Examiner's report

Financial Management (FM)
March 2020

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 a computer-based exam (CBE). 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 using 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 preparing 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 inventory management.

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

Example 1

The inventory ordering policy of ZAR Co is to order 100,000 units when the inventory level falls to 20,000 units. The cost of placing and processing an order is $200, while the cost of holding inventory is $0.50 per unit per year. Orders are received one week after being placed with the supplier. The production requirement for the next year (50 weeks) is 600,000 units.

What is the cost of ZAR Co's inventory ordering policy?

The correct answer is $30200

Ordering cost = $200 x (600,000/100,000) = $1,200 per year
Consumption during one week lead time = 600,000/50 = 12,000 units
Buffer inventory = re-order level less lead time usage = 20,000 – 12,000 = 8,000 units
Average inventory held during the year = 8,000 + (100,000/2) = 58,000 units
Holding cost = 58,000 x $0·50 = $29,000 per year
Total cost = ordering cost plus holding cost = $1,200 + $29,000 = $30,200 per year

Example 2

Which TWO of the following derivative instruments are characterised by a standard contract size?

A Forward contract
B Forward rate agreement
C Futures contract
D Swap
E Over-the-counter option
F Exchange tradable option

The correct answers are C and F.

Exchange tradable options and futures contracts are the instruments which have standard contract sizes. All of the other instruments can be tailored to the exact requirements of the hedge.

<u>Section B</u>

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 correctly calculate the cost effects of introducing accounts receivable factoring or offering an early settlement discount.

A further question, testing what impact given actions would have on a company's working capital position led to a significant number of incorrect answers, with many candidates believing that offering an early settlement discount would increase the length of the cash operating cycle.

Business finance

Many candidates made errors on a question regarding the dilution of earnings per share following an expansion financed by a rights issue, with candidates either not using the correct increase in earnings, or the correct revised number of shares.

Business valuation

one question which caused difficulties for candidates, required the calculation of an asset-based valuation on a replacement cost basis. It appears that candidates are not familiar with the method of how to perform such a calculation.

One question highlighted that a significant number of candidates appeared to be unsure what earnings yield represents and how it is calculated.

A number of candidates also struggled to correctly identify the impact which practical considerations can have on the valuation of shares.

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.

One question involved candidates needing to use forward contracts on both income and expenses in different currencies and therefore use different ends of the forward contract spreads provided. This appears to have caused difficulty for a significant number of candidates.

A number of candidates appeared to not know the features of a forward rate agreement. It also remains the case that some students are confused between forward exchange contracts and forward rate agreements.
A further question involved comparing a lead payment against a forward contract. For the comparison to be valid the cost comparison needs to be made at the same point in the future and not comparing the cost of a lead payment now against a forward exchange contract payment which is, say, six months in the future.

In a further question, many candidates did not correctly time apportion their money market hedging calculations.

Section C

It is essential in section C that candidates read the scenarios carefully and answer the requirements directly. Candidates writing all that they know about a topic without answering the question will invariably score few marks.

Question requirements frequently refer to the company that forms part of the scenario, in which case candidates must refer to the company in wring their answers in order to maximise the marks awarded.

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 discussed effects of a business expansion on working capital investment policy and working capital financing policy, discussions were often much briefer than needed for the marks on offer. Many candidates also lacked understanding of the difference between the two policy areas, confusing one with the other. Although the requirements for the two policy areas were separate, many answers combined them and it was common to find answers discussing working capital management topics that were not relevant, such as management of trade receivables. It is essential with discussions such as this, which have analysis which informs the answer, to relate the answers to the company illustrated or the scenario provided with the question.

Answers showing understanding and use of relevant financial management terms and concepts are rewarded. Discussions of the benefits of centralised treasury management often failed to use key terms such as 'cash pooling', 'foreign currency risk' and 'liquidity management', talking instead in general terms about centralisation or about management in general, such as inventory bulk purchasing or imposing strategic objectives. Where relevant treasury management points were made, they failed to gain full marks because the points made were not sufficiently developed. Discussions of cash management models also tended to lack depth, sometimes the models being discussed were not clearly identified.

