Examiner's report
Financial Management (FM)
June 2019

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 primarily offered in a computer-based (CBE) format. The CBE exam delivery model means that candidates do not all receive the same set of questions. In this report, the examining team share observations from the marking process, highlight strengths and weaknesses in candidates' performance, and offer constructive advice for future candidates.

- 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, we hope that you will study the content of this report carefully as part of your preparation for your next attempt.

Performance in the June 2019 examination diet was generally satisfactory and there were some very good individual performances. That said, it is disappointing to see that once again some candidates were inadequately prepared for the Financial Management examination. As has been said 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 particularly true of Section C of this examination, where candidates are expected to demonstrate in-depth knowledge through performing detailed calculations and discussing and explaining Financial Management concepts as applied to the given scenarios. In order to do this, candidates must prepare well for the examination through dedicated study and question practice and be ready to apply this knowledge to the Section C questions.

In general, candidates were well prepared in some areas of the syllabus, particularly those that have featured regularly such as performing a discounted cash flow appraisal of an investment project. However, candidates were less prepared to demonstrate knowledge in other areas of the syllabus such as 'Determining working capital needs and funding strategies' and 'Estimating the cost of capital'.

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 money market instruments.

Example 2 is a question testing knowledge of working capital.

Example 1

A listed company is to enter into a sale and repurchase agreement on the money market.

The company has agreed to sell $10m of treasury bills for $9.6m and will buy them back in 50 days' time for $9.65m.

Assume a 365-day year.

What is the implicit annual interest rate in this transaction (to the nearest 0.01%)?

The correct answer is 3.80%

The calculation is as follows
Increase in value = $9.65m – $9.6m = $0.05m
As a percentage of the original value = $0.05m/$9.6m = 0.52%
Annualising this value = 0.52% x 365/50 = 3.80%.

Example 2

Increasing which TWO of the following would be associated with the financial objective of shareholder wealth maximisation?

A Share price
B Dividend payment
C Reported profit
D Earnings per share
E Weighted average cost of capital

The correct answer is A and B.

The sources of shareholder wealth are share prices and dividend payments, so increasing both of these would be associated with the objective of shareholder wealth maximisation.

Section B

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

One question which caused a problem required candidates to identify the effects on the company of changing the working capital financing policy from aggressive to matching.

A number of candidates were unable to correctly forecast a quick ratio for a company, because they did not factor sales revenue growth into their revised receivables figure.

A further question, testing whether given actions would reduce the cash operating cycle led to many incorrect answers, with a significant number of students thinking that paying suppliers earlier would reduce the cycle.

Business finance

A number of candidates struggled with a question on portfolio theory and its relationship with the capital asset pricing model and in particular, believing that portfolio diversification reduces systematic risk.

Similarly to this, in a different question a significant number of candidates believed that the capital asset pricing model assumes that investors require a premium for unsystematic risk.

Business valuation

One issue noted from this session is that candidates typically struggle more with questions about the uses and limitations of the valuation models, rather than applying the models to produce valuation.

An important point for future candidates to note is that if a question asks for the market value of loan notes, but not the total value, then the answer must be given as the market value for one nominal unit of the loan notes. This will be given in the question and is typically $100.

A number of students also struggled to correctly identify what happens under various forms of market efficiency.

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 options and futures contracts.

A further question involved calculating a future spot rate using purchasing power parity, but many students did not time apportion the annual inflation rates when calculating their answer.

Many candidates struggled with a question which required them to understand the relationships under the four-way equivalence model, with a significant number of candidates showing that they did not understand the relationship expressed by the International Fisher effect.

<u>Section C</u>

This section of the examination is where candidates are required to have deeper knowledge of topics. While there were many reasonable attempts at most parts of questions, especially numerically-based requirements, there were once again some candidates whose discursive question responses displayed little or no knowledge of Financial Management.

