



Think Ahead

Financial Management (FM) March / June 2021 Examiner's report

The examining team share their observations from the marking process to highlight strengths and weaknesses in candidates' performance, and to offer constructive advice for those sitting the exam in the future.

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General comments

This examiner's report should be used in conjunction with the published March/June 2021 sample exam which can be found on the [ACCA Practice Platform](#).

The Financial Management (FM) exam is offered as a computer-based exam (CBE). The model of delivery for the CBE exam means that candidates do not all receive the same set of questions. In this report, the examining team provide constructive guidance on how to answer the questions whilst sharing their observations from the marking process, highlighting the strengths and weaknesses of candidates who attempted these questions. Future candidates can use this examiner's report as part of their exam preparation, attempting question practice on the [ACCA Practice Platform](#), reviewing the published answers alongside this report.

- Section A objective test questions – four specific questions that caused difficulty in these exam sessions.
- Section B objective test case questions – one whole objective test case to illustrate the types of questions candidates can expect to receive in this section of the exam.
- Section C constructed response questions – guidance on what was done well and where candidate performance could be improved from the published exam questions.

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 purchasing power parity.

Example 2 is a question testing knowledge of money market instruments.

Example 3 is a question testing working capital funding strategy.

Example 4 is numerical and tests the dividend valuation model.

Example 1

The expected future spot rate in one year is 1.4505 euro per \$1. The predicted inflation rates for the year ahead are:

Eurozone	Dollar
2% per year	3.5% per year

What is the current spot rate (to four decimal places)?

_____ **euro per \$1**

The correct answer is 1.4718

Future Spot Rate = Current Spot Rate $\times$ (1 + inflation rate in counter currency) / (1 + inflation rate in base currency)

The \$ is the base currency for the given future spot rate.

Therefore an unknown rate $\times 1.02 / 1.035 = 1.4505$

Rearrange the formula so that Current Spot Rate = Future Spot Rate / (1 + inflation rate in counter currency / 1 + inflation rate in base currency)

Therefore $1.4505 / (1.02 / 1.035) = 1.4718$ euro per \$1

Many candidates switched the inflation rates and instead calculated $1.4505 / (1.035 / 1.02) = 1.4295$ euro per \$1

Example 2

Which of the following statements relating to money market instruments is/are correct?

- (1) Discounted instruments do not pay coupon interest
- (2) Commercial paper is secured on assets of the issuing company

- A 1 only
- B 2 only
- C Both 1 and 2
- D Neither 1 nor 2

The correct answer is A.

Statement (1) only is correct.

Discounted instruments are originally sold for a price below their face value and do not pay interest

Commercial paper is an unsecured money market instrument.

Candidate responses were fairly evenly split across the four answer options, indicating a lack of knowledge of different types of money market instruments.

Example 3

Two companies, Acacia and Birch, have the following average levels of working capital:

Working capital level (\$m)	Acacia	Birch
Maximum	10	12
Minimum	6	9

Acacia's working capital is financed with \$4m of long-term debt and Birch's working capital is financed with \$9m of long-term debt.

The balance of finance is from short-term sources.

Identify, by clicking on the relevant boxes in the table, which type of working capital funding strategy each company is employing.

Acacia's working capital funding strategy	Aggressive	Matching	Conservative
Birch's working capital funding strategy	Aggressive	Matching	Conservative

The correct answers are:

Acacia's working capital funding strategy	Aggressive
Birch's working capital funding strategy	Matching

Acacia has \$4m of long-term working capital finance, but permanent working capital of \$6m. Therefore it is using short-term finance for both fluctuating and some of its permanent working capital. This means its working capital funding strategy is aggressive.

Birch has \$9m of long-term working capital finance and permanent working capital of \$9m too. This means it is using short-term finance for fluctuating working capital and long-term finance for permanent working capital. Therefore this is a matching strategy.

Neither company is using long-term finance for any of its fluctuating working capital, which would be a conservative approach. However, many candidates did incorrectly identify Birch as following a conservative strategy.

Example 4

Bilbo Co is an unlisted company with 800,000 issued shares. Seema is one of the founders and owns 20% of the issued shares.

Bilbo Co has just paid its annual dividend of \$0.30 per share. It is expected that next year's dividend will be \$0.32 per share. After that it is expected that dividends will grow indefinitely at 2% per year.

