

Financial Management (FM) March/June 2026 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 2026 sample exam which can be found on the [ACCA Practice Platform](#).

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.

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 offer detailed debriefs of selected questions from each section of the exam.

- Section A objective test questions – we focus on four specific questions that caused difficulty in the March/June 2026 sittings of the exam.
- Section B objective test case questions – here we look at one case from syllabus area B in detail.
- Section C constructed response questions – here we provide commentary on two questions, providing guidance on answering these questions and where exam technique could be improved.

Section A

In this section we will look at FOUR Section A questions which proved to be particularly difficult for candidates.

Example one

Blue Co has five million 6% preference shares in issue with a nominal value of \$0.50 per share which are currently quoted at \$0.59 cum div. Blue Co pays corporation tax at 25%.

What is the cost of capital of the preference shares?

- A. 4.1%
- B. 5.4%
- C. 5.1%
- D. 3.8%

What does this test?

- ✓ Tests students' knowledge of how to calculate the cost of preference share capital

What is the correct answer?

- ✓ The correct answer is **B**

$$k_p = d/P_0$$

$$d = \text{Dividend} = \$0.50 \times 6\% = \$0.03$$

$$P_0 = \text{Market value of share ex-dividend} = \$0.59 - \$0.03 = \$0.56$$

$$k_p = \$0.03/\$0.56 = 5.4\%$$

Common errors included candidates failing to recognise that they had to use the ex-dividend price to calculate k_p , while others deducted tax after calculating k_p .

Example two

Which TWO of the following statements about the payback method of investment appraisal are false?

- A. It considers the profitability of the whole investment project
- B. It ignores cash flows after the payback period
- C. It indicates the financial benefit of undertaking an investment project
- D. It reduces uncertainty by focusing on the short-term

What does this test?

- ✓ Tests students' understanding of the advantages and disadvantages of the payback period

What are the correct answers?

- ✓ The correct answers are **A & C**

The payback period method of investment appraisal considers the relevant cashflows of the project rather than its profitability. However, it does not measure the financial benefit of undertaking the investment. In contrast, the net present value (NPV) method evaluates the financial benefit by considering all relevant cash flows over the project's life.

A major disadvantage of the payback period method is that it ignores cash flows occurring after the payback period. Furthermore, by focusing on earlier cash flows, it reduces uncertainty.

Some students were unable to identify which statements were false, indicating a lack of understanding of the advantages and disadvantages of the payback method of investment appraisal.

Example three

A listed company is to enter into a sale and repurchase agreement on the money market.

The company has agreed to sell \$20m of treasury bills for \$19.23m and will buy them back in 60 days' time for \$19.34m.

Assume a 360-day year.

What is the implicit annual interest rate in this transaction (to the nearest 0.01%)?

_____ %

What does this test?

- ✓ Tests students' knowledge of how to calculate the implicit annual interest rate

What is the correct answer?

- ✓ The correct answer is 3.48%

The implicit annual interest rate is:

$$[1 + ((19.34 - 19.23) / 19.23)]^{(360 / 60)} = 1.0348, \text{ i.e. } 3.48\%$$

The most common error involved the use of a simplified method to calculate the implicit annual interest rate. The percentage figure is multiplied by a fraction representing either the period to be pro-rated or the period which requires annualisation, as follows:

Increase in value = \$19.34m – \$19.23m = \$0.11m

As a percentage of the original value = \$0.11m/\$19.23m = 0.572%

Annualising this value = 0.572% x 360/60 = 3.43%.

The technically correct method for annualising interest rates, which students are required to use, is the one specified in the correct answer above and described in the following [technical article](#) on “Interest rates”.

Example four

Which TWO of the following are NOT functions of the money market?

- A.** Providing investment opportunities
- B.** Risk transformation
- C.** Aggregation of funds
- D.** Arranging short-term liquidity

What does this test?

- ✓ Tests students’ knowledge of identifying the functions of the money market

What is the correct answer?

- ✓ The correct answers are **B** and **C**

Risk transformation and aggregation of funds are not functions of the money market. Rather, these are roles typically associated with financial intermediaries.

Providing investment opportunities and arranging short-term liquidity, on the other hand, refer to functions of the money market.

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.

The following is an example case question on syllabus area F business valuations.