A requirement to evaluate the financial effects of an early settlement discount and a factor's offer often led to accurate calculations, although some answers were fragmented or poorly presented, so that their conclusions were not clear. Some candidates experienced difficulty in evaluating the change in the financing cost of receivables as a result of the factor's offer. This is a problem that could be avoided by reviewing such questions prior to the exam.

Preparing a forecast statement of financial position for a company planning an expansion of business and calculating the changes in key working capital ratios was undertaken successfully by a number of candidates. The main problem encountered was a lack of understanding of how entries in the statement of financial position were affected by the proposed business expansion, for example target values of key accounting ratios, expected increase in credit sales, and increased debt finance.

Oscar Co (September/December 2018) is a recommended past exam question.

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

Investment appraisal

As in previous exam diets, candidates scored relatively well on questions requiring an NPV calculation, although there are number of approaches such a calculation may adopt, for example including inflation and taxation; including sensitivity analysis; making in-house or buying in; and using an expected NPV approach. Candidates therefore need an in-depth knowledge of the range of NPV calculations and when they are required.

Treatment of inflation in NPV calculations is an area where candidates often make errors. The detailed information provided by the question scenario must be studied carefully to identify whether unit price and costs are given in nominal or real terms, and whether there are different annual inflation rates for each price or cost element. Where inflation is given as a percentage per year, it is important to remember that cash flows arising more than one year in the future will need to incorporate incremental inflation for each subsequent year.

Where current price-terms selling price or variable cost per unit are given but have different values in each year, cumulative inflation for a given year must be applied to the current price-terms value for that year.

Candidates must carefully check the timing of cash flows, for example whether tax liabilities are paid one year in arrears or not, when initial investment is made, and when terminal value arises. Working capital has initial investment, incremental investment and recovery and all of these cash flows need to be timed as required by the question scenario.

These and many other relevant issues are coved in the 'Advanced Investment Appraisal' article on the ACCA website, as follows: https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f9/technical-articles/advanced-investment-appraisal.html.

An NPV calculation including inflation and taxation gained good marks for many candidates, although some did not pay taxes in arrears where a question required this. Also some candidates struggled to calculate working capital investment and disinvestment correctly ,and some candidates included total investment in working capital each year, rather than incremental working capital. An investment appraisal question requiring an expected (mean) NPV approach was often done well, gaining good marks for candidates, although some candidates paid tax in arrears, when the requirement was to pay tax at the end of the year in which the profit arose. One error also encountered in such questions was the inclusion of development costs, which are a sunk cost; only relevant costs are included in an NPV calculation. An investment appraisal question including inflation and taxation in a manufacturing in-house scenario led to many good answers, although the subsequent requirement to evaluate buying in was not answered as well.

As with all calculations in the Financial Management examination, it is essential that all workings are shown in candidate answers. In the absence of workings, markers cannot give credit for application of the correct method following an arithmetical error.

Pinks Co (March/June 2019) is a recommended past exam question. The article 'Inflation and Investment Appraisal' on the ACCA website should also be studied:
https://www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f9/technical-articles/inflation-investment-appraisal.html.

Discussions on the relative merits of investment appraisal techniques, for example NPV and IRR, and ROCE and IRR, showed in general a need for deeper study. There was a tendency to adopt a list approach when the requirement was for discussion, and many answers did not adopt a comparative approach when this was the requirement. Candidates must not only be able to apply the tools of investment appraisal: they must understand those tools and the theoretical basis that underpins them.

Melanie Co (September/December 2018) is a recommended past exam question here.

A requirement to discuss the difference between risk and uncertainty requires an answer that does more than state that risk is quantifiable while uncertainty is not, or offer a few bullet points, especially when the answer is required to be linked to the scenario within which an investment appraisal is being undertaken. Similarly, a requirement to discuss the usefulness of the information provided by sensitivity analysis calls for more than a very brief discussion of how sensitivity can be measured, or a list of bullet points.

