SoftDayta Learning

ICAEW Financial Management

Guidance for Attempting Common Questions

Use this document as a practical checklist before and after attempting FM-style questions. The aim is simple: numbers first, judgement second, recommendation clearly stated.

Based on the March, June and September 2025 FM practice results and student mark plans.

Big Picture Exam Approach

The FM paper is usually three questions in 2.5 hours for 100 marks:

1. Question 1: investment appraisal and business decision support, usually 35 marks.
1. Question 2: financing, WACC, dividend policy, behavioural finance, ethics and advice, usually 35 marks.
1. Question 3: risk management, usually foreign exchange, interest rate risk, futures, options, swaps or FRAs, usually 30 marks.

Use the marks as your time budget. A 35-mark question is about 52 minutes. A 30-mark question is about 45 minutes. Do not spend 20 minutes perfecting one NPV schedule if later parts contain easy discussion marks.

Always answer the requirement directly. ICAEW repeatedly rewards a calculated result plus advice. A technically correct calculation with no recommendation often leaves easy marks behind.

Question 1: Investment Appraisal

Common Requirement

You may be asked to calculate NPV or ENPV, advise whether to accept the project, calculate sensitivities, discuss risk, identify real options, comment on sustainability, or solve a related operational decision such as capital rationing or asset replacement.

Attempt Method

Set up a clean cash flow table with columns for t0, t1, t2, t3 and t4. Keep all figures in the same units, usually £000 or £m.

Use this structure:

1. Revenue.
2. Variable costs.
3. Contribution.
4. Incremental fixed costs.
5. Relevant one-off costs.
6. Taxable operating cash flow.
7. Tax.
8. Capital expenditure and disposal proceeds.
9. Tax saved on capital allowances.
10. Working capital movements.
11. Net cash flow.

12 Discounted cash flow and NPV or ENPV.

Then write a one-line conclusion:

> The project has a positive NPV/ENPV and should be accepted, as it is expected to increase shareholder wealth.

If the result is negative, say reject unless there are strategic, real option or sustainability reasons that justify further consideration.

Frequent Adjustments

1 Sunk costs: ignore market research or analyst reports already paid.

1 Depreciation: add back, because it is not a cash flow.

1 Incremental costs: include only costs caused by the project.

1 Allocated overheads: exclude unless incremental.

1 Consultant fees: include if future and project-specific.

1 Working capital: include incremental movements and recover the balance at the end.

1 Capital allowances: start at the correct time and include the balancing allowance or charge at disposal.

1 Sale/MBO proceeds: include if the question says the project will be sold or transferred.

1 Rent foregone: include as an opportunity cost.

1 Tax: apply to taxable operating cash flow and capital allowance tax shields.

Sensitivity Analysis

The common sensitivity formula is:

> Sensitivity = NPV / PV of the relevant variable after tax

For revenue sensitivity, do not use total revenue if variable costs move with revenue. Use contribution after tax:

> PV of after-tax contribution = contribution x (1 - tax rate), discounted

Then:

> Sensitivity to revenue = NPV / PV of after-tax contribution

For cost of capital sensitivity, calculate the IRR. The IRR is the maximum money cost of capital the project can bear before NPV becomes zero.

Recent examiner comments show that many candidates lose marks by not attempting IRR, even when it has appeared repeatedly. If asked, attempt it using the spreadsheet IRR function.

Risk And Scenario Questions

If asked to calculate a fall in demand, rise in costs, or both, revise the cash flows and compare the new NPV with the base case.

Your discussion should be scenario-specific:

1 Is the NPV still positive after the adverse change?

1 Which variable is the project most sensitive to?

1 Are estimates reliable or based on volatile prices?

1 Is there competitive pressure?

1. Does the result depend heavily on terminal proceeds?
1. Would the advice change?

Do not simply say "the project is risky". Link the risk to the data.

Real Options

Real options are strategic choices created by undertaking or delaying a project. Common examples:

1. Option to expand if demand is strong.
1. Option to abandon if the project underperforms.
1. Option to delay until uncertainty reduces.
1. Option to follow on with related products or markets.
1. Option to switch inputs, outputs or production method.

To score well, identify the option and explain why it applies to the scenario. One clear scenario-linked option is better than a list of generic options.

Sustainability

For ICAEW FM, sustainability is not only environmental. Use the impacts/dependencies distinction:

1. Impacts: how the organisation affects environmental, social and governance matters.
1. Dependencies: how ESG matters affect the organisation's ability to create and maintain value.

Examples:

1. Sustainable sourcing may protect reputation and customer demand.
1. Delivery fleets may create emissions, health and safety risks, or community impacts.
1. Resource scarcity may increase input costs.
1. Poor ESG performance may restrict access to finance.

