



Examiner's report

Financial Management (FM)

December 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 (FM) exam is a computer-based exam (CBE). 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, I hope that you will study the content of this report carefully as part of your preparation for your next attempt.

Section A

The objective test questions in Section A ensure a broad coverage of the syllabus, and so all areas of the syllabus need to be carefully studied, as all learning outcomes can be tested in this part of the examination. Candidates preparing for the examination are therefore advised to work through as many objective test questions as possible, reviewing carefully to see how correct answers are derived in areas where they experience difficulty.

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

Example 1 is numerical and tests working capital knowledge.

Example 2 is a question testing knowledge of the efficient markets hypothesis.

Example 1

For the coming year, a company has budgeted sales of \$2m per month, 80% of which will be on credit. It expects its accounts receivable payment period to be three months.

Forecast average inventory and average accounts payable for the coming year are \$10m and \$4m respectively.

What is the company's working capital requirement for the coming year (to one decimal place)?

The correct answer is \$10.8m

This question tests the use and understanding of the elements of working capital. The correct calculation is as follows

Accounts receivable = $(\$2m \times 12 \times 80\% \times 3/12) = \$4.8m$

Working capital requirement = $\$4.8m + \$10m - \$4m = \$10.8m$.

Example 2

The efficient markets hypothesis refers to the way in which the prices of traded financial securities reflect relevant information.

Which TWO of the following are true for a weak-form efficient market?

- A Share prices fully and fairly represent past information
- B Share prices fully and fairly represent private information
- C Share prices appear to follow a 'random walk'
- D The market does not provide enough information to make good buying and selling decisions

The correct answers are A and C.

Statements A and C are correct about weak-form efficient markets. Statement B is not true, this would only be true about a strong-form efficient market. Statement D is not true about any form of efficient market.

Section B

Similarly to Section A, questions can come from any area of the syllabus. This reinforces the earlier point about 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 a number is being requested in millions, there will be an 'm' after the number entry box. If a candidate puts a full answer of say 13000000 in the box rather than 13, this will be marked as incorrect.

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 were unable to assess whether given reasons why just in time manufacturing would be appropriate were applicable to the given scenario.

A further question, testing what impact a change in ordering costs would have in relation to the economic order quantity model led to many incorrect answers, with a significant number of candidates thinking that these higher ordering costs would lead to more orders being placed in an attempt to minimise costs.

Business finance

A number of candidates made errors on a question regarding possible sources of finance for SMEs and in particular, which sources would be applicable in a given situation. A further question which asked for reasons why an SME may have difficulty raising sufficient finance was also challenging to candidates.

Another issue, which has appeared in many different exam sessions, is that some candidates use cum dividend share prices in the dividend growth model, rather than ex dividend prices. Some candidates also do not correctly include growth in their calculations of the cost of equity, using the dividend growth model.

Business valuation

In addition to the example in Section A, it was also noted in Section B that candidates also struggled with questions testing the efficient markets hypothesis. In particular a number of answers stated that it is possible to gain abnormal returns using insider information in a strong form efficient market.

One question highlighted that a significant number of candidates appeared to be unsure of the process for valuing a company's equity using discounted cash flows.

A number of candidates also struggled to correctly identify the future maintainable earnings to be applied to a given P/E ratio. This has been noted in past sessions as well, so it should be emphasised to future candidates that, where relevant, it is future maintainable earnings, rather than historic earnings which should be multiplied by the P/E ratio.

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 features of futures contracts compared with forward contracts.

A further question involved testing understanding of the four-way equivalence model. Future candidates should ensure they understand each of the relationships that make up this model.

In a further question, many candidates were unclear on how asset and liability management could be used to hedge foreign currency transactions.

Section C

In respect of all questions in section C, it is important that candidates read the scenario carefully and answer the requirements directly. Candidates writing 'all that they know about the topic' without answering the question will invariably score few marks.

Question requirements will often make reference to the company in the scenario, in which case candidates need to refer to the company's circumstances in order to maximise the marks that can be gained.