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.

In discussing the problem of capital rationing and how an optimal investment schedule could be determined, it is important not to focus too much on the hard and soft causes of capital rationing, since a balanced discussion will need to discuss the nature of investment projects (divisible or indivisible) and the process of investment selection as well.

Business finance

If the requirement is for calculation of weighted average cost of capital (WACC) using market values, candidates should not use book values for equity or debt finance, unless a bank loan is being considered.

It has been said before that candidates must take great care in arithmetic operations and in using spreadsheet functionality. Magnitude errors, for example combining a 12% cost of equity with a 0.07 cost of debt (actually 7% but expressed as a decimal), should be avoided. A study of past exam questions will show that extreme values for cost of capital are never used. Another calculation where care is needed is the final WACC calculation. Take note of the highest and lowest cost of capital values being averaged: the WACC must have a value between these highest and lowest values.

In using spreadsheet functionality, it is essential to show all workings and candidates should place their calculations or functions in a cell, so the workings and the calculated value are clear. Markers cannot recalculate a value from a written-out calculation to check whether a single value placed in a cell is numerically correct. The place for the calculation is in the cell. If spreadsheet functions for NPV and IRR are used, the accompanying cash flows must be carefully laid out and labelled.

Where the cost of capital of convertible debt must be calculated, evaluation of the likelihood of conversion must be evaluated by calculating the conversion value and comparing it with the alternative value arising from redemption. The conversion value is a future value: it should not be used as the current market value of the convertible debt.

When calculating the cost of equity with the dividend growth model (DGM), care should be taken to justify any growth period used in calculating the dividend growth rate which does not include all the dividend payments provided by the question. Care should also be taken to avoid magnitude errors when setting out the values to be inserted in the DGM.

A recommended past question in this area is Corfe Co (March/June 2019).

Candidates must be able to evaluate the impact of sources of finance on financial position and shareholder wealth and this calls for an ability to calculate changes in profit after tax and earnings per share. Where growth in profit from operations is expected as a result of business expansion, existing finance charges cannot be ignored in calculating revised values of profit after tax and earnings per share. If a rights issue is selected, changes in shareholder wealth can be assessed by comparing the theoretical ex rights price per share with the revised share price. If a debt issue is selected, the comparison would be between the current share price and the revised share price, with the revised profit after tax needing to take account of increased interest payments.

A recommended past question in this area is Tin Co (March/June 2018).

Answers to a requirement to discuss the relative merits of the capital asset pricing model (CAPM) and the DGM in calculating the cost of equity often discussed the models separately rather than comparatively. Some answers had much more to say about the CAPM than the DGM, but a balanced discussion was needed here for full marks. A discussion of the process by which a project-specific cost of equity was calculated from a proxy beta was not required. When discussing ways in which a company might issue equity finance, a number of candidates were unsure of the differences between a public offer, a placing and an initial public offer, although most candidates were on firmer ground when discussing rights issues.

A requirement for a discussion of the connection between the creditor hierarchy and the relative costs of sources of finance drew a mixed response from candidates, mainly because of uncertainty as to the nature of the creditor hierarchy. As it represents the order in which financial claims on a company are settled in a liquidation, it becomes a factor in determining the relative risk of sources of finance, which in turn is a factor in determining their relative costs of capital.

Finally in this syllabus area, a requirement to discuss whether a company in the question scenario should raise investment finance by reducing its annual dividend called primarily for discussion from a dividend relevance perspective, rather than for a dividend irrelevance, Miller and Modigliani perspective. A good approach here was to focus on the signalling effect and the clientele effect. Some answers lost a mark by not making a recommendation, even though this was part of the question requirement.

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 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 or =NPV formulae are 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. Marks are not lost through poor spelling or grammar, but candidates do need to ensure their sentences are written so that markers can understand the point being made.

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.