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

As in previous diets, some candidates failed to score marks where a recommendation and/or a comment was required on calculated figures. For instance, if asked whether a company should undertake an investment project, it is not enough for a candidate to simply say ‘Good project so invest’, without justifying the decision. Saying ‘the project is financially acceptable as it has a positive NPV’ offers a suitable justification.

Finally, in terms of general comments about Section C, it must be emphasised that if asked to discuss factors/benefits/reasons/merits, it is not enough to simply list a few words. ACCA’s guidance is 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”.

In this diet, candidates were presented with Section C questions drawn mainly from the following areas of the Financial Management syllabus:

- 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 DCF (discounted cash flow);
- specific investment decisions;
- sources of and raising business finance;
- estimating the cost of capital.

Management of inventories, accounts receivable, accounts payable and cash

This part of the FM syllabus includes outcomes relating to the use of relevant techniques in managing inventory, including the Economic Order Quantity (EOQ).

A question on this topic was answered well by many candidates. Errors that prevented some candidates gaining full marks included not recognising the need to compare total cost (the sum of ordering cost and holding cost) under the current and EOQ systems. Some candidates were also not aware that total holding cost is based on average inventory, or made mistakes in entering values into the EOQ formula, provided in the exam formulae sheet. Although the question required a calculation of the effect on inventory management cost of adopting an EOQ approach, some answers failed to provide this.

It should be noted when a requirement is solely to 'calculate': there is no credit for discussion, for example discussion of the effect of adopting an EOQ approach, or discussion of the features of cash management models.

This part of the FM syllabus also includes outcomes relating to the use of relevant techniques in managing accounts receivable including assessing creditworthiness, collecting amounts owing, offering early settlement discounts, and using factoring.

One question in this diet required discussion of one source of information used in assessing creditworthiness. While some answers were too brief for the marks available or failed to discuss assessing creditworthiness, many candidates gave good answers. Some answers wasted valuable examination time by discussing more than one source of information and, as has been emphasised in previous Examiner Reports, it is essential that candidates ensure that their answers address the question requirement.

A similar question in this diet required discussion of one method of collecting amounts owing and again, while many candidates gave good answers, some candidates wasted valuable time by discussing more than one method. As has already been emphasised, candidates must ensure that their answers address the question requirement. Discussing additional methods did not gain additional marks.

In this exam candidates were asked to calculate the net cost or benefit of introducing an early settlement discount and there were many good answers. Some candidates lost marks by calculating revised receivables incorrectly, or by leaving out the cost of the discount, or by not reconciling 'before and after' positions to quantify net cost or benefit. In questions requiring an assessment of a change in credit policy, candidates must use a clear, planned approach. The two commonly-adopted approaches use either a ‘benefits versus costs’ format or a ‘before and after’ format. Candidates must not mix these approaches up.

Candidates were also asked to evaluate a scheme offered by a factor. Just like evaluating an early settlement discount, this called for calculating the net cost or benefit of a change in policy and the comment made earlier about the need for a clear, planned approach apply here also. Many candidates gave good answers here and gained good marks. Some candidates lost marks by ignoring the contribution margin in calculating lost contribution, or using lost sales revenue instead of lost contribution.

A question asking candidates to discuss the advantages and disadvantages of factoring was often answered well. Weaker answers offered only advantages or only disadvantages when both were required: some answers were too brief for the marks available.

In general, candidates must take care in presenting computational answers such as this in the CBE spreadsheet environment. All entries must be carefully labelled. All workings must be shown. The extremes of using excessive rounding and using many decimal places should be avoided. If text is entered in the spreadsheet, it must not extend beyond the edge of the screen. Answers must be carefully formatted so that they can easily be read and understood. Presentation should be of a professional standard.

Determining working capital needs and funding strategies

The detailed outcomes in this part of the Financial Management syllabus include an understanding of the key factors determining working capital funding strategies, including the relative cost and risk of short-term and long-term finance, and the relative costs and benefits of aggressive and conservative funding policies.