Orla Co is a listed company, with a cost of equity of 12%, which plans to achieve dividend growth of 4% per year for the foreseeable future. Orla Co operates in an industry with an average price/earnings ratio of 9 times. The ordinary shares of the company have a nominal value of \$0.50 per share. Extracts from the financial statements of the company are as follows:

	\$m
Operating profit	111
Interest expense	(6)
Profit before income taxes	105
Tax at 20%	(21)
Profit for the year	84
Ordinary dividends	(49)
Retained profit	35

	\$m
Equity and liabilities:	
Share capital	36
Reserves	290
Total equity	326
Non-current liabilities:	
Long-term borrowings	120
Current liabilities	146
Total liabilities	266
Total equity and liabilities	592

The long-term borrowings consist of loan notes paying interest of 6% per year, which are redeemable in four years' time at a 5% premium to their nominal value of \$100 per loan note. The before-tax cost of debt of Orla Co is 7% per year.

Question one

What is the value of Orla Co using the price/earnings ratio method?

- A. \$315m
- B. \$999m
- C. \$756m
- D. \$786m

What does this test?

- ✓ Calculation of the value of the company using the price/earnings ratio method

What is the correct answer?

- ✓ The correct answer is **C**

Market value (MV) = profit for the year x P/E = \$84m x 9 = \$756m

The most common errors in the calculation of the company's value were: (1) some students used the retained earnings instead of the profit of the year, and (2) some students also added the growth rate ie value of the company = \$84m x 9 x 1.04 = \$786m

Question two

What is the value of Orla Co using the dividend valuation model?

- A. \$637.0m
- B. \$612.5m
- C. \$1,019.2m
- D. \$408.3m

What does this test?

- ✓ Calculation of the value of the company using the dividend valuation model

What is the correct answer?

- ✓ The correct answer is **A**

$MV = d_0 (1 + g) / (k - g) = (\$49m \times 1.04) / (0.12 - 0.04) = \$637m$

A number of candidates either did not use the growth rate to calculate d_1 or did not use a growth rate at all.

Question three

What is the market value of the loan notes of Orla Co?

- A. \$124.7m
- B. \$115.9m
- C. \$120.5m
- D. \$119.8m

What does this test?

- ✓ Calculation of the market value of a loan note

What is the correct answer?

- ✓ The correct answer is **C**

The market value of a redeemable loan note is equivalent to the future interest and redemption payment, discounted at the debt holders' required return, ie 7%.

Annual interest = Coupon rate x nominal value of debt = 6% x \$100 = \$6

Redemption payment at 5% premium = \$100 x 1.05 = \$105

Market value of a redeemable loan note = $(\$6 \times 3.387) + (\$105 \times 0.763) = \$100.44$ per loan note

The total market value of redeemable loan notes is calculated as follows:

Market value of a redeemable loan note x number of redeemable loan notes in issue.

In this case, the number of redeemable loan notes in issue is as follows:

$\$120\text{m} / \$100 \text{ per loan note} = 1,200,000 \text{ loan notes}$

Therefore, the total market value of redeemable loan notes is as follows:

$\$100.44 \text{ per loan note} \times 1,200,000 \text{ loan notes} = \120.5m

The most common errors in the calculation of the market value of redeemable loan notes were: (1) some students not considering the premium on redemption, and (2) some students using the wrong discount rate. Instead of using the before-tax cost of debt of Orla Co of 7%, which is the debt holders' required return, they used the coupon rate of 6%.

Question four

Which TWO of the following statements relating to capital market efficiency are correct?

- A. In a weak form efficient capital market, share prices take several days to respond to new information
- B. In a weak form efficient capital market, technical analysis cannot produce abnormal gains
- C. In a strong form efficient capital market, abnormal gains can be obtained using insider knowledge
- D. In a semi-strong form efficient capital market, the share price will increase following the public announcement of a positive net present value (NPV) project

What does this test?

- ✓ An understanding of the efficient market hypothesis

What is the correct answer?

- ✓ The correct answers are **B** and **D**

It is correct to say that in a weak form efficient capital market, technical analysis cannot produce abnormal returns and that in a semi-strong form efficient market the share price will change following the announcement of the project with a positive NPV.