Shareholders expect a 12% return from their investment.

Using the dividend valuation model, calculate the value of Seema's shareholding.

- A \$512,000
- B \$522,240
- C \$489,600
- D \$480,000

The correct answer is A.

The value of next year's dividend has been given, so the share price calculation is:

$$\text{Share price} = D_1 / (k_e - g) = 0.32 / (0.12 - 0.02) = \$3.20$$

Seema's shareholding is $800,000 \times 20\% = 160,000$ shares

The value of this shareholding is $160,000 \times \$3.20 = \$512,000$

Many candidates did not take the given figure for D_1 and either used the dividend just paid with 2% growth to get an answer of \$489,600 or incorrectly added growth of 2% to the given dividend figure of \$0.32 to get an answer of \$522,240.

Conclusion

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.

Section B

Section B tests candidates' knowledge on a number of topics in more detail than section A, with three case questions containing five two-mark objective test questions.

Here is an example case question on the topic of business finance.

Nolciln Co needs to raise more capital and wants to identify the most appropriate capital structure to maximise its shareholders' wealth. The company has approached you for advice on aspects of its financial and operational gearing.

The following has been extracted from Nolciln Co's 20X9 financial statements:

	\$'000
Revenue	9,540
Profit before interest and tax (PBIT)	1,590
Profit after tax	1,072
Dividends paid	500
Ordinary shares (nominal value \$1)	7,800
8% loan notes	3,125

Detailed analysis has shown that variable costs are equal to 60% of Nolciln Co's revenue. You have been informed that it is company policy to calculate operational gearing as:

Operational gearing = Contribution / PBIT

The directors of Nolciln Co are also seeking advice on the optimal capital structure. They are aware of the Modigliani and Miller models but seek further information, in particular in respect of what is meant by market imperfections.

Question 1

What was Nolciln Co's operational gearing in 20X9 (to one decimal place)?

_____ times

The correct answer is 2.4.

Variable costs are 60% of revenue, so contribution is 40% of revenue.

Contribution = $0.40 \times \$9,540,000 = \$3,816,000$.

Operational gearing = Contribution / PBIT

$\$3,816,000 / \$1,590,000 = 2.4$ times

The most common error here was to take the 60% variable costs figure and use this as the contribution percentage. This gave an answer of 3.6.

Question 2

What was Nolcilm Co's interest cover in 20X9 (to one decimal place)?

_____ times

The correct answer is 6.4.

Interest cover is PBIT / interest.

Interest = $0.08 \times 3,125,000 = \$250,000$

$\$1,590,000 / \$250,000 = 6.4$ times.

Incorrect answers to this question were spread over a range of different answers, indicating a lack of knowledge of the elements of the interest cover calculation. This suggests that the calculation of interest cover is an area future candidates could benefit from practicing.

Question 3

Which TWO of the following are consistent with traditional capital structure theory?

- A There is no optimal capital structure
- B The value of the company remains unchanged with increased gearing
- C The cost of equity is higher when there is a high proportion of debt capital
- D There is a point at which the weighted average cost of capital is minimised

The correct answers are C and D.

Traditional capital structure theory states that there will be a point at which the weighted average cost of capital is minimised and also that the cost of equity will be higher when there is a high proportion of debt capital.

A significant number of candidates selected option B, indicating that they were thinking about Modigliani and Miller's model with no tax instead of the traditional theory.

Question 4

Responding to the directors' request for advice, which of the following is consistent with Modigliani and Miller's with-tax model?

- A The value of Nolciln Co decreases with increased gearing
- B The weighted average cost of capital remains constant with increased gearing
- C The optimal capital structure is made up almost entirely of debt
- D The cost of equity remains constant with increased gearing

The correct answer is C.

Modigliani and Miller's theory stated that the optimal capital structure is made up almost entirely of debt. Under this model companies should have high financial gearing.

Candidates who selected option A, perhaps did not read the question carefully enough as the value of Nolciln Co would increase. Option B may have been selected by candidates who were thinking about Modigliani and Miller's model with no tax instead.

Question 5

In relation to capital structure, which TWO of the following are valid statements about market imperfections?

- A Tax exhaustion occurs when there is a very high proportion of equity capital
- B Debt-holders may impose restrictive covenants in loan agreements
- C Agency costs, tax exhaustion and bankruptcy risk encourage very high gearing levels
- D When a company's gearing creates a high risk of bankruptcy the weighted average cost of capital will be higher

The correct answers are B and D.