Capital Rationing

If projects are divisible, rank by profitability index:

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PI = PV of inflows / initial investment
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If projects are indivisible, test combinations within the funding limit and choose the combination with the highest total NPV.

Explain hard versus soft capital rationing:

1. Hard: external market constraint; the company cannot raise more finance.
1. Soft: internal management-imposed limit; the company chooses not to raise or allocate more finance.

Asset Replacement

For replacement-cycle questions, calculate equivalent annual cost or average annual cost over each possible replacement period. Include purchase price, running costs, residual value and discounting where required.

Recommend the replacement cycle with the lowest annual cost, then mention limitations such as uncertain running costs, changing technology, inflation, operational disruption and non-financial factors.

Question 2: Financing, WACC, Dividends And Advice

Rights Issues

Typical steps:

1. Calculate number of new shares.
2. Calculate issue price.
3. Calculate discount to current market price.
4. Calculate theoretical ex-rights price.
5. Discuss whether actual price will equal TERP.

TERP structure:

> TERP = total value of old and new shares / total number of shares after the issue

Discussion points:

1. Market reaction to the rights issue.
1. Whether funds are invested in positive NPV projects.
1. Take-up by existing shareholders.
1. Information signalling.
1. Behavioural finance effects, if asked.

Debt Valuation And GRY

For debentures with semi-annual interest:

1. Number of periods = years x 2.
1. Coupon per period = annual coupon / 2.
1. Use the six-month yield in RATE or PV.
1. Annualise the six-month GRY if needed for discussion.

Common mistakes are using annual periods when payments are semi-annual, using the wrong redemption value, or applying another company's yield without discussing risk differences.

When discussing whether a comparator yield is valid, mention:

1. Same or different sector.
1. Different financial risk.
1. Different term to redemption.
1. Different coupon.
1. Different redemption premium.
1. Security and credit risk.

Gearing

Use market values where asked:

> Gearing = debt / equity

or

> Gearing = debt / (debt + equity)

Be clear which basis you are using. Recalculate equity after rights issues using the post-issue share price or total market value, depending on the data.

Cost Of Equity And WACC

Dividend valuation model:

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Ke = D1 / P0 + g
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Be careful with ordinary versus special dividends. Special dividends are normally excluded from sustainable growth calculations.

CAPM:

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Ke = Rf + beta x equity risk premium
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Do not treat the market risk premium as the market return.

WACC:

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WACC = Ke x E/(D+E) + Kd after tax x D/(D+E)
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Use market values for weights unless the question says otherwise. Use post-tax cost of debt.

Risk-Adjusted WACC

Use the current WACC only if the project has similar business risk and financing risk to the existing company.

If the project changes business risk, adjust using a suitable proxy beta or project-specific discount rate. Explain that a riskier growth plan should be appraised using a higher discount rate than current WACC.

Equity Versus Debt Advice

For equity:

1 No mandatory interest or repayment.

1 May reduce gearing.

1 Dilution of control and EPS.

1 Issue costs and possible negative signal.

For debt:

1 Interest tax relief.

1 No ownership dilution.

1 Increases financial risk and gearing.

1 Requires servicing and repayment.

1 May breach covenants or reduce borrowing capacity.

For a combination:

1 May balance risk, cost and control.

1 Can preserve target gearing.

1 More complex to arrange.

Always conclude based on the scenario, not theory alone.

Dividend Policy

Common topics:

1. Stable dividend policy.
1. Constant payout ratio.
1. Scrip dividend.
1. Special dividend.
1. Share buyback.

For listed companies, a stable and predictable dividend is often considered appropriate because it reduces uncertainty and supports investor expectations.

Use surplus funds carefully:

1. Special dividend distributes cash directly.
1. Share buyback returns cash and may improve EPS, but can signal limited investment opportunities.
1. Scrip dividend preserves cash and does not distribute surplus cash.

Ethics

Use a practical structure:

1. Identify the threat.
2. Explain who is affected.
3. Explain why it matters.
4. Recommend action.

Common threats:

1. Conflict of interest.
1. Confidential information.
1. Self-interest.
1. Pressure from management or client.
1. Misleading forecasts or selective disclosure.
1. Lack of professional competence.

Actions:

1. Inform relevant parties.
1. Obtain consent where appropriate.
1. Use separate teams and information barriers.
1. Escalate internally.
1. Decline or withdraw if safeguards are inadequate.
1. Document advice.

Question 3: Risk Management

Foreign Exchange Hedging

The recurring pattern is to calculate sterling outcome under:

1. Forward contract.
1. Money market hedge.

1. OTC currency option.
1. No hedge.

Then compare and advise.

