e.g. a receipt of a loan incorrectly classed as a cash outflow;
- Failing to recognise that the company began the period with an overdraft.

Following the preparation of a cash flow forecast, candidates were then asked to discuss ways in which the company's cash management could be improved. Many answers did not focus directly upon cash management and instead focused upon accounts receivables management (factoring, early settlement discount, credit checks etc) or trade payables management. This was a classic case of candidates answering the question that they would have liked to have seen and not the one facing them.

Better responses were structured around the syllabus areas of the benefits of centralised treasury management and cash control (for a company with multiple subsidiaries), cash management models, such as the Baumol model and the Miller-Orr model and investing short-term (for a company with short-term cash surpluses).

Responding to a requirement asking for a critical discussion of the reasons for holding cash, many candidates had the basic ideas underpinning the transactionary, precautionary and speculative motives for holding cash, although the correct Financial Management terminology was not always used. Some candidates, however, used a chatty, scattergun approach rather than demonstrating knowledge and understanding of Financial Management theory relating to cash management, with the consequence that the critical discussion required to gain most of the marks was lacking. Short bullet points do not comprise a critical discussion and are unlikely to score many, if any, marks.

Determining working capital needs and funding strategies

One part-question at this diet required candidates to calculate the length of the working capital cycle for a company. This was usually done well with the odd errors including using sales and not cost of sales in the trade payables days' calculation and the occasional instance of calculating the working capital cycle of the benchmark company and not the company being directly considered. See past question Pangli Co for further guidance

Questions in this syllabus area often require in depth discussion and previous Examiner's Reports have commented upon this. On this occasion a requirement to critically discuss the key factors in determining working capital funding strategies needed a reasonably detailed discussion about the distinction between permanent and fluctuating current assets, the relative cost and risk of short term and long-term finance, the matching principle, the relative costs and benefits of aggressive, conservative and matching funding policies and management attitudes to risk, all as in the Financial Management syllabus.

Disappointingly, candidates' answers often did not do this and hence failed to gain enough of the marks on offer. Specifically, some answers:

- Were far too brief for the marks on offer;
- Offered only bullet points, although the requirement was for a critical discussion;
- Did not consider or explain the analysis of current assets into fluctuating and permanent current assets;
- Did not attempt, or only briefly attempted, to consider the relative risk and cost of short-term and long-term finance, despite being specifically asked to do this in the requirement;
- Did not consider a matching or moderate policy

Furthermore, some answers talked about working capital management in general terms or about sources of funds rather than working capital financing policies, once again displaying either a lack of detailed knowledge and/or answering the question that the candidate wanted rather than the one that was actually asked.

Investment appraisal techniques and allowing for inflation and taxation in DCF

As has previously been the case candidates tend to score well on questions requiring the computation of a net present value (NPV), but must take care to address fully the second part of any requirement, typically asking for a comment on financial acceptability or on the choice of discount rate.

Where errors were seen, then they were in the following areas:

- Relevant cash flows, such as not adding back depreciation to operating profits to arrive at annual cash flows or the omission of, the mistiming of, or failure to inflate, a residual value;
- Inflation, such as applying just one year's inflation to cash flows arising more than one year in the future or in some cases deflating, rather than inflating, future cash flows;
- Working capital, where candidates need to recognise that there are three distinct parts which need to be dealt with and correctly timed, namely the initial investment in working capital, the incremental investment in working capital usually arising from the growth of the value of the revenue or operating cash flows, and the recovery of the working capital when the project ends;
- Tax, such as mistiming tax liabilities, including tax allowable depreciation (TAD) benefits but also subtracting TAD from taxable cash flow to give taxable profit, failing to recognise or correctly calculate the final year TAD, taxing cash flows that included working capital figures and/or the residual value of the asset and not displaying an understanding of the difference between computing TAD on a straight line as opposed to a reducing balance basis.

Some responses did not recognise that an approach where tax effects are ignored required a before-tax cost of capital rather than the after-tax cost of capital required when tax effects are included.

Future candidates are advised to study the following questions for further guidance in this area: Pelta Co (September/December 2017), Vyxyn Co part (b) (March/June 2017) and Hebac Co part (a) (September 2016).

Another question at this diet had a requirement involving a discussion of the usefulness of the internal rate of return as an investment appraisal method. Once again the standard of answers was very disappointing and indicated a lack of preparation in this part of the FM syllabus. Some answers simply explained the IRR investment appraisal method with a description about the procedure for its calculation, without undertaking a critical discussion of its usefulness as an investment appraisal method and hence did not answer the requirement of the question, whilst other answers were too brief for the marks on offer.

Adjusting for risk and uncertainty in investment appraisal

In this area of the syllabus, candidates were tested on their ability to discuss the usefulness of probability analysis in assisting investment decisions. Overall, this was not done well, with many responses far too brief for the marks on offer.