However, it is not correct to say that share prices take several days to respond to new information if a capital market is weak form efficient, since weak form efficiency does not say anything about the speed of response to new information. Insider information cannot be used to produce abnormal gains in a strong form efficient market as the information is already incorporated into the share price.

A significant number of students failed to identify the correct answers, indicating that they do not have a clear understanding of the topic area examined.

Question five

Which TWO of the following statements about noise traders are correct?

- A. They typically follow market trends
- B. They make rational decisions based on fundamental data
- C. They generally overreact to good news and bad news
- D. They make well-timed investment decisions

What does this test?

- ✓ An understanding of behaviour finance

What are the correct answers?

✓ The correct answers are **A** and **C**

It is correct that noise traders generally over-react to good news and bad news and that they follow trends. However, noise traders make investment decisions on an uninformed basis, i.e. without using fundamental data and their decisions are not well-timed.

Many candidates were unable to identify the correct answers, indicating gaps in their knowledge of the relevant syllabus area.

Section C

In this section we will look in detail at TWO constructed response questions from different syllabus areas. The full questions and solutions have been published and are available on the [ACCA Practice Platform](#).

AgeAid Co

AgeAid is an investment appraisal question focusing on the specific investment decision of whether a charity should lease or buy vehicles together with a consideration of the nature and importance of Value for Money as an objective in not-for-profit organisations.

AgeAid required candidates to demonstrate and apply knowledge from the 'Investment Appraisal' area of the syllabus (section D) in parts (a) and (b), whilst part (c) required an explanation of the 3Es framework from the 'Financial Management Function' area of the syllabus (section A). The question stated that the organisation is a charity, a not-for-profit organisation, providing services to the elderly and contained financial information relating to a lease or buy decision.

Whilst there were many good answers to this question, the focus for this detailed commentary, rather than simply recreating the suggested solution, will be to highlight areas where candidates could do better in future. Such areas of poor exam technique include:

- not fully addressing the requirement;
- not presenting workings; or
- not adequately using the information in the scenario.

AgeAid contains three requirements.

Requirement (a) – 10 marks

Evaluate, on financial grounds, whether AgeAid should buy or lease the vehicles. You should show clearly how all the costs mentioned are treated.

This part of the question tests syllabus area D4(a) where candidates are required to evaluate the specific investment decision of whether to lease or buy an asset.

The starting point, when addressing a problem such as this, is to have a clear plan of what to do. The clearest approach is to prepare two schedules: one for the net cost of buying the vehicle and one for the cost of leasing the vehicles. Then a comparison can be made between the present value of the relative net costs of the approaches and a conclusion made based on financial grounds.

Buying

Setting out a schedule with the years across the top of each column is a good starting point e.g.

	A	B	C	D	E	F	G
1							
2	Buying						
3		0	1	2	3	4	
4		\$	\$	\$	\$	\$	
5							

Then, a methodical approach is required to dealing with all of the information, clearly including all the relevant costs and excluding all irrelevant costs with explanation.

Therefore, firstly, we can insert the initial outflow of \$300,000 for the vehicles together with the year 1 cost of maintenance of \$12,000.

	A	B	C	D	E	F	G
1							
2	Buying						
3		0	1	2	3	4	
4		\$	\$	\$	\$	\$	
5	Initial cost	-300,000					
6	Maintenance costs		-12,000				
7							

Note that these are cash outflows, and all cash outflows should be shown as negative values.

The maintenance costs are subject to an annual percentage increase as stated in the table in question, i.e., 20% in year 2, 30% in year 3 and 40% in year 4. These are annual increases; therefore, the percentage increases accumulates year on year e.g., the year 3 maintenance cost is 30% higher than the year 2 maintenance cost:

i.e.

Year 2: $\$12,000 \times 1.20 = \$14,400$

Year 3: $\$14,400 \times 1.30 = \$18,720$

Year 4: $\$18,720 \times 1.40 = \$26,208$

F6							
	A	B	C	D	E	F	G
1							
2	Buying						
3		0	1	2	3	4	
4		\$	\$	\$	\$	\$	
5	Initial cost	- 300,000					
6	Maintenance costs	-	12,000	- 14,400	- 18,720	- 26,208	
7							

Other running costs are \$20,000 in year 1 and then subject to an annual rise of 5% i.e., a rise of 5% year on year:

i.e.

