Chartered Accountant

SINGAPORE CA QUALIFICATION (FOUNDATION) EXAMINER'S REPORT

MODULE: Financial Management (FMF)

EXAMINATION DATE: 17 June 2020

Section 1 General comments

The June 2020 Financial Management exam is a well-structured and comprehensive paper. This paper tests the fundamental knowledge of Financial Management and comprises a good combination of both quantitative and qualitative questions. The paper required Candidates to apply the concepts in tackling the computational and qualitative questions.

Generally, candidates did not perform well for this paper.

From the responses in the answer scripts of Candidates, three key contributing factors are observed:

- 1. Candidates did not get their fundamental concepts right and lose marks
- 2. Candidates did not spend sufficient time or perform adequate practice in preparing for their examination
- 3. Time management was also an issue for some Candidates who did not manage to attempt all the questions.

In relation to the first observation above, it was noted that:

- Candidates showed weakness in the computation element, especially in deriving the correct computation of WACC and IRR in question
- With regards to the qualitative questions, especially in question 2 and 4, most Candidates showed weak understanding of the requirements and as a result, demonstrated poor articulation of these questions.

Section 2 Analysis of individual questions

Question 1

Question 1 tested the fundamental concept of Net Present Value. This question assessed the Candidate's knowledge on computation of cash flows of revenue, variable costs as well as the computation involved to derive the NPV of the project. Most Candidates passed this question or failed marginally.

Part (a) required Candidates to calculate the Sales Revenue and variable cost of each year of the project. The computation is relatively straightforward, and most candidates managed to score well for this question.



Part (b) required Candidates to come out with the computation of the Net Present Value of the project. Most Candidates only scored an average of pass for this question. The common mistakes pertained to Candidates not being able to recognise the timing and calculation of changes in the working capital. In addition, most Candidates also wrongly included head office overhead costs of \$750,000 into the computation of NPV.

Part (c) required Candidates to assess the impact of NPV because of inflation. The answers of this question were mixed, and most Candidates were not able to explain that an increased in inflation would lead to an increased in the level of return required. Instead, most of the explanation delved into how inflation would affect the selling price or the cost of production. The impact to NPV was poorly explained.

Question 2

Question 2 is a mixture of quantitative and qualitative questions. It assessed the Candidates' ability to choose the best combination of projects possible within a limited budget. The question was poorly attempted, with less than half the Candidates passing the question.

For **part (a)**, most Candidates managed to provide the computation using NPV/ \$ Invested and hence derived the correct answer. However, many failed to explain that Project Epsilon had a negative NPV and hence would not be chosen in the absence of a capital constraint scenario. Some Candidates did not realise that the projects could be invested partially even though it was stated in the question.

Most Candidates failed **part (b)** of the question. Candidates were able to explain clearly using the "Equivalent Annual Annuity" method for comparing projects of different lengths. While Candidates chose the right project to invest in, they failed to calculate the NPV of the approach (i.e. treating the investment decision as a perpetuity).

Candidates did relatively well for **part (c)** with only a handful of Candidates failing this question. This question tested the Candidates on the advantages and disadvantages of acquiring an existing business vs investing in the project. Most Candidates were able to identify speed as well as leveraging on the existing resources as the advantages. For disadvantages, most Candidates cited cost as well as post integration issues. The observation for this question was that the explanations were not clearly elaborated, either due to lack of time or failure to clearly understand the requirement of the question. Most Candidates missed out on the third part of the question, which is to recommend an option for Lucas and provide reasons to support their recommendation.

Question 3

Question 3 tested on the concept of weighted average cost of capital, Modigliani and Miller Theorem, and the Traditional view (trade-off theory). Candidates performed reasonably for this question, with more than half passing the question. **Part (a)** of this question presented data on a company's debt and equity and required Candidates to calculate the cost of capital. Candidates generally did well in this question part.

Common mistakes made by Candidates were:

- Failing to calculate the redemption value of convertible shares.
- Failing to recognise that, based on the case facts, its conversion value at maturity (into shares) would be higher than its par value as a bond, and hence the company should convert to shares at maturity.
- Mistakenly using par value of the convertible debt as the market value at time 0.
- Assigning a tax rate to calculate after-tax cost of debt although the question explicitly requires candidates to ignore taxation.

Part (b) required Candidates to recommend whether to use debt or equity to finance a project, with reference to the Traditional View ('trade-off theory') and the Modigliani and Miller Theorem (M&M). Candidates performed poorly in this question. Several Candidates did not attempt this question or made a weak attempt at answering the question.

The following observations were noted:

- Candidates in general were not very clear on the distinction between Traditional Theory and M&M.
- Some did not indicate whether they were referring to Traditional Theory or M&M in their explanation.
- Many did not recognise or highlight that there exists an optimal gearing level according to Traditional Theory.
- While Candidates recognised that the value of the firm would be unaffected by capital structure under the M&M theory without taxes, they were unable to apply this observation to conclude with the implication of this theory --- that the company KPL should be indifferent between using debt and equity to finance its new investment.

Question 4

Question 4 mainly tested the annual cost/ savings of employing a debt factor. This was the worst performing question of the entire paper, with majority of the Candidates failing to receive a passing grade. There were also a number of Candidates who did not manage to attempt parts of the question due to poor time management.

For **part (a)**, there were a handful of Candidates who achieved full marks for this question part. However, most Candidates could not interpret "reduce receivables days to the 30-day standard term" correctly and overlooked that RBSL finances its working capital using an overdraft at a cost of 5%. As a result, they did not manage



to work out the finance cost saved from lower receivables and finance charge for advance.

Part (b) was generally not well answered. This question required a non-textbook answer and looked for answers like damaged customer relationship, image to the marketplace, more objectivity in the collection process or any reasons that should be considered whether or not to employ a debt factor. Only a small portion of Candidates managed to pass this question.

Part (c) was another question that required common sense, non-textbook answer and it was not well answered. Some Candidates quoted, irrelevantly, various dividends models, without directly answering the question. Candidates could have better answered the question if they had taken the perspective of the existing and potential shareholders. This was the worst performing part of this question with only a handful of Candidates scoring a passing grade.