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

- Working capital management
- Investment appraisal
- Business finance

Working capital management

Where candidates identified the objectives of working capital management, and discussed the conflict between them, the discussions were often briefer than required for the marks on offer.

Whilst many candidates offered liquidity and profitability as the objectives, and were able to identify the relevant points about the trade-off between them, there needed to be more depth to the discussion such as explaining the lower returns on short-term securities and the increase in profitability as the investment period increases, as expressed by the normal yield curve and the term structure of interest rates.

Weaker answers talked about financing working capital when not asked for, rather than working capital's objectives. Furthermore, a list of points in this, or any other, syllabus area is unlikely to qualify as a discussion.

In a question where candidates were asked to explain and apply relevant accounting ratios, and to consider a potential overtrading situation, there were some good calculations performed in respect of working capital ratios, but there could have been more analysis of the other financial information provided such as year-on-year movements. In the required discussion, overtrading needed to be

explained better, the analysis of the calculated ratios needed to be more than simply stating that a figure had 'gone up' or 'gone down' without elaboration, and a logical conclusion based upon the preceding discussion should have been provided.

As has been stated in previous reports, candidates often seem to lack confidence in discussing their own figurework, but can be reassured that sensible, appropriate comments based upon their own figures will be awarded marks by the marker.

Crago Co (March/June 2016) and Pangli Co (March/June 2017) are recommended past questions

Also, a helpful article on working capital management can be found on the ACCA website:
<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f9/technical-articles/wcm.html>

The ability to prepare a cash flow forecast is a fundamental skill in Financial Management, and should be an area where candidates score high marks. Whilst some do just that, it is nonetheless surprising to see rather basic errors being made such as the incorrect timing of cash flows. Trading on credit usually brings about timing differences between a transaction and its cash flow; this is fundamental, as is the ability to apply inflation to the various elements of income and cost.

Good layout and examination technique is as important here as anywhere. Workings should be shown on the spreadsheet, ideally in a separate working area visible to the marker. When asked for a cash flow forecast for each month, it is necessary to show the month's opening balance, net cash flow and closing balance.

Also at this diet candidates were required to compare the alternative approaches to financing a company's working capital, including the conservative and aggressive approaches.

In order for higher levels of marks to be gained, a response needs to comprise an in-depth discussion, not only correctly defining the different approaches but explaining the greater security of the conservative approach to working capital financing compared to the lower cost of the aggressive approach.

Disappointingly, many answers confused the financing of working capital with other aspects of working capital such as the level of working capital, working capital management, working capital policies, or working capital objectives. Other responses simply did not understand the conservative and aggressive approaches to financing working capital, which suggested a lack of study of this syllabus area.

When discussing the cash operating cycle's relationship with working capital financing, responses tended to be vague and rarely went beyond an explanation of the cycle, instead of extending the discussion into the link to the financing needs.

Investment appraisal

When asked to undertake calculations using investment appraisal techniques, candidates scored good marks in general. The payback period is an example of this, but care must be taken to use the correct cash flows. It is only when asked to calculate the discounted payback period that the

present values of cash flows be used. Furthermore, spreadsheet functionality means that candidates can sometimes overcomplicate a routine computation.

In terms of the return on capital employed (accounting rate of return), the denominator of average investment was often computed correctly. Errors occurred mainly in computing the numerator of average profit. Too many responses simply used unadjusted cash flows or even the present values of cash flows. A fundamental principle is being tested here; a disappointing number of candidates made no effort to deduct depreciation.

As usual, candidates continued to score relatively well on questions requiring the computation of a net present value (NPV), but future candidates need to be fully aware that there are a variety of ways in which this section of the syllabus can be tested, and therefore should practice a wide range of past questions covering the range of syllabus learning outcomes.

The treatment of inflation remains an area where errors are seen. It is crucial for candidates to read the detailed information in the scenario as to whether the unit price and costs are given in nominal or real terms and as to the different annual inflation rates for each price or cost element. Where inflation is given as a '% per year', it is important to remember that cash flows arising more than one year in the future will need to incorporate inflation for each subsequent year.