Year 2: $\$20,000 \times 1.05 = \$21,000$

Year 3: $\$21,000 \times 1.05 = \$22,050$

Year 4: $\$22,050 \times 1.05 = \$23,153$ (rounded to nearest \$)

Since the annual rise of 5% is consistent across all years, proficient use of the spreadsheet will enable candidates to copy the formula from cell C7 across the row to cell F7.

F7							
	A	B	C	D	E	F	G
1							
2	Buying						
3		0	1	2	3	4	
4		\$	\$	\$	\$	\$	
5	Initial cost	- 300,000					
6	Maintenance costs	-	12,000	- 14,400	- 18,720	- 26,208	
7	Other running costs	-	20,000	- 21,000	- 22,050	- 23,153	
8							

The next piece of information in the question is about annual depreciation. Depreciation is not a cash flow and must be ignored. Candidates should state this, as the requirement says that “you should state clearly how all the costs mentioned are treated.”

The depreciation policy (annual rate of 20% reducing balance) has relevance, however, as the residual value of the asset at the end of year 4 is equal to its carrying value at that point. This computation should be done in a separate working:

i.e.

Year 1 depreciation

H	I	J
W1	20% depreciation	
Year		\$
0 Cost		300,000
1 Depreciation	=I3*J5	

Year 2 depreciation, where the 20% rate of depreciation is applied to the year 1 Written Down Value (WDV)

H	I	J
W1	20% depreciation	
Year		\$
0 Cost		300,000
1 Depreciation	-	60,000
WDV		240,000
2 Depreciation	=I3*J7	

And so on for years 3 and 4

H	I	J
W1	20% depreciation	
Year		\$
0 Cost		300,000
1 Depreciation	-	60,000
WDV		240,000
2 Depreciation	-	48,000
WDV		192,000
3 Depreciation	-	38,400
WDV		153,600
4 Depreciation	-	30,720
Residual value		122,880

The residual value can now be inserted into the main schedule as a cash inflow in year 4 i.e. a positive value.

F8						=J13
	A	B	C	D	E	F
1						
2	Buying					
3		0	1	2	3	4
4		\$	\$	\$	\$	\$
5	Initial cost	- 300,000				
6	Maintenance costs		- 12,000	- 14,400	- 18,720	- 26,208
7	Other running costs		- 20,000	- 21,000	- 22,050	- 23,153
8	Residual value (W1)					122,880
9	Net cash flow	- 300,000	- 32,000	- 35,400	- 40,770	73,520
10						

Common errors seen here included the calculation of 3 years' depreciation only or including the residual value at year 5.

With all relevant costs now included, and the irrelevant cost of depreciation excluded, the net cash flow for each year can be computed and discounted at the stated cost of capital of 9%. This is important as the requirement asks for candidates to "Evaluate, on financial grounds...." Future cash flows are subject to the time value of money concept and must therefore be discounted to their present values.

The most efficient way to do this is via the spreadsheet's NPV function:

i.e.

B11						=NPV(9%,C9:F9)+B9
	A	B	C	D	E	F
1						
2	Buying					
3		0	1	2	3	4
4		\$	\$	\$	\$	\$
5	Initial cost	- 300,000				
6	Maintenance costs		- 12,000	- 14,400	- 18,720	- 26,208
7	Other running costs		- 20,000	- 21,000	- 22,050	- 23,153
8	Residual value (W1)					122,880
9	Net cash flow	- 300,000	- 32,000	- 35,400	- 40,770	73,520
10						
11	Net present value	- 338,552				
12						
13	NB Depreciation has been excluded as it is not a cash flow					

NB The NPV formula discounts the cash flows from year 1 onwards. The year 0 cash flow needs to be included, but separately from the NPV formula. Therefore, the net cost of buying the vehicles is \$338,552 (there is a rounding difference compared to the suggested solution, due to the use of the NPV formula).

Leasing

As stated earlier, a separate computation for the lease option is advised. There are slightly fewer variables to deal with under leasing, consequently there are fewer marks available here (3 marks for leasing, compared to 6 marks for the buying option). Nonetheless, the rows and columns can be set up in the same manner as before, since the same time period is under consideration i.e., 4 years:

15	Leasing					
16		0	1	2	3	4
17		\$	\$	\$	\$	\$
18						

Four fixed payments of \$80,000 are payable annually in advance.