Choosing The Correct Rate

For a foreign currency receipt:

1. You will receive foreign currency and sell it for £.
1. Use the rate that gives the appropriate £ receipt.
1. For options, this normally means a put option on the foreign currency.

For a foreign currency payment:

1. You need to buy foreign currency using £.
1. For options, this normally means a call option on the foreign currency.

Always state whether the option is exercised and why.

Forward Contract

For a receipt:

> £ receipt = foreign currency receipt / forward rate

For a payment:

> £ payment = foreign currency payment / forward rate

Use the forward premium or discount exactly as given in the question. The examiner frequently notes wrong-rate errors.

Money Market Hedge

For a foreign currency receipt:

1. Borrow the present value of the foreign currency receipt now.
2. Convert it to £ at spot.
3. Invest £ until the receipt date.
4. Use the actual foreign receipt to repay the foreign loan.

For a foreign currency payment:

1. Deposit the present value of the foreign currency payment now.
2. Buy that foreign currency at spot using £.
3. Borrow £ if needed.
4. The foreign deposit grows to meet the payment.

Use the correct borrowing and deposit rates for the correct currency.

OTC Options

For a receipt, normally use a put option. For a payment, normally use a call option.

Include:

1. Exercise price.

1. Premium.
1. Lost interest on premium if the question requires it.
1. Exercise decision.
1. Net receipt or total cost.

Options protect downside risk while allowing upside potential, but the premium can make them worse than a forward or money market hedge.

Advice Paragraph

Compare the hedged results, but do not recommend no hedge simply because it is better in hindsight. No hedge leaves the company exposed to exchange risk.

A good advice paragraph says:

1. Which hedge gives the best certain outcome.
1. Whether options are worth the premium.
1. What risk remains.
1. Which method is recommended and why.

Interest Rate Swaps

Common steps:

1. Identify which company has the comparative advantage.
2. Compare fixed-rate differentials and floating-rate differentials.
3. Calculate the net benefit.
4. Share the benefit if instructed.
5. Show each party's final effective rate.

Advantages:

1. Can reduce borrowing cost.
1. Allows access to preferred fixed or floating exposure.
1. Can manage interest rate risk without refinancing the original loan.
1. Terms can be tailored.

FRAs And Interest Rate Futures

For an FRA:

1. Identify whether the company fears rates rising or falling.
1. Calculate actual interest cost.
1. Calculate FRA compensation or payment.
1. Combine to get net cost.

For futures:

1. Determine whether to buy or sell futures.
1. Calculate number of contracts.
1. Calculate futures gain or loss.
1. Combine with actual interest cost.

Expect imperfect hedging due to basis risk, contract size rounding and timing mismatch.

Interest Rate Parity

Interest rate parity links spot rates, forward rates and interest rate differentials. In exam answers:

1. Calculate the predicted forward rate using interest rates.
2. Compare it with the actual quoted forward rate.
3. State whether parity appears to hold.
4. Explain possible reasons for difference, such as transaction costs, risk, controls or market imperfections.

Index Futures

For portfolio hedging:

> Number of contracts = portfolio value x beta / futures price x contract multiplier

Then calculate futures gain/loss and compare with portfolio loss/gain.

The hedge will not be perfect because of basis risk, beta estimation error, rounding to whole contracts, timing mismatch and differences between the portfolio and index.

Common Examiner Error List

Avoid these recurring mistakes:

1. Recalculating pre-populated spreadsheet figures when the question says they are correct.
1. Including sunk costs.
1. Excluding relevant future consultant or project-specific costs.
1. Treating depreciation as a cash flow.
1. Starting capital allowances one year late.
1. Forgetting balancing allowance or balancing charge.
1. Mishandling working capital movements or failing to recover working capital.
1. Omitting terminal proceeds such as MBO sale proceeds.
1. Using revenue instead of after-tax contribution for sensitivity.
1. Not attempting IRR when asked.
1. Giving generic risk or sustainability discussion with no scenario link.
1. Using annual periods for semi-annual debenture interest.
1. Treating market risk premium as market return in CAPM.
1. Using the wrong exchange rate.
1. Using a call option for a receipt or a put option for a payment.
1. Adding option premiums when they should reduce receipts or increase costs.
1. Choosing no hedge purely because it is best with hindsight.

Final Answer Style

For each requirement, aim for this rhythm:

1. Calculation.
2. Brief interpretation.

3 Scenario-specific advice.

Example:

> The project has a positive NPV of £Xm and should therefore be accepted because it is expected to increase shareholder wealth. However, the sensitivity analysis shows that the result depends heavily on terminal proceeds, so management should verify the reliability of the sale value before committing.

This is the FM sweet spot: numbers first, judgement second, recommendation clearly stated.