Debt-holders may impose restrictive covenants in loan agreements and when a company's gearing creates a high risk of bankruptcy the weighted average cost of capital will be higher. This is because higher returns will be required as compensation for the higher risk of bankruptcy.

Agency costs, tax exhaustion and bankruptcy risk discourage very high gearing levels and tax exhaustion occurs when there is a very high proportion of debt capital, but these options may have been selected by candidates who did not read the answer options carefully.

Section C

We have selected two constructed response questions, Zeddemore Co and Cabrerias Co, which are available on the [ACCA Practice Platform](#).

Zeddemore Co

The screenshot displays the ACCA Practice Platform interface. On the left, the 'Zeddemore Co' scenario is presented, including a table of its capital structure. The table is as follows:

	\$m
Equity:	
Share capital (\$0.50 per share nominal value)	40
Retained earnings	35
Long-term liabilities:	
6.5% irredeemable loan notes (\$100 per loan note nominal value)	250
7% bank loan	20

Below the table, additional information states: 'Zeddemore Co's loan notes are quoted at \$65 per loan note and both the loan notes and the bank loan are secured. Zeddemore Co's equity beta is 2.3.'

The right side of the interface shows two questions for the user to answer:

- (a)(i) Using the Capital Asset Pricing Model, calculate Zeddemore Co's current cost of equity and a project-specific cost of equity suitable for the new venture. (6 marks)
- (ii) Referring to your calculations above, comment briefly on the view of the commercial director. (2 marks)

Below the questions is a blank spreadsheet grid with columns A through O and rows 1 through 20, ready for the user to input their calculations.

The question, Zeddemore Co, is based on syllabus section E, Business Finance.

The scenario is divided into three parts:

- First, the question considers the project specific cost of capital and the application of CAPM in calculating the project specific discount rate. A technical article specifically looking at CAPM and project specific discount rates is available [here](#).
- Second, the question covers the problems associated with high levels of gearing.
- Third, it covers the topic on risk-return relationship and its effect on financing costs.

For parts (b) and (c) the requirement is to demonstrate knowledge in a discursive manner for discussing or explaining Financial Management concepts. Candidates need to prepare well for the examination, and then be able to apply such knowledge to the scenarios presented in the question.

The next section will describe how to answer each of the requirements well.

Requirement (a)(i) – 6 marks

(a)(i) Using the Capital Asset Pricing Model, calculate Zeddemore Co's current cost of equity and a project-specific cost of equity suitable for the new venture.

(6 marks)

The question clearly says to calculate the current cost of equity and a project-specific cost of equity. This implies that a comparison between the two will be required.

The first step is to calculate Zeddemore Co's current cost of equity:

There are two ways of calculating the cost of equity: dividend growth model and the CAPM. In this example the information given only allowed the use of CAPM.

Step 1: Begin by inserting the values given in the scenario for Zeddemore Co to calculate the current cost of equity.

$$E(r_i) = r_f + \beta_i(E(r_m) - r_f) \quad \text{Equation 1}$$

$E(r_i)$	= Cost of Equity or the return required for Zeddemore Co
r_f	= Risk free rate of return
β_i	= Beta value of Zeddemore Co
$E(r_m)$	= Expected average return of the market
$E(r_m) - r_f$	= market risk premium

Find the relevant figures required for using the CAPM formula from the question. The key figures from the question: risk free rate, r_f (4%); expected return on the market portfolio, $E(r_m)$ (10%) and Beta, β_i (2.3). It is important that candidates recognise whether the expected return of the market is given or the risk premium as this will affect the answer. In this example the expected return of the market was provided. Hence the calculation of the current cost of equity is shown below:

$$E(r_i) = 4\% + (2.3 \times (10\% - 4\%))$$

Step 2: calculate the asset beta using the proxy company:

Using the information of proxy company WCP, calculate the asset beta which will reflect the systematic risk of the new venture that Zeddemore Co is proposing. The following formula is included in the formulae sheet available in the exam.

$$\beta_a = \left[\frac{V_e}{(V_e + V_d(1-T))} \beta_e \right] + \left[\frac{V_d(1-T)}{(V_e + V_d(1-T))} \beta_d \right] \quad \text{Equation 2}$$

It is important to remember that in the Financial Management exam, β_d is assumed to be zero and therefore the formula is simplified as follows:

$$\beta_a = \left[\frac{V_e}{(V_e + V_d(1-T))} \beta_e \right] \quad \text{Equation 3}$$

Here, you are required to use the **market values** and not book values, where V_e is the market value of equity, V_d is the market value of debt, and T is the corporation tax rate.