A good starting point for an answer to this type of question would be to explain the difference between risk and uncertainty in the context of investment appraisal, but this was done quite infrequently. The question Vyxyn Co (March/June 2017), has a suggested solution to part (a) that gives clear guidance as to the type of response which would attract these initial marks.

Good answers should then develop into a critical discussion of the usefulness of probability analysis. Whilst many mentioned the subjectivity of probabilities as a disadvantage, few could articulate how probability analysis can be used to assess the level of risk in a project. Weaker responses often confused probability analysis with the probability index.

Candidates were also asked a part-question in relation to being able to apply and discuss other techniques of adjusting for risk and uncertainty in investment appraisal, in this instance how risk-adjusted discount rates can improve investment decisions. Good answers displayed a clear understanding of the nature of business risk and financial risk and also included discussion about how to deal with them.

Disappointingly, the overall standard of answers was not good and, once again, indicated a lack of preparation in this part of the FM syllabus. Some answers discussed risk-adjusted cash flows, when the question requirement was for a discussion of risk-adjusted discount rates. Other answers simply adopted a generic chatty style to a discussion about risk or, in some cases, just rephrased the question as their answer. Future candidates are advised to study parts (c) of Vyxyn Co (March/June 2017) and Copper Co (March/June 2018) for guidance on risk-adjusted discount rates.

Specific investment decisions

Within this sub section of the Investment Appraisal area of the syllabus, it is expected that candidates are able to evaluate leasing and borrowing to buy using the before- and after-tax costs of debt, evaluate investment decisions under single-period capital rationing via the calculation of profitability indexes for divisible investment projects and to discuss the reasons for capital rationing. Question at this diet tested candidates in this part of the syllabus.

In a question requiring a ‘leasing versus borrowing to purchase’ choice, there were very few completely correct answers. Instead, there were a range of fundamental errors made, most of which had been commented upon in September’s Examiner’s Report, and hence many of the following comments have been seen before.

There were too many answers that were not structured or formatted correctly, largely because candidates were unable to recognise that a discounted cash flow approach is needed to be able to compare the two options. Taking out a bank loan to be able to meet the cost of buying a new machine does not mean that a loan repayment schedule should be presented

The two most fundamental errors made were:

- The use of the WACC to discount cash flows instead of the project specific cost of capital presented in the question, namely in the form of the percentage cost of the bank loan;
- The inclusion of interest payments within the computation of net cash flow. The correct cost of capital to be used to discount the cash flows incorporates the cost of the debt finance being used, and hence the inclusion of interest payments in the cash flow schedule means that such interest payments are effectively being double counted.

Further errors by candidates included:

- Not showing all of their workings;
- Confusing tax relief on lease payments with tax allowable depreciation available for the purchase option;
- Incorrectly spreading the cost of the bank loan over five years;
- Incorrectly taxing the residual value;
- Not using a discounted cash flow approach at all;
- Failure to place the lease rental payments at the start of each year;
- Incorrectly including the purchase cost and/or the residual value of the machine in the evaluation of leasing as a source of finance;
- Failure to justify their conclusion as to whether to lease or buy.

Additionally, when discount and annuity factors are provided to three decimal places, candidates should not round these values down to fewer decimal places or simply ignore the figure in the third decimal place. Annuity factors were often not calculated or used well.

Future candidates are advised to study the question Melanie Co (September/December 2018) for further guidance in this area.

When candidates were asked to use profitability indices in order to compute an optimum combination of products, computations were often not supported by a comment, which was asked for, and a justification. Some candidates seemed to ignore the fact that the investments were divisible, leading to the presentation of various alternative bundles based upon indivisible investments, and others misunderstood the nature of complimentary products.

In a question where candidates were asked to discuss the reasons behind both hard and soft capital rationing, there were some very good answers. Where responses did not gain the marks on offer, it was often due to a lack of awareness of the nature of hard and soft capital rationing, the reasons advanced for capital rationing were often brief or in bullet point form, whilst some responses discussed ways of solving the problem of capital rationing, but this was not required by the question.

Sources of and raising business finance

As a part of this syllabus area, candidates are expected to identify and discuss internal sources of finance, including the theoretical approaches to, and the practical influences on, the dividend decision, including legal constraints, liquidity, shareholding expectations and alternatives to cash dividends.

Good responses to a requirement asking why dividends may be limited discussed the reasons why retained earnings can be a preferred form of funding, whilst weaker answers did not discuss this notion in enough detail, with some simply rephrasing the question.

Responding to a suggestion that shareholders may be unhappy with lower dividends, good answers correctly commented on the need for some shareholders to receive dividend income and discussed the signalling effect of dividends. Weaker responses were quite general and needed to be developed more for additional marks to be gained.

Sources of finance and their relative costs

At this diet, one question involved the assessment of the impact of sources of finance on financial position, financial risk and shareholder wealth using appropriate measures, including ratio analysis using operational and financial gearing and the interest coverage ratio.