One question requiring a discussion of the relative risk and cost of short-term and long-term finance in relation to funding working capital was often answered well. However, some candidates discussed different kinds of finance rather than relative risk and cost, while some discussed risk and cost in general terms rather than in relative terms. Some answers discussed different kinds of working capital funding policy rather than relative risk and cost, or failed to address the question entirely, discussing topics such as overcapitalisation, overtrading and pecking order. Some answers were very brief for the marks available.

Candidates must understand and be able to apply relevant accounting ratios and a question in this diet required candidates to use a range of identified accounting ratios in relation to recommending whether a company should follow a conservative or an aggressive approach to funding its working capital. The question required candidates to consider profitability, financial risk, solvency and liquidity, thereby suggesting a structure that candidates could adopt in their answers. The question also required answers to use calculations, specifying that half of the available marks were for calculation.

While many answers gained good marks on this question, some unprepared candidates found it challenging. Although the question required calculations, some answers offered a general discussion of, for example, the company’s working capital position, or improving its working capital management. Some answers, ignoring the requirement to assess adopting a conservative or an aggressive funding policy, compared the company's current position with the average ratios of similar companies. Other errors that led to some candidates receiving less than full marks included:

- not making the required comparison between current, aggressive and conservative funding policies;
- ignoring the need for profit before tax and net current asset calculations;
- making errors in calculating interest payments and accounting ratios;
- using other given rates as the overdraft interest rate;
- omitting the benefit of investing surplus cash under the conservative funding policy;
- failing to consider profitability, financial risk, solvency and liquidity;
- discussing working capital investment policy instead of funding policy;
- not providing the required recommendation.

Investment appraisal techniques and allowing for inflation and taxation in discounted cash flow (DCF)

As in previous diets, candidates usually did well on questions requiring investment appraisal using net present value (NPV). Where errors were found, these echoed errors seen in previous examination diets and were in the following areas:

- Errors relating to inflation, such as inflating each year's cash flows by one year only: or using an inflation rate different to the one given in the question; or using a constant value per unit as the basis for inflating values per unit, when the forecast value per unit varied from year to year; or in some cases ignoring inflation completely.
- Errors relating to cash flows, such as failing to add back sunk costs, apportioned overhead costs and accounting depreciation: omitting residual value; and using annual fixed costs as costs per unit.
- Errors relating to taxation, 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; not appreciating the difference between TAD on a straight line basis and TAD on a reducing balance basis; and ignoring the tax effect of a negative cashflow in year 1, when the scenario states that the company can absorb any initial losses.
- Errors relating to working capital, where three distinct elements must be addressed and correctly timed: initial investment in working capital, incremental investment in working capital, and working capital recovery at the end of a project.
- Timing errors, such as locating initial investment at the end of year 1, or deferring taxation-related cash flows when the question states that tax is paid at the end of the year to which it relates.
- Errors relating to cost of capital, such discounting by the general rate of inflation; or calculating a different nominal cost of capital to the one provided in the question; or using the nominal cost of capital as the real cost of capital and vice versa.
- Failing to comment on the financial acceptability of an investment project.

Although investment appraisal calculations tend to be done well, improvement in discussion is needed. The Financial Management syllabus requires candidates to be able to discuss the usefulness of an investment appraisal method, discuss the superiority of DCF methods over non-DCF methods, and to discuss the relative merits of NPV and IRR.

One question in this examination diet required calculation of simple payback and answers were of variable quality, primarily because of uncertainty as which cash flows to use: some candidates incorrectly used before-tax cash flows rather than after-tax cash flows, while others incorrectly used discounted after-tax cash flows when the requirement was for calculation of simple payback. Some candidates were unable to calculate the fractional year.

In commenting on financial acceptability, most candidates can justify acceptability with respect to NPV, but comments on financial acceptability with respect to other methods are more mixed in quality. Where two investment appraisal methods offer conflicting advice regarding acceptability, candidates should have the knowledge to discuss that conflict.