Many candidates have erroneously used book values here or ignored taxation. When tax was used, some candidates used an incorrect tax rate, which was not provided in the question.

Remember we are using WCP information to calculate asset beta, β_a .

The asset beta, β_a , is now calculated using equation 3.

Step 3: Regear the asset beta, β_a to convert it to an equity beta based on the gearing levels of Zeddemore Co.

First calculate the market values of debt and equity of Zeddemore Co. One key point to note here is that the retained earnings are not included in the calculation of V_e .

The equity beta can be calculated by rearranging the formula in equation 3 to represent the equity beta in terms of the asset beta as shown below, then insert the gearing and the tax rate related to Zeddemore Co and the calculated asset beta.

$$\text{Equity Beta, } \beta_e = \beta_a \left((V_e + V_d(1 - T)) / V_e \right) \quad \text{Equation 4}$$

It is recommended to break down the formula into manageable steps, for example, calculate $V_e + (V_d(1 - T))$, divide the answer by V_e and finally multiply the answer with the calculated asset beta, as this reduces the chances of an error under exam conditions.

The calculations should be done using the spreadsheet but ensuring that the markers are able to clearly see all workings and hence determine where any errors have originated.

Step 4 – Calculate the project specific cost of capital, using the CAPM formula

Finally, CAPM is used to calculate the project specific cost of the new venture, using the equity beta, β_e .

The difficulty in part (a)(i) was reading through the detail in the scenario to pick out the figures needed in the calculations/equations shown above. The formula seems daunting, but remember it is given in the formula sheet and a little practice at similar examples will get you through. It does require some planning and then the correct use of the spreadsheet to make the calculations easier. You will need to practise these skills before sitting the exam.

Requirement (a)(ii) – 2 marks

(ii) Referring to your calculations above, comment briefly on the view of the commercial director.

(2 marks)

Overall, candidates need to understand and explain the change in the risk as per their calculation. Candidates need to understand the risk-return principle and its impact on the investment decision. Here, a comparison of the two cost of equities is required, current cost (17.8%) and the project specific cost (19.4%). Recognising that the latter is higher and therefore higher risk and subsequently higher return is required by the shareholders in accepting this new project. In addition, some discussion on the wrong rate potentially leading to the wrong decision being taken was needed. Some candidates just agreed / disagreed with the commercial director but needed to go beyond and say why.

Requirement (b) – 6 marks

(b) Discuss THREE problems Zeddemore Co may be facing as a result of its current high level of gearing.

(6 marks)

Paragraph ▾

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2	
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This part of the question required the discussion of problems of high levels of gearing for Zeddemore Co. Candidates failed to achieve full marks for the following reasons: the discussion was usually sparse; the discussion was on operational gearing and not financial gearing; the discussion was very generic and not related to the question scenario.

Since three problems were required, it is important that candidates discuss three separate problems which could have been from any of the following areas: earnings volatility, cost of equity finance, debt capacity, bankruptcy risk, repayment risk and debt covenants. Some candidates went on to discuss capital structure theories such as the traditional view and the Miller and Modigliani theoretical perspectives. This question did not explicitly ask for a discussion of capital structure theories, but there were some marks available if it referred to the problems of high gearing and its effect on the costs of both debt and equity.

In this example, no financial analysis was required to gain full marks, but some candidates only provided financial analysis for this part, thus not obtaining marks as the requirement was to discuss.

Requirement (c) – 6 marks

(c) In respect of both equity and debt, discuss the risk-return relationship and how it affects Zeddemore Co's financing costs.

(6 marks)

In part (c) candidates had to discuss the risk-return relationship in respect of both debt and equity and in terms of how it will affect the financing costs of the company. In this example, no financial analysis was required to gain full marks.