In respect of a requirement about operational gearing, many candidates calculated contribution incorrectly by failing to deduct all of the variable costs from revenue. Other errors in computing operational gearing included candidates who used their own definition of operational gearing, instead of the definition given in the question and who used profit before tax and not profit before interest and tax as given in the question.

Discussions about the views of external finance providers on operational gearing were scarce, with the comments required here either simply not presented or being irrelevant to the discussion e.g. confusion with financial gearing. This displayed a clear lack of knowledge of what the figures meant.

With regards to financial gearing, which was a later part of the question, in general most candidates were able to work out debt/equity and interest cover ratios, although ratios were inverted in a number of cases. Further errors included counting current liabilities as debt in calculating the debt/equity ratio, which is an error of principle.

In a similar vein to the comments about operational gearing above, good discussions about the views of external finance providers on financial gearing were quite scarce, but responses were slightly better than those for operational gearing.

Finance for small and medium sized entities (SMEs)

One part of this syllabus area involves candidates being able to describe the nature of the financing problem for small businesses. Good answers here were structured around the lack of history of SMEs in terms of profitability and/or credit records and also around the lack of security, such as an asset base, being a problem for SMEs. Other discussions used the funding gap and the maturity gap as a basis for an answer.

Weaker responses talked in general terms about difficulties in raising finance and not those difficulties faced specifically by SMEs, whilst others drifted away from the requirement with irrelevant discussions about, for example, capital rationing or how to raise finance.

To reiterate, a discussion of problems such as these requires more than a few, brief, listed points. Instead, and as is the case with all discursive type requirements in section C, what is required is an in-depth discussion involving complete, fully explained concepts using the correct Financial Management terminology.

Spreadsheet and Word Processing Technique

There continues to be an improvement in the extent to which spreadsheet functionality is being used well by CBE candidates. There were many instances where numerical responses were beautifully presented, professionally constructed and clearly labelled, with workings showing the build-up to final figures.

By contrast, candidates need to use care and precision in spreadsheets. It is good practice for candidates' work to be presented in a way that can be easily read and understood i.e. it should be clearly visible without the need for markers to manipulate the cell. Furthermore, where text is entered into a cell, the presentation should be as good as it would be in a professional work environment.

Cell formulae can, of course, be used to perform computations, but care must continue to be taken in entering formulae in the spreadsheet. For instance, when using the sum formula, the figures need to be added correctly. Errors here include adding all items when some figures should be deducted and also the summation of too many or too few items yielding incorrect totals and sub totals.

Markers can see the formula in a cell and hence apply the own-figure rule where appropriate. However, the own-figure rule cannot be applied to figures, rather than formulae, placed in spreadsheet cells with no supporting calculations.

The same principles apply to calculations in computer based examinations as in previous paper based ones. Workings should be shown in order that 'method marks' to be awarded and workings should be shown where markers can see them, in other words close to the main schedule being presented. It is not acceptable for workings to be placed in spreadsheet rows and columns far away from the main body of the candidate's answer.

In word processed answers, candidates should respond to the requirements here as they would be expected to do in the professional work environment via continuous prose and appropriate Financial Management terminology. The use of a computer does not remove candidates' responsibility to prepare answers in this manner.

Furthermore, CBE candidates should continue to be guided by the provision of the designated spaces for some discursive responses. For example, requirements asking to 'Discuss three ways' will, in the CBE environment, ask candidates to respond in three separate 'boxes'. This should help candidates focus on providing the correct number of 'ways' or whatever is being asked for.

Guidance and Learning Support resources to help you succeed in your exam

Preparing for the Financial Management exam can appear challenging but there are many resources available to help you. You should refer to these throughout your studies.

You should make sure you have made use of all of the resources found under technical articles for FM – these include technical articles, study support videos and exam technique resources – all developed with you in mind.

Additionally Examiner's Reports are available after each exam session. These are a valuable tool for understanding the exam, avoiding common pitfalls and developing exam technique. Work through the FM resource 'A guide to using the examiner's report' if you are sitting the exam for the first time or 'A guide to reflection' if you are retaking your exam. Both of these interactive tools can be found under the technical articles page for FM. These have been developed to sit alongside the self-study guide and the retake guide respectively, and provide you with further pointers for using the examiner's reports for previous sittings.

It is essential to practise as many exam standard questions as you can in the lead up to your exam. We strongly recommend that you use an up to date question and answer bank from one of our Approved Content Providers and also to work through the most recent past exams on our website. However, please note if you are using the past exams that these are not updated for syllabus changes or changes to the exam format since September 2016 and so should be used with caution – so check the latest syllabus and study guide for changes.

It is essential that you have a good understanding of the verbs typically used in ACCA FM exam questions. Take a look at the article What is the examiner asking? which sets out some of the most commonly used verbs, and ensure that you understand how these are used in the FM questions.