Another question asked for a discussion of the usefulness of ROCE and there were some good responses. Weaker answers could not define ROCE, or said it considered the time value of money, or did not address the technique's usefulness, as required by the question.

Still in the area of discussing investment appraisal techniques, one question asked for a discussion of advantages of using NPV rather than IRR in investment appraisal. A similar question can be found in Melanie Co, one of the September-December 2018 Sample Questions. In general, answers to this question were disappointing for the following reasons:

- comments on NPV were often brief and vague;
- many answers failed to adopt a comparative approach to IRR;
- many answers were too brief for the marks on offer;
- rather than discussion, many answers offered brief statements;
- some answers offered more than the required number of advantages of NPV over IRR;
- some answers offered fewer than the required number of advantages of NPV over IRR.

One question required an explanation of the real terms and nominal terms methods of NPV analysis and the circumstances under which each might be used. Many candidates struggled to gain good marks on this question, for the following reasons:

- not explaining the meanings of 'real-terms method' and 'nominal terms method';
- not describing the conditions under which each method might be used;
- believing incorrectly that the real-terms method ignored inflation;
- offering answers that were too brief for the marks on offer;

Specific investment decisions

This part of the Financial Management syllabus requires candidates to be able to evaluate leasing and borrowing to buy using the before- and after-tax costs of debt, and to evaluate investment decisions under single-period capital rationing, including calculating profitability indexes for divisible investment projects, and to discuss the reasons for capital rationing.

One question required candidates to evaluate a ‘leasing versus borrowing to buy’ choice and there were some good answers. A similar question can be found in Melanie Co, one of the September-December 2018 Sample Questions. Errors included:

- including interest payments in calculating net cash flow;
- omitting tax savings on emissions tax;
- showing residual value as an outflow;
- calculating TAD on a 25% reducing balance basis;
- discounting cash flows with the WACC rather than the after-tax cost of borrowing;
- mistiming lease rental payments;
- omitting tax savings on lease rental payments;

Candidates were required by another question to determine the optimal investment plan and resulting NPV for a set of investments. Many answers calculated correctly the profitability index of each divisible investment, although some did not offer a ranking. As in previous diets, some answers lacked understanding of the term ‘mutually exclusive’ and included two such projects in their optimal investment plan. Some answers lacked understanding of the term ‘divisible’ and after ranking projects by profitability index, calculated the NPV of different combinations of projects to determine the optimum combination, instead of using ranking by profitability index to determine the investment plan.

A related question that asked candidates to discuss reasons for hard capital rationing produced many answers of good quality. However, some candidates were unsure of the difference between hard and soft capital rationing, while others did not relate their answers to the company in the scenario, though the question required this. Some answers were vague, for example citing ‘political factors’ or ‘economic factors’ as reasons for capital rationing without further explanation. In general, many answers were very brief for the marks offered.

Sources of and raising business finance

This part of the Financial Management syllabus requires candidates to be able to identify and discuss lease finance and methods of raising long-term Islamic finance including mudaraba (equity finance) and musharaka (venture capital).

One question asked for a discussion of reasons, other than after-tax cost advantages, why a company might prefer to lease rather than buy an asset and answers were of variable quality. One problem here was answers making generic comments that were not backed up by Financial Management knowledge, such as ‘leasing is cheaper than borrowing’. Apart from making very brief answers, other errors included:

- not recognising that the distinction between operating leases and finance leases was basically removed by IFRS 16, *Leases*;
- not linking leasing and borrowing in the discussion.

Another question required candidates to discuss sources of Islamic finance to satisfy a need for equity or similar finance and many answers gained reasonable marks here. Some candidates gained marks from general comments relating to the forbidding of riba, or the forbidding of business in proscribed areas, or the need to share profit and loss. Some candidates were unsure of the names of Islamic finance sources, while making reasonable attempts to outline the natures of muduraba and musharaka. Murabaha, ijara and sukuk were excluded from the discussion because of their non-equity nature. Common errors included:

- considering Islamic finance sources other than Mudaraba and Musharaka, such as Ijara and Sukuk;
- confusing descriptions of sources of Islamic finance.