The term “in advance” is important, since this means that the first payment is made at year 0, in effect, immediately. Once, take care to show the payment as a negative figure since it is a cash outflow.

15	Leasing					
16		0	1	2	3	4
17		\$	\$	\$	\$	\$
18	Lease payment	- 80,000	- 80,000	- 80,000	- 80,000	
19						

Under the leasing option, the question states that “the other running costs for the vehicles would be 75% of the other running costs if the vehicles were bought.”

Once again, proficient spreadsheet use means that the 75% can be applied as a cell formula and copied and pasted across the row.

15	Leasing					
16		0	1	2	3	4
17		\$	\$	\$	\$	\$
18	Lease payment	- 80,000	- 80,000	- 80,000	- 80,000	
19	Other running costs	=0.75*C7				
20						

and,

15	Leasing					
16		0	1	2	3	4
17		\$	\$	\$	\$	\$
18	Lease payment	- 80,000	- 80,000	- 80,000	- 80,000	
19	Other running costs	- 15,000	- 15,750	- 16,538	- 17,364	

Finally, and, as with the buying option, the net cash flow in each year can be computed and the present value of the cost of leasing can be found via the NPV formula:

15	Leasing						
16		0	1	2	3	4	
17		\$	\$	\$	\$	\$	
18	Lease payment	- 80,000	- 80,000	- 80,000	- 80,000		
19	Other running costs	-	15,000	15,750	16,538	17,364	
20	Net cash flow	- 80,000	- 95,000	- 95,750	- 96,538	- 17,364	
21							
22	Net present value	=NPV(9%,C20:F20)+B20					

This gives the present value of the cost of leasing of \$334,593 (again, small rounding difference compared to the suggested solution).

It is of vital importance that signage for both options should be the same; otherwise, confusion arises when it comes to the final comment or recommendation. Both options, as shown here, display a negative value; this is correct as both options will create a cost to the charity.

Evaluation

For the tenth and final mark, a clear statement is required in line with the calculations:

e.g.

The best option, on financial grounds, is leasing since it is the option which gives the lowest present value of the cost:

	\$
Present value of cost of buying	338,552
Present value of cost of leasing	<u>334,593</u>
Leasing is lower by	3,959*

(*In the suggested solution, this difference is \$4,016, which is due to rounding)

Some candidates made an extra, unnecessary calculation by going on to compute the Equivalent Annual Cost (EAC) of each option. This is not needed here, as the same time period of four years is being considered. The EAC approach is only required when trying to find the optimum asset replacement cycle, which was not asked for here.

It would be beneficial for candidates preparing to sit the Financial Management examination in the future to **be fully proficient in the use of the spreadsheet software**. Full use should be made of the [ACCA Practice Platform](#). Being fully competent in the use of the spreadsheet can improve the accuracy of numerical responses and save valuable time in the examination. Tuition providers can help with this.

[A Topic explainer video: Lease or buy decisions](#) is available, where expert tutor Rashaad Hussain unpacks the topic of 'Lease vs buy decisions' (opens in YouTube).

Published questions which also cover the lease or buy decision, namely Hawker Co, Melanie Co and Dink Co, are available from approved publishers' question kits.

Requirement (b) – 4 marks

Discuss TWO reasons, other than the present value of costs, why AgeAid should lease the vehicles rather than buy them.

This part of the question also tests syllabus learning outcome area D4(a) where candidates are required to evaluate the specific investment decision of leasing or borrowing but focuses instead on aspects not addressed in part (a).

Any decision in financial management, indeed in business more generally, will of course consider its financial implications but decisions should take into account all aspects of the decision-making process, including those not addressed in the financial evaluation. This is the purpose of part (b) of the question.

In part (a), candidates should have reached a conclusion about whether to lease or buy the vehicles based upon the present value of the cost of the two alternatives. Part (b) requires candidates to discuss two reasons, other than the present value of costs, why the charity should lease the vehicles rather than buy them.

The published solution suggests reasons such as the cash flows implications, the maintenance of the vehicles and the replacement of those vehicles.

