Chartered Accountant
SINGAPORE

SINGAPORE CA QUALIFICATION (FOUNDATION) EXAMINER'S REPORT

MODULE: Financial Management (FMF)

EXAMINATION DATE: 11 June 2019

Section 1
General comments

The June 2019 paper was structured well to give room for high performers to excel while incorporating fundamentals of Financial Management analysis to test the basic foundation knowledge of the topic. The level of difficulty and the amount of knowledge required from the Candidates are relatively similar in expectations.

The Candidates were generally weak in their articulation of qualitative questions. The strategic perspective of the Candidates on investment options could be further improved as Candidates could not articulate the sell-off option in question 3(b) at all. Candidates were also not able to articulate the tweak from the usual Net Present Value analysis.

Candidates demonstrated the basic quantitative skills with focus on key ratios. Some Candidates elaborated their arguments with specific recommendations. Candidates could improve the application of their knowledge in answering the questions.

As always, Candidates could do a lot better by having better time management with a more systematic approach in answering the questions. Parts of the questions which were left out largely manifested in Question 4, with some Candidates leaving out the entire question.

Candidates should also pay attention to the marks allocation as some Candidates provided overwhelming and extensive solutions for Question 4 which carried fewer marks.

Section 2
Analysis of individual questions

Question 1

The question centres on investment in new mining equipment for a new mine site between buying and leasing using WACC computations, the underlying assumptions and comparison between buy or lease. The structure of this question is fairly straightforward, focused on base line understanding of financing costs.

Part (a) required Candidates to calculate the WACC in relation to the case facts. The question part was not done very well. While most Candidates managed to answer the bank loan component well, almost the entire cohort missed the NPV calculations for preference shares and may have treated the preference shares as irredeemable. However, none of the Candidates mentioned the corresponding assumption in **part (b)**. As such, no marks were awarded. Many Candidates also had problems calculating the cost of equity by failing to consider the growth element.

Candidates were required to list the key assumptions of the WACC calculation in **part (b).** Most Candidates were able to list down at least 1 assumption. However, a handful of Candidates left the answer blank.

For **part (c)**, majority of the Candidates were able to discuss the advantages and disadvantages of leasing, obtaining a passing mark for the question part.

Question 2

The question centres on short term working capital requirements on cash flow forecast, suggesting courses of action and recommendations. This question was tedious but structured and required Candidates to illustrate key components of cash flow forecasting.

Most Candidates did well on this question. The Candidates generally performed better in the computation component than in the qualitative requirements.

Part (a) was not answered very well, as Candidates either (1) calculated the loss from raw material to finished goods wrongly or (2) added non-cash items (depreciation, bad debt) into the cash flow forecast. Method marks were mostly awarded to answers which had workings clearly presented. With the inclusion of the method marks, most Candidates managed to pass this question part.

Overall, **part (b)** was handled much better than **part (a)**. However, there were multiple incidents where the answers provided did not include justifications, or that the justifications did not match the answer in **part (a)**. In addition, there were some Candidates who did not indicate a preferred option among the two presented.

Question 3

The question was centred on market analysis based on low to high demand simulations, Net Present Value (NPV) computations and recommendations, and decision making components. This was a computation question on investment analysis. The marks weightage and structure of the questions allowed high performers to be differentiated.

Only a handful of Candidates passed the question. The Candidates were generally able to articulate well on NPV computations and sensitivity analysis.

Part (a)(i) required Candidates to calculate pre-tax contribution based on different demand conditions. Majority of the Candidates did well for **part (a)(i)**. Common mistakes that Candidates made were:

- Failing to take account of contribution margin in their calculations
- Erroneously presenting pre-tax contribution net of fixed cost even though they were required to present only the pre-tax contribution.

Part (a)(ii) this question required Candidates to calculate the NPV of the project based on expected demand and to conclude whether the company should proceed with the project.

Common mistakes made by Candidates were as follows:
- Failed to condense the pre-tax contribution to a single weighted average contribution based on the probability of occurrence of the 3 scenarios presented.
- Failed to include the initial cost in the calculation of NPV.

A few Candidates also failed to take account of the benefit from writing down allowances for the 3 years or made errors in their calculations (some did not take account of the tax effect in their calculations).

For **part (b)**, Candidates were required to assess the impact on NPV of the project if given the option of selling the business for $400,000 after taxes, at the end of Year 1.

Candidates performed the worst on this question part and a significant number of Candidate did not attempt this question part. Majority of the Candidates had no idea on how to approach this question.

A large number of Candidates calculated NPV in Year 1, which was irrelevant. They failed to recognise that the value of an investment is the PV of its future cash flows and hence, any changes to NPV from the option to sell after Year 1 would come from comparisons with NPV from Years 2 and 3. This was a valuable option as it enabled the company to abandon the project after Year 1 and exercise the option to sell the business.

None of the Candidates correctly incorporated the $400,000 price into the calculation.

Question 4 – Currency and interest rate hedging (15 Marks)

This question tested Candidates on the basic interest and currency hedges. Some resourceful Candidates covered swap options and hedge accounting which deserved discretionary bonus marks.

A number of Candidates did not attempt or abruptly answered the question. As this was the last question, it could be attributed to poor time management.

Part (a) tested Candidates on hedging foreign exchange risk. The question part was well answered with most Candidates being able to describe the advantages and disadvantages between the foreign exchange forward and futures contract. Candidates who achieved high marks demonstrated their ability to apply their knowledge to the company in the question and recommended using the foreign exchange forward to hedge their exposure.

Part (b) was on hedging interest rate risk and was generally not well answered. Some Candidates did not answer the question at all and most answers were too brief and lacked sufficient depth. Stronger Candidates applied their knowledge of how a swap can be used as a tool to manage interest rate risk for the company in question in a rising interest rate environment.

Part (c) required Candidates to discuss the two director's perspective on risks and how this was going to affect their decision on the hedging derivatives. This was fairly well answered as most Candidates could identify that the marketing director was risk adverse and the finance director was risk seeking. Better Candidates provided more details on how the directors would make his hedging decision based on their risk perspectives. Weaker Candidates used pre-learned knowledge as the basis for their answers and did not integrate or apply the case material adequately.

To sum up, it was common for Candidates to make errors due to inadequate understanding of the risk management derivatives. This was from both a foreign exchange and an interest rate perspective, but particularly noticeable for question parts on interest rate derivatives, in particular interest rate swaps.

Candidates must continue to exercise good time management in the examination. There were some Candidates who did not attempt this final question at all.