Errors were also seen where candidates have not recognised that the selling price (and/or unit cost) information provided in the question is different for each year and therefore it is incorrect to use the year 1 selling price (and/or unit cost) as the basis of all inflated sales income (and/or variable costs).

Question scenarios need to be read carefully in terms of the timing of cash flows. A good example of this is where there are cash flows relating to taxation; questions always state whether tax is payable at the end of the year in which the liability arises, or if it is payable one year in arrears. Candidates should not 'hedge their bets' by placing tax-allowable depreciation (TAD) benefits 'in the year', but deferring tax payments by one year. The timing stated in the scenario applies to all tax related cash flows.

The cash flows relevant to working capital continue to cause difficulties in respect of a combination of issues such as the initial working capital, incremental working capital and the working capital recovered at the end of the project's life. Future candidates are advised to practice this technique.

Many of these issues have been well covered in this article on the ACCA website and it is recommended reading for future candidates.

<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f9/technical-articles/advanced-investment-appraisal.html>

A question which tested candidates' ability to apply and discuss the real-terms and nominal-terms approaches to investment appraisal created confusion amongst some candidates. Whilst there were some correct responses, at the other end of the scale some candidates simply did not know the difference between the two approaches.

Even where there was some knowledge in this area, there was often an inability to calculate real cash flows, with some candidates believing that a real terms approach ignores specific inflation.

Another incorrect response was to take the same (nominal) cash flows used in the prior part question and then simply to discount them at the real rate.

Future candidates are advised to study past question Pinks Co (March/June 2019) and this article on the ACCA website:

<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f9/technical-articles/inflation-investment-appraisal.html>

The calculation of the internal rate of return (IRR) continued to produce a wide variety of answers, ranging from perfectly correct responses to others where the IRR% presented was illogical in the context of the cash flows and net present value(s) already computed.

Care needs to be taken when using spreadsheet functions such as =IRR since such a function must be formulated properly, and the annual cash flows need to be set out on a year-by-year basis. Where the interpolation approach is used, the IRR computation needs to be performed with the correct arithmetic order of operations e.g. if $A/(B+C)$ is written as $A/B+C$, it effectively becomes $(A/B)+C$, and gives the incorrect answer.

Discussions around the suitability of investment appraisal techniques were generally performed well, but the question requirement must be addressed. The ability to discuss the relative merits of NPV and IRR is clearly a syllabus requirement, but this requires the ability to compare and contrast the methods, rather than to simply list the advantages and disadvantages of each method.

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

Candidates' responses, when asked to explain the difference between risk and uncertainty, should involve more than simply stating that the one is quantifiable and the other is not. Published question Vyxyx Co from March/June 2017 demonstrates this in part (a).

Also, whilst sensitivity analysis can often be explained by candidates, there was overall a very limited amount of the required critical discussion. Published question Hraxin Co from June 2015 exemplifies the point that a critical discussion needs to include the limitations of sensitivity analysis. As has been said before, a list of brief points, sometimes poorly expressed and with incorrect terminology, is not a discussion and will yield few marks.

Finally under the investment appraisal section of the syllabus, candidates were expected to be able to evaluate investment decisions under single period capital rationing. As stated often, it is so important to read the scenario fully and with attention to the details contained within it, as it contains vital information, for example, whether a project must definitely be undertaken or whether some projects cannot be done together.

As with all calculations in the examination, it is essential that candidates show all of their workings.

Where a divisible approach is required, project profitability indices should be calculated and displayed, as should the ranking of projects. The ranking of projects based upon the size of their NPVs is incorrect and will not lead to the optimum allocation of limited capital investment funds.

Candidates need to display how the optimal use of the limited funds and the total NPV has been calculated.

Likewise, under an indivisible approach, it is important to consider all feasible project combinations and the associated total NPV of each, before arriving at a conclusion regarding the optimum combination of projects.

Unfortunately, some candidates failed to recognise the different approaches needed and produced the same answer for both approaches.

A previous question for recommended study by future candidates is OAP Co (June 2014).

Business finance

Candidates were asked to calculate the weighted average cost of capital (WACC) using market value weightings. Despite this, some candidates used book values for equity and/or debt components.

