

SINGAPORE CA QUALIFICATION (FOUNDATION) EXAMINER'S REPORT

MODULE: Financial Management (FMF)

EXAMINATION DATE: 6 June 2022

Section 1

General comments

The overall performance for the June 2022 examination was satisfactory. The level of difficulty for the examination remains comparable with the previous examinations and there was a good mix of both quantitative and qualitative questions.

Generally, the quality of the answers and time management has improved slightly from the previous examinations. However, examination time management skill is still an area requiring improvement as it was observed that some Candidates did not manage to complete all parts of the questions.

It is recommended that Candidates practice more questions and to make an effort to present the calculations involved so that they can gain marks for workings shown. It would also be beneficial for Candidates to read widely so that they appreciate the qualitative aspects of the examination questions. A strong foundation is necessary to perform well for this module.

Section 2

Analysis of individual questions

Question 1

Question 1 tested the Candidates on the concept of Weighted Average Cost of Capital (WACC). Candidates were required to compute the WACC for a company as well as to compute the impact of a change in the corporate tax rate. This was a relatively straightforward computation and the majority of the Candidates did relatively well for this question.

For **Part (a)**, common mistakes made by Candidates were as follows:

- (i) Erroneously included retained earnings in the calculation of the market value of equity.
- (ii) Used the cum-dividend share price instead of the ex-dividend share price to calculate the market value of equity.
- (iii) Failed to recognise that the preferred dividend amount was based on par value, and hence incorrectly calculating the cost of preference shares.
- (iv) Calculated the market value of preference shares incorrectly. It should be calculated as the product of ex-dividend market price and number of preference shares.
- (v) Divided the number of shares by its nominal value of \$0.10 before multiplying by share price, which was incorrect.

Part (b)(i) required Candidates to calculate the impact on WACC of an increase in corporate tax rate. Most of the Candidates were able to perform this calculation correctly.

For **Part (b)(ii)**, Candidates were required to discuss whether the increase in taxes in **part b(i)** would increase or decrease the value of the company. Some Candidates merely stated whether WACC would rise or fall without discussing its effect on the value of the company, while some Candidates stated the effect on the value of the company without explanation. In both cases, marks were deducted.

Some candidates did not pass for question **Part (c)**. It tested the Candidates on the concept of financing decisions which required an assessment of two options: issuing new debt versus withholding dividends to raise funds for a new investment. They were required to discuss the impact of each option on WACC and the value of the company. Many Candidates did not provide sufficient explanation to support their answers.

Candidates lost marks in the following areas:

- (i) Failed to calculate the company's current gearing level to compare to the industry average. Hence, they were unable to determine whether the current gearing level was above or below the optimal level assuming industry gearing was optimal.
- (ii) Gave a general account of the effects of each source of finance without making reference to the company in the question.
- (iii) Failed to link the WACC to company value and only focused on whether WACC would rise or fall.

Question 2

Question 2 tested the concept of purchasing power parity, calculating the annual operating cashflows and net present value of a project. Candidates' performance for the question was satisfactory. It was observed that a handful of the Candidates did not attempt or complete **part (b)**.

Part (a) required Candidates to calculate the expected future exchange rates of PHP per SGD. Many Candidates were able to compute the figures correctly.

Common mistakes made by Candidates were as follows:

- (i) Mixed up the inflation rates applicable in the purchasing power parity equation.
- (ii) Used the current exchange rate as the end of year exchange rate.

Part (b)(i) required Candidates to calculate the annual operating cash flows expressed in SGD. Candidates were required to calculate the probability-weighted sales volumes and \$ revenues using the prices for the 4 years given in the case

facts. Some Candidates erroneously adjusted the sales price for inflation when the prices for each of the years was already given.

Common mistakes made by Candidates were:

- (i) Did not use probability weights when calculating volumes.
- (ii) Failed to adjust the manufacturing, transportation and administration costs for inflation.
- (iii) Included the apportioned head office costs. These costs should be excluded since they were not incremental.

For part (b)(ii), Candidates were required to calculate the NPV of the proposed new project to determine if the project should proceed or not.

Candidates lost marks in the following areas:

- (i) Included the terminal value of the project until infinity when it was only a 4-year project.
- (ii) A handful of Candidates placed the initial investment at Year 1 instead of Year 0.
- (iii) Error in the computation of the discount factor or failed to consider the need to discount the cash flows.
- (iv) Failed to conclude whether the project should be undertaken based on their NPV calculations.

Question 3

Question 3 tested Candidates on the amount of working capital required, the cost of associated financing arrangements and the impact of different scenarios of changes in working capital. This was the best performing question of the paper.

For **Part (a)**, most Candidates were able to calculate the amount of investment made in working capital. However, there were some areas which were not well answered. Some Candidates erroneously used revenues instead of cost of sales when computing the amount of payables and inventories and some did not compute the total investment after calculating the individual working capital components.

Part (b) required Candidates to calculate the net annual cost of financing using the current financing arrangement. A handful of Candidates left this question part blank.

Common mistakes made by Candidates were:

- (i) Used the amount of money tied up in working capital instead of the loan principal amount as the base to calculate loan interest.
- (ii) Failed to calculate the interest received on spare cash.

For **part (c)**, most Candidates managed to provide a satisfactory answer for the question.

Common mistakes for **part (c)(i)**:

- (i) Used 400% for computing the new payables amount instead of 500% (as the question required an **increase** of 400%).
- (ii) Used revenues instead of cost of sales when computing the payable and inventory balances.
- (iii) Failed to calculate the new total investment amount.
- (iv) Failed to calculate the impact on the investment (new investment amount after the changes minus the existing investment amount).

Common mistakes for **part (c)(ii)**:

- (i) Calculated the new finance charge but did not calculate the change in the finance charges.

Part (d) was a qualitative question, and it required the Candidates to discuss the potential consequences to the inventories, receivables and payables due to the changes in policy.

The potential consequences included:

- (i) Potentially lower sales, e.g., if customers move to other suppliers due to stricter credit terms or the company is unable to service them due to insufficient inventory levels.
- (ii) Higher costs, e.g., from increased manpower costs spent on chasing receivables collection or disruptions to production due to a lack of inventory.
- (iii) Reputational damage from the company being unable to service customers effectively due to insufficient inventories or suppliers deciding to pull back from servicing the company due to concerns over the viability of the business.

Question 4

Question 4 tested Candidates on issues with the valuation of a start-up business, the computation of the value of the business's equity, the potential impacts of reducing dividends and the consequential impact on shareholder relationships. It was the poorest performing question of the paper.

For **part (a)**, the performance of this question part was satisfactory. Candidates were able to point out issues such as a lack of history, a lack of accurate forecasts, an uncertain business model, a lack of comparative businesses, a lack of earnings and long timescales.

The reasons that were less frequently mentioned included:

- (i) Pointing out the value of the business was hugely dependent on the two key personnel; and
- (ii) The company had limited tangible assets.

Part (b) required Candidates to calculate the current value of the business' equity. This was the worst performing part of this question. Candidates needed to address the question in two parts: (i) calculate the present value of the cash flows for the first 10 years and (ii) calculate the terminal values from year 11 onwards for revenues and costs separately given their different growth rates, before discounting back to present value subsequently. It was also observed that several Candidates used the wrong discount rate in their calculations.

For **Part (c)**, Candidates lost marks as they only provided reasons for publicly listed companies in general and did not take into account the information provided in the case facts. In particular, the private equity fund already had significant borrowings, so a reduction in dividends should reduce the cost of capital given this high level of gearing. Another part missed by many Candidates was the impact due to the nature of investors in private equity funds (and not a publicly listed company).