Examiner's report
F9 Financial Management
September 2015

Introduction

Performance at the September 2015 diet was unsatisfactory. Too many candidates are under prepared for an examination in financial management, neither having studied the whole syllabus in enough depth, nor having worked enough examples of past paper standard.

General Paper Comments

The examination consisted of two sections. Section A contained twenty objective testing questions for a total of 40 marks and Section B contained three questions of 10 marks each, and two questions of 15 marks each (total 60 marks). In common with all of the ACCA examinations, for success to be achieved, there is a significant investment required in terms of time, discipline and energy in order to obtain the necessary level of knowledge and application.

Candidates need to have knowledge of the entire syllabus and will not be successful if they simply rely on 'question spotting' a few selected areas for study. Candidates should manage their own learning and not be totally reliant on a single textbook or revision course for their knowledge.

Candidates need to take greater care and be more precise in presenting answers to numerical questions in Section B. All workings should be shown and the requirement should be read more carefully. For example, where a company valuation is asked for in total and per share, relatively straightforward marks are not being gained when only one of the two is presented.

Furthermore, in response to requirements in Section B requiring a discussion or explanation, candidates should address the requirements of the question asked and not the one they'd have liked to have been asked (or were asked in questions in an earlier diet).

Section A

It was very pleasing to see that almost all candidates attempted all of the questions. Candidates preparing for the next examination of F9 are advised to work through the specimen exams, any published past exam papers and questions available from approved content providers and to carefully review how each of the correct answers were derived.

Section A questions aim to provide a broad coverage of the syllabus, and future candidates should aim to revise all areas of the F9 syllabus, rather than attempting to question spot.

The following questions are reviewed with the aim of giving future candidates an indication of the types of questions asked and guidance on dealing with such exam questions.

Example 1 is numerical and illustrates how both reading all of the question's information and the question's requirement are essential.

Example 2 is a question requiring knowledge of principles and illustrates how all parts of the F9 syllabus can be tested.

Example 1

Ling Co has annual credit sales of $4,500,000 and on average customers take 60 days to pay, assuming a 360-day year. As a result, Ling Co has a trade receivables balance of $750,000. Ling Co relies on an overdraft to finance this at an annual interest rate of 8%.

Ling Co is considering offering an early settlement discount to its customers of 0·5% for payment in 30 days. It expects that 25% of its customers (representing 35% of the annual credit sales figure) will pay on 30 days in order to obtain the discount.

If Ling Co introduces the proposed discount, what will be the NET saving?

A $2,625
B $1,875
C $7,500
D $10,500

The *correct response* is as follows:

A
Reduction in receivables = $4·5m x 30/360 x 0·35 = $131,250
Interest saved = $131,250 x 8% = $10,500
Cost of discount = $4·5m x 0·35 x 0·005 = $7,875
Net saving = $10,500 – $7,875 = **$2,625**

A significant minority incorrectly opted for B $1,875, arrived at *where 25% has been used instead of 35%.*

B
Reduction in receivables = $4.5m x 30/360 x 0.25 = $93,750
Interest saved = $93,750 x 8% = $7,500
Cost of discount = $4·5m x 0·25 x 0·005 = $5,625
Net saving = $7,500 – $5,625 = $1,875

The other incorrect responses, C $7,500 and D $10,500, were arrived at as follows:

C *Receivables in total reduces to 30 days*
Reduction in receivables = $4·5m x 30/360 = $375,000
Interest saved = $375,000 x 8% = $30,000
Cost of discount = $4·