Candidates need to take greater care in respect of arithmetic operations and spreadsheet functionality. Errors are seen too frequently in terms of the magnitude of some figures, such as mixing a cost of equity expressed as a percentage e.g. 12%, with a cost of debt expressed as a decimal e.g. 0.07. Also, candidates sometimes produce WACC percentages which are out of range. If, as above, the capital elements have costs of 12% and 7% respectively, then the WACC % must be between those values.

Greater care must be taken when using the spreadsheet functionality. All workings must be shown and candidates are encouraged to use the cells to do so. As said earlier, spreadsheet functions such as =IRR must be formulated properly, and the annual cash flows need to be set out on a year-by-year basis. This needs to be practised in advance of the examination.

In terms of the debt elements of the WACC, candidates need to recognise not only the tax-deductible nature of interest payments, but also at the appropriate point in the process, as well as the need for the cost of a bank loan to be expressed after-tax.

In terms of the equity element of the WACC, where use of the dividend growth model was required, common errors included the omission or incorrect use of the growth rate (including its expression as a percentage, with the rest of the formula being in decimal terms). Where CAPM was required to calculate the cost of equity, there was some confusion between the average return on the market and market risk premium, as well as errors in arithmetic functionality in the CAPM formula e.g. in $4 + (1.2 * 10)$, the multiplication must be performed firstly, $4 + 12 = 16$ (and NOT $5.2 * 10$).

Within the WACC calculation, the cost of a convertible loan note was reasonably well attempted, though some candidates overlooked (or incorrectly calculated) the conversion element, and failed to use the current market value of the loan note in the IRR computation. When discussing the reasons for a company to use a convertible loan note, candidates often discussed generic reasons for choosing debt as opposed to equity or described the convertible loan notes from the incorrect

viewpoint i.e. investors rather than the company. The need to add depth to each of the reasons was ignored, thus limiting the marks gained even by competent candidates.

Recommended past questions: Corfe Co (March/June 2019), Tufa Co (September/December 2017).

Responses to a requirement about the relationship between a company's average and marginal cost of capital were unsatisfactory, with few candidates recognising the arithmetic connection. A significant number of candidates produced a response to a question not asked, for example a discussion about whether the use of a WACC was appropriate, and how to arrive at a project specific cost of capital.

Finally in this syllabus area, when asked to critically discuss capital structure theories, a good proportion of candidates produced reasonable responses based upon the optimum capital structure debate, with the main theories (Traditional, Modigliani and Miller, Pecking Order) often stated. That said, some responses were far too brief and/or generic for the marks on offer, and there were only a few responses discussing market imperfections or static trade off theory.

Two articles covering this syllabus area can be found on the ACCA website here:

<https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f9/technical-articles/capm-1.html>

As stated in every previous Examiner's Report, there is room for improvement in the discussion parts of section C questions.

Spreadsheet and Word Processing Technique

Many candidates are now taking full advantage of the spreadsheet functionality that is available. There were many instances where numerical responses were well-presented, professionally constructed and clearly labelled, with workings showing how the final figures were computed.

However, candidates need to be continually mindful of the presentation of their work and whether it can be easily read and understood i.e. it should be clearly visible without the need for markers to manipulate the cell. It is recommended that where text is entered into a cell, the words should not disappear or scroll into non-visible screens. This would be good practice expected in the workplace.

Cell formulae should be used to perform computations, but, for example, correct use of the =SUM formula is still not as widespread as it should be. Greater care must to be taken in entering formulae in the spreadsheet, such as sub-totalling or totalling the correct rows within a column of figures or when the =IRR formula is used, as explained above.

Workings should be shown in order that 'method marks' can be awarded and workings should be shown where markers can see them. The so-called 'own-figure rule' cannot be applied to figures, rather than formulae, placed in spreadsheet cells with no supporting calculations.

In word processed answers, candidates should present their work here as they would be expected to do in the professional work environment. There are some candidates whose spelling and grammar are poor to the point that markers cannot understand exactly what is being said.

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.