A good answer would have begun by discussing the relationship between risk and return. This would be followed by the discussion of equity and debt and highlighting the reasons why equity is higher risk and debt is lower risk. Ideally the discussion would have then expanded on the loan notes and the bank loan and whether they are irredeemable/redeemable; secured/unsecured on Zeddemore Co's assets. Using the figures from part (a)(i), the discussion should have further related to the financing costs with equity (17.8%) and comparing it to the cheaper loan notes (10%) and the bank loan (7%).

Again, the discussion of capital structure theory may gain some marks provided it addresses the requirements of the question.

Candidates need to practice both the numerical and the discursive parts of the question to confidently pass the Financial Management exam.

Cabreras Co

FM March/June 2021 (20/21 syllabus)

Symbol Highlight Strikethrough Calculator Scratch Pad

This scenario relates to three requirements.

Cabreras Co is a construction company. It uses a large earth moving vehicle called the Beast to prepare foundations for buildings. It needs to decide whether the cheapest replacement interval for the Beast is three or four years.

The following details are available:

Cabreras Co purchases the Beast from a manufacturer for \$800,000, payable one year after delivery. Its resale value will fall by 40% of the purchase price at the end of its first year of operation. The resale value will then reduce by 25% of its previous year's resale value for each further year of operation.

Yearly maintenance costs are \$20,000 at the end of its first year of operations, rising by 5% per year. Maintenance must be provided in the year of sale.

Yearly fuel costs are \$28,000 in the first year rising by \$5,000 for each extra year it is operated.

If the Beast is operated beyond three years it is subject to a government safety and carbon emissions test. The test would be paid for and would take place at the beginning of the fourth year of operation. Correction of any faults discovered by this test is mandatory. There is an 80% chance that the test and remedial work will cost Cabreras Co \$50,000, and a 20% chance it will cost \$120,000.

Cabreras Co's cost of capital is 8%.

Ignore taxation.

(a) Calculate the equivalent annual cost of the three-year and four-year replacement intervals for the Beast and advise Cabreras Co which replacement interval to adopt.

(11 marks)

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A clear strategy for answering such a question is necessary and a structured approach is recommended. This means the candidates should clearly show for each situation the equivalent annual costs (EAC) for the 3-year and 4-year intervals separately. A justified recommendation can then be made. For each replacement interval, the equivalent annual cost method involves the following steps:

- **Step 1**– Determine the net present value of costs for the 3- year and 4- year replacement intervals.
- **Step 2**– For each of the 3- year and 4- year replacement cycles an equivalent annual cost is calculated using the formula, net present value calculated in Step 1 divided by the cumulative annuity factor for that period.
 - **EAC formula = sum of the present value of costs/annuity factor**
- **Step 3** - The decision – The replacement cycle with the lowest equivalent annual cost should be selected, as this is the annual cost and can be compared. Note other factors may also have to be considered, for example, in the scenario for Cabrerias Co the given probabilities were used to calculate the expected value of the safety test, \$64,000 $((\$50,000 \times 0.8) + (\$120,000 \times 0.2))$. This allowed candidates to comment on its use in the advice given as well as considering the worst case scenario of \$120,000.

Other issues related to the calculation of the net present value.

- Although there is duplication in the calculations and labels, it is advised to use separate NPV cash flows for each cycle. Many candidates combined the calculations for 3- year and 4-year replacements, but this approach is more complicated and tends to lead to more mistakes being made.
- As investment appraisal is one of the key topics in the Financial Management syllabus, many candidates have learnt how to deal with inflation correctly, but there were some candidates who still need to master this.
 - For example, the question was very clear that the maintenance costs are \$20,000 at the end of the first year of operations, rising by 5% per year. Therefore, the inflation begins in year 2 and not in year 1. Many candidates did not show the detailed working for the inflation, and any errors were difficult to assess. This question specifically stated maintenance costs were incurred in the year of sale, whereas in some past questions the annual maintenance cost required at each year end was not required in the year of disposal as realistically a company is may not repair an asset just prior to disposal. This highlights the need to read the scenario carefully.
 - It is recommended that candidates show all the workings separately, e.g. maintenance costs, fuel costs, residual value and the government test. This approach leads to fewer calculation errors being made.