For exam technique purposes, it is important to note that two reasons are required for four marks. Therefore, two marks are available for each reason and therefore each reason must be discussed in sufficient detail in order to score the two marks on offer for that reason. Simply stating a relevant reason without further discussion would score a maximum of one mark. Simply stating two relevant reasons without further discussion would score a maximum of two marks.

The requirement refers specifically to the case in the question, i.e.

“...why AgeAid should lease the vehicles rather than buy them.”

Therefore, one of the best ways to develop a reason from being worth **one mark** into being worth **two marks** is to explain the reason in more detail, either by comparing leasing versus buying in more depth and/or by using the information in the case for illustration of the reason.

Taking the reason headed “Regular payments” in the suggested solution, it is true to say that leasing provides regular, annual outflows of \$80,000, which can be budgeted for, and which can be paid out of annual donations (1 mark). A well-developed reason would go on to say that this contrasts with buying the vehicles immediately, as buying would require a large, immediate outflow of \$300,000, which may place a strain on the charity's cash balances and cause other purchases or worthwhile activities to be postponed (2 marks) or indeed may require loan finance with all the issues that debt entails, such as

the need for security for the loan, or being unable to secure a loan at reasonable rate (alternatively worth a second mark).

The points about maintenance of vehicles and replacement of vehicles can also be developed into reasons gaining two marks instead of one, as in the suggested solution.

Weaker responses from candidates simply repeated or rephrased points which were relevant to the present value of costs and therefore were not creditworthy, as these had been specifically ruled out by the requirement. Some candidates discussed matters relating to tax, such as being able to obtain tax relief on lease payments or tax-allowable depreciation on a purchased asset. Whilst theoretically correct, it was not a creditworthy point in the case of AgeAid, as the charity is exempt from tax and also, therefore, cannot claim tax-allowable depreciation. This is clearly stated in the case scenario.

The previously mentioned published question Hawker Co also considers whether leasing or buying should be undertaken.

Requirement (c) - 6 marks

Explain the 3Es framework and how this can be applied by AgeAid.

This part of the question tests syllabus learning outcome A4(b); discuss the nature and importance of Value for Money as an objective in not-for-profit organisations.

For six marks, candidates were required to explain the 3Es framework, namely economy, efficiency and effectiveness and **how it can be applied by AgeAid**. Therefore, we have another requirement which references the case in the question, giving a clear signal that good marks can only be scored by application to the scenario.

For each E in the 3Es framework, one mark was available for the correct definition of the term with a second mark available for development of the reason via an explanation of how it can be applied by the charity.

Taking, initially, the correct definitions of the terms, it was of vital importance to clearly show how each of the Es is different from each other. In the simplest possible terms:

- Economy is an input-based concept;
- Efficiency is an input-output-based concept and
- Effectiveness is an output-based concept.

More specifically, ACCA's technical article ["Value for Money \(VFM\) and performance measurement in not-for-profit organisations"](#) states:

Economy is about obtaining the appropriate quantity and quality of resources at the lowest cost possible; optimising the resources **(inputs)** which an organisation has.

Efficiency is about maximising the output generated from units of resource used; optimising the process by which **inputs** are turned into **outputs**.

Effectiveness is about the relationship between the organisation's intended and actual results (**outputs**); the extent to which it achieves its objectives.

Weaker answers confused the terms and sometimes contradicted each other.

Candidates' responses which provided only the definitions above could not score the six marks on offer for this requirement as no reference had been made to the charity AgeAid and its operations.

Taking economy for illustration, a correct definition needed to be developed in the context of the charity. Where the organisation's name is used in the requirement, this is a clear sign that the organisation's circumstances should be used for illustration.

Therefore, an illustration of economy would be the provision of nutritional, hot lunches for the lowest cost possible by using the cheapest ingredients available (subject to the required standards). An alternative illustration may refer to providing day centre activities for the lowest staff cost possible, by making maximum use of volunteers who give their services free of charge (note the emphasis on the cost of inputs here).

An illustration of effectiveness would focus on the outputs achieved e.g. number of activities offered in day centres, whilst an illustration of efficiency would look at the input-output relationship such as number of hot meals delivered per vehicle; hot meals being the output, the delivery vehicle being the input.

Weaker candidate responses gave only basic definitions of terms and failed to illustrate them with relevant examples.