Estimating the cost of capital

This part of the Financial Management syllabus includes estimating the cost of equity using the dividend growth model (DGM) and the capital asset pricing model (CAPM) and calculating the weighted average cost of capital (WACC).

One question required candidates to calculate the historic dividend growth rate and the cost of equity using the DGM and most answers calculated both correctly. Errors included:

- basing the dividend growth calculation on an incorrect number of years;
- including total dividend in the numerator but share price in the denominator;
- not using the most recent dividend in the DGM calculation;
- subtracting rather than adding the growth rate when calculating cost of equity.

Candidates were also required to calculate the cost of equity using the CAPM. Many answers either ignored the need to regear the asset beta provided or were unable to regear correctly. Errors included:

- using the asset beta provided in the CAPM calculation and therefore ignoring the need to calculate a regeared equity beta;
- using sector average gearing in the regearing calculation when the company’s gearing was needed to calculate the company’s equity beta;
- failing to use the after-tax value of debt in the regearing calculation;
- ungearing and then regearing the asset beta;
- using the market return as the risk premium;
- performing arithmetic calculations in the incorrect order.

Candidates were also required to discuss the relative merits of the DGM and the CAPM. In general, answers lacked quality and failed to score many marks because they did not focus on ‘relative merits’, offering instead short descriptive points about one model, then the other, often describing problems rather than merits, with little or no attempt to link the statements being made. Discussion was often weak and there was poor application of the scenario. In general, there were two common errors in answering this question:

- not appreciating the requirement to discuss the ‘relative merits’ of the two methods;

- failing to respond to the requirement to relate the answer to the company and so making no attempt to use any of the information in the scenario: as this report has said before, candidates must use the scenario and apply theory to the specifics of the case in question, especially when explicitly required to do this.

One short question required candidates to calculate the WACC of a company and there were many good attempts at this question. Common errors included:

- calculating the cost of debt from a perpetuity instead of using an IRR calculation;
- ignoring tax in calculating the cost of debt;
- using the after-tax interest payment as the cost of debt in the WACC, thereby ignoring the need to calculate the cost of capital of redeemable debt;
- mixing per loan note interest payments with total market value and redemption value in an interpolation calculation;
- arithmetic errors in the interpolation (or extrapolation) of the IRR;
- making errors when using the spreadsheet IRR function;
- not using a given cost of equity as required by the question;
- using sector gearing to calculate the company's WACC instead of the company's gearing;
- arithmetic errors in calculating WACC, for example calculating a WACC that is higher than the highest cost of capital in the calculation.

Spreadsheet and Word Processing Technique

The extent to which spreadsheet functionality is being used well by CBE candidates continues to improve. There were many well-presented numerical responses, professionally constructed and clearly labelled, with workings showing how final figures were built up.

However, candidates need to use care and precision in spreadsheets. It is essential for 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 cells or column width. Furthermore, where text is put into cells, the presentation should be as good as it would be in a professional work environment. Markers should not need follow text across a large distance in screen terms in order to read it.

Spreadsheet formulae can be used in calculations, but care must be taken in entering formulae in the cell. For instance, when using the sum formula, the cell range needs to be specified correctly. Errors that have been encountered here include adding all items when some figures should be deducted, and adding 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 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' can be awarded, and workings should be shown where markers can see them, in other words close to the main schedule being presented.

In word-processed answers, candidates should respond to the requirements here as they would be expected to do in a professional work environment, using continuous prose and relevant Financial Management terminology. Using a computer does not remove the candidates' responsibility to prepare answers in a professional manner.

CBE candidates should continue to be guided by the provision of designated spaces for some discursive responses. For example, a requirement 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' for whatever is being asked, so two 'ways' should not be placed in one 'box'.

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.