Examples of the type of workings which could have been used are as follows:

Workings - Maintenance Costs

Year1	Year 2	Year 3	Year 4
\$	\$	\$	\$
20000	$=20000*(1+5\%)^1$	$=20000*(1+5\%)^2$	$=20000*(1+5\%)^3$
20,000	21,000	22,050	23,153

Workings - Fuel costs

Year1	Year 2	Year 3	Year 4
\$	\$	\$	\$
28000	$=28,000+5000$	$=28000+(5000*2)$	$=28000+(5000*3)$
28,000	33,000	38,000	43,000

- Another typical error is the mistiming of the cash flows such as the purchase cost (stated as being payable one year after delivery i.e., Year 1), resale value, and the safety test (stated as being at the beginning of the fourth year i.e., Year 3).
- A few candidates did not discount cash flows thereby making any subsequent 'EAC' figure incorrect because an NPV has not been computed.
- Candidates should ensure that they put brackets or minus sign for cash outflows as otherwise negative items may be treated as positive when the cash flows are totalled.
- A few candidates failed to recognise that the normal assumption for the NPV cash flows is that the asset is disposed of on the last day of the last year of either the 3-year or 4-year replacement intervals.
- Since the question was specific for three-year and four-year replacement intervals, some candidates unnecessarily spent time calculating the residual values for 1 and 2-year replacement intervals and included them in their NPV cash flows.
- Some candidates included depreciation in the NPV cash flows.

Discursive

For the recommendation, most candidates were able to state the correct replacement cycle based on the lowest equivalent annual cost, although some candidates used the net present value to base their decisions. It is wrong to compare using the net present values for the following reason: The cost of buying and keeping an asset for a 3-year period is likely to be lower than buying and keeping it for a 4-year period of time. For Cabrerias Co this was the case where the NPV for the 3-year was lower than the NPV for the 4-year. A justification should be provided and answers without justification, for example, "choose 4-year cycle" only will not get the required mark allocated.

There is a lot of information contained within the question itself that candidates will need to become familiar with. It is important to take the time to read through the

information in the question and use the onscreen tools available to highlight important information, use your scratch pad or answer space to make any key notes. It is important to read through the requirements and allow some time at the end for checking the answer.

Requirement (b) – 4 marks

(b) Discuss why replacement interval decisions should be based upon equivalent annual cost (EAC).

(4 marks)

Here, candidates needed to provide a rationale for using EAC. Many candidate responses were based on the “how” rather than “why” so that they described the process in arriving at the decision far more than explaining why it is needed. Candidates provided the EAC formula and explaining this as using the lowest cost per year that is equivalent to the NPV of the replacement cycle and using this as the decision rule, having already demonstrated this in part (a).

Candidates need to discuss that for a continual replacement of an asset, a meaningful comparison using NPV’s of different lengths of replacement intervals is not possible.

Hence, the use of EAC provides us a way to compare asset replacement of different time lengths on an equivalent basis i.e., annual cost.

Time value of money was often mentioned but there was not enough discussion about relevant costs. A good answer should have discussed that when the project (3-year interval is considered as one project etc,) could be repeated in perpetuity and the projects have unequal lives then using the EAC approach is appropriate. It was rare for candidates to discuss about an infinite chain or about like for like asset replacements.

Many answers concentrated on the factors to be considered when making replacement decisions such as capital cost of the equipment, operating costs, resale value, taxation and inflation – which did not address the requirement of the reasons why replacement interval decisions should be based on EAC.

Requirement (c) – 5 marks

(c) Discuss why discounted cash flow methods of investment appraisal are considered superior to non-discounted cash flow methods.

(5 marks)

Candidates must recognise that for a requirement worth five marks needing them to 'discuss' the answer should yield more than brief points, sometimes comprising sentences of fewer than six words and/or where the technical discussion is unsatisfactory.

This part of the question was often overlooked by candidates which demonstrated a possible lack of time management. This was a standalone requirement for five marks which could have been attempted first to ensure that it was covered.

A good answer as a minimum should have discussed the relative merits of discounted cash flow methods over non discounted cash flow methods in the following areas: time value of money; cash flow over profit; clear decision rules; link to shareholders' wealth.

It was common to see that the only discussion on offer was about time value of money and many answers scored limited credit as a result. Answers tended to discuss only the discounted cash flow methods and nothing on non discounted cash flow methods. Others did offer cash flow over profit as a reason, and some did mention a clear decision due to the link to shareholders' wealth. Often there was a lack of comparison between the discounted cash flow and non discounted cash flow methods.