The aforementioned technical article addressing the 3Es is available [here](#), but please note that the article is written for the Advanced Performance Management examination and therefore the illustration shown is in more detail than is required for the Financial Management examination.

Time Co

This question is from section E Business finance of the syllabus.

Time Co required candidates in part (a)(i) to calculate operational gearing, discuss the implications for external finance providers and in part (a)(ii) to calculate debt/equity, interest cover, effective interest rates and to discuss the company's financial risk. In requirement (b) candidates were required to discuss the relationship between dividend policy and financing decisions and in requirement (c) to discuss the financing problems faced by SMEs.

It required candidates to combine technical calculations with discussion and evaluation, applying finance theory to the circumstances of Time Co rather than reproducing generic textbook knowledge.

Candidates demonstrated a good understanding of the computational aspects of the question, while the discussion requirements provided the main differentiation between stronger and weaker responses.

Before attempting the question, candidates should read all five requirements carefully and identify which financial statements and which years are relevant to each calculation. The question contained both historical information (20X1 and 20X2) and forecast information (20X3), together with two alternative financing scenarios (internal funding and bank loan funding). Correctly identifying which figures were required for each calculation avoid unnecessary errors. Candidates should also remember that each discussion requirement builds directly on the calculations and should therefore be linked to the circumstances of Time Co rather than answered using generic theory.

Requirement (a)(i) – 5 marks

Calculate Time Co's operational gearing for 20X1, 20X2 and 20X3 and discuss the views that external finance providers may have about the company's operational gearing.

Note: Operational gearing is defined as Contribution / Operating profit

This requirement tested candidates' understanding of operational gearing and its relationship with business risk (section E3(d) of the syllabus). Candidates first needed to identify that this calculation used the historical results for 20X1 and 20X2 together with the forecast 20X3 statement of profit or loss prepared using the internal funding scenario.

Contribution was not provided and therefore had to be calculated by deducting both variable cost of sales and other variable operating expenses from sales revenue. Operating profit was already given in the statement of profit or loss and should then be used to calculate operational gearing.

A sample calculation for 20X1 is as follows:

	A	B	C	D
1		(a)(i)		
2			20X1	
3			\$000	
4		Sales revenue	7,500	
5		Variable cost of sales	(3,450)	
6		Other variable operating expenses	(300)	
7		Contribution	3,750	
8				
9		Contribution/operating profit	= 3,750 / 1,580	
10		Operational gearing	2.37	
11				

After completing the calculations, candidates needed to interpret the results rather than simply describe the movement/direction in the ratios. Better answers explained that operational gearing increased between 20X1 and 20X2 and was forecast to increase further in 20X3, indicating that a greater proportion of operating costs were fixed. As a result, profits become more sensitive to changes in sales revenue, increasing business risk. A strong answer would apply this directly to Time Co by recognising that if forecast sales were not achieved, the company would find it more difficult to cover its fixed costs and maintain the expected level of profitability. Thus increase the level of risk perceived by external finance providers.

Common errors included omitting other variable operating expenses when calculating contribution, recalculating operating profit instead of using the figure provided in the statement of profit or loss, and describing the increase in operational gearing without explaining its implications for business risk or external lenders.

Requirement (a)(ii) – 7 marks

Calculate:

- **Time Co's debt/equity ratio for 20X2, using both statements of financial position;**
- **Time Co's interest cover for 20X3, using both statements of profit or loss; and**
- **The effective rates of interest on the loan from the director and the bank loan, and discuss the views that external finance providers may have about the company's financial risk position.**

This requirement tested candidates' understanding of financial risk and their ability to assess the impact of alternative financing decisions using financial ratios (section E3(d) of the syllabus). Candidates were required to compare two alternative financing options and evaluate their implications from the perspective of external finance providers.

Before attempting the calculations, candidates should identify the two financing options and select the correct financial information for each ratio. The summary below shows the figures that should have been selected before applying the relevant formulae.

Calculation	Internal funding	Bank Loan Funding	Learning point
Debt/equity (20X2)	Statement of Financial Position: Director's loan is \$1,000; Equity is \$4,440	Statement of Financial Position: Director's loan + Bank loan is \$2,200; Equity is \$3,240	Use long-term financing debt only. Do not include current liabilities, such as trade payables or accruals, in the debt figure.
Interest cover (20X3)	Forecast Statement of Profit or Loss: Operating profit is \$2,020; Finance cost is \$20	Forecast Statement of Profit or Loss: Operating profit is \$2,020; Finance cost is \$140	Although the forecast operating profit is unchanged under both financing options, the finance cost differs because of the additional bank borrowing. Use the operating profit and finance cost from the same forecast statement.
Effective interest rate	Director's loan: Finance cost is \$20; Loan balance is \$1,000	Note: Bank loan: Additional finance cost = \$140 – \$20 = \$120; Loan balance = \$1,200	Calculate each interest rate using the finance cost and loan balance for the individual loan, not the total finance cost.

Candidates should then apply the standard formulae:

- Debt/equity = Long-term debt ÷ Equity × 100
- interest cover = Operating profit ÷ Finance cost
- Effective interest rate = Finance cost ÷ Loan balance × 100

Once the calculations had been completed, candidates need to compare the two financing options rather than discuss each ratio separately. Better answers recognised that the bank loan option increased financial gearing and therefore financial risk. However, they also recognised that the forecast interest cover remained strong (14.4 times), suggesting that Time Co should still be able to meet its finance costs provided the forecast operating profit was achieved.

Stronger answers also considered the implications of the existing director's loan. Although it carried a lower effective interest rate (2%) than the proposed bank loan (10%), external finance providers would wish to understand its repayment terms, its priority relative to future borrowing and whether the current interest rate was likely to continue. These factors will influence the company's overall financial risk and additionally affect the willingness of lenders to provide further finance.

Common errors included selecting figures from the wrong financial statements, including current liabilities within debt, treating the director's loan as new borrowing rather than existing finance, failing to compare the two financing options, and providing generic comments on gearing without applying the discussion to Time Co's circumstances.

Requirement (b)(i) – 2 marks

Discuss why the finance director may wish to limit dividends.

This requirement tested candidates' understanding of internal sources of finance and the relationship between dividend policy and financing decisions (Section E1(e) of the syllabus). Candidates should have linked their discussion to Time Co's planned expansion. Better answers recognised that limiting dividends would:

- retain earnings to provide an internal source of finance for future investment;
- preserve cash and maintain liquidity during a period of expansion;
- reduce the need to raise external finance, avoiding the associated costs and time involved; and
- support investment in projects before distributing profits to shareholders, consistent with a residual approach to dividend policy.

Candidates only needed to develop two relevant points to achieve full marks. Repeating similar ideas about retaining cash did not attract additional marks.

Requirement (b)(ii) – 2 marks

Discuss why some shareholders may be unhappy with lower dividends.

This requirement tested candidates' understanding of the practical influences on dividend policy, particularly shareholder expectations (section E1(e) of the syllabus).

Better answers recognised that some shareholders depend on dividends as a source of regular income and may be dissatisfied if payments are reduced. Other shareholders may believe that Time Co should obtain external finance for its expansion while continuing to provide an acceptable return to investors. The discussion should have been applied to Time Co rather than providing generic comments about dividend policy.

Common errors in parts (b)(i) and (b)(ii) included discussing the advantages and disadvantages of debt finance instead of dividend policy, repeating the same point in different words, and failing to apply the discussion to the circumstances of Time Co.

Requirement (c) – 4 marks

Discuss the problems that small and medium-sized enterprises (SMEs) face in obtaining funds for expansion of their business.

This requirement tested candidates' understanding of the financing problems faced by SMEs (section E5 of the syllabus). Candidates were expected to discuss financing difficulties rather than describe sources of finance.

Better answers identified and developed relevant points such as:

- Limited trading history – SMEs often have a relatively short trading record, making it more difficult for lenders to assess future performance. In the scenario, Time Co had only been trading for four years.
- Inadequate security – SMEs frequently have limited assets available as security, making lenders less willing to provide finance.
- Limited shareholder funding – Existing shareholders may be unwilling or unable to provide further finance to support expansion.
- External investor requirements – Equity investors may require greater control, board representation or a clear exit route before investing, which existing owners may be unwilling to accept.

Candidates only needed to discuss four distinct financing problems to achieve full marks. Repeating similar points or describing sources of finance, rather than the difficulties of obtaining finance, did not gain additional marks.

ACCA's technical article, "Business finance for SMEs" is available [here](#).