

## Examiners Report

Financial Management FM/A 2021

26 July 2021

### Paper performance overview

Overall the standard of responses was extremely high, particularly on the calculative elements of the paper. Candidates also scored well on the knowledge based questions but were weakest when applying the knowledge to the scenarios.

### Question 1 - **Investment decisions and valuation 35%**

#### Part a

This question on NPV was on the whole well done, with many candidates scoring close to full marks. The main areas which caused problems were as follows:

- The price of £200 was clearly stated to be in current terms, yet the majority of candidates failed to inflate for the first year's revenue.
- Although most candidates recognised there would be an opportunity cost by using an existing machine, only a handful recognised that there would be tax implications of a balancing allowance foregone too.
- A significant minority also failed to recognise that working capital would be returned at the end of the project in 2024.

#### Part b

This question addressed sensitivity of the project to a change in volume. The majority scored at least passing marks here by correctly calculating the sensitivity as a %. The own figure rule was applied here.

Fewer were able to apply the % to the first year's volume and fewer still were able to then comment that there was a 50% chance of not achieving that volume based on the probability distribution.

The written comments on this element were weak.

#### Part c

This question was very well answered but some candidates went on to discuss the benefits of expected values. Given that the question asked to critically discuss the **limitations**, any such discussion was awarded no marks.

Part d

This was a question addressing the presence of real options in the scenario. Many candidates scored full marks by correctly identifying the options and categorising them appropriately. A small minority limited their answers by regurgitating examples from the text books and not applying to the scenario provided.

Question 2 Daizells- **Financing options 35%**

Part a

This was a standard WACC question which candidates on the whole did well on with some scoring full marks. There were no major common failings but the more common ones were.

- Taking the cost of the preference shares as the coupon rate of 10%
- Failing to recognise that the debentures were redeemed at a premium of 3% ie £103
- Arithmetical errors using the DVM equation

Part b

This question on the risk adjusted WACC required candidates to take the published beta of a company in a different industry and adjust it for Daizells' specific gearing.

Performance was mixed. Most candidates recognised the approach to use and were able to degear appropriately. Very few regearred correctly with only a handful recognising that the preference share did not benefit from the tax shield.

Although candidates then calculated a risk adjusted cost of equity fewer went on to calculate a risk adjusted WACC. Of those that did, only a minority correctly identified that the cost of debt was the new loan specific to the project.

The discussion aspect of the question was mixed. Candidates recognised that the existing WACC was inappropriate but did not articulate the calculations well. Others said that the WACC was inappropriate because of the new finance despite the question stating that the capital structure would be unchanged.

Part c

This question on EMH was poorly answered with many just copying out the levels of market efficiency. Better answers recognised that Sandra's comments suggested that markets were not efficient at any level. Very few candidates appreciated that the share price would ultimately depend on whether the markets liked the project in the first place.

Part d

This was a practical question asking why the cost of debt could be different for two different finance packages. Candidates in the main picked up on the increased gearing and the maturity dates but were unable to bring in prevailing interest rates or what the risk of the new project or security available.

Part e

The ethics was well answered with candidates identifying both the ethical and legal implications of what could amount to insider dealing. Fewer identified appropriate actions ie telling them not to do it in the first place.

**Question 3 Suze - Managing financial risk 30%**

Part a

This was a standard currency hedging question with many candidates scoring full marks. The forward and money market hedge were very well answered. Some candidates calculated the finance cost of the option premium with it being paid up front despite the question not mentioning whether the company was operating with an overdraft or positive cash balance. Although this was unnecessary, they weren't penalised for doing so. The future was the weakest part of the question with errors including the buy/sell decision, the number being flexed for 9 months as if they were interest futures and not recognising that the gain on the future would be in dongs.

Part b

The question then went on to ask for advice on whether to hedge the transaction. Responses were mixed with the majority seeing this as an excuse to talk about the features of each of the hedging techniques without considering whether hedging was necessary in the first place. Very few picked up on the fact that the receipt was far from certain as the contract had not been won which would have suggested an option. Worryingly, only a handful of candidates answered the question and gave advice on whether to hedge or not.

Part c

This was the poorest answered question on the paper. Although candidates were mainly able to give an explanation of economic risk, fewer applied it to Suze which had receipts in one currency and costs in another. Candidates also suggested inappropriate protection techniques such as hedging products and FX bank accounts which would only be suitable for short term transaction risk.

Part d

This question addressed the factors affecting the time value of an option with most candidates correctly identifying all three items.

**Summary and helpful hints**

Candidates should apply their knowledge more in the discursive elements of questions to score top marks. It's not enough to be able to copy from the textbook - read the scenarios and think how the theory applies to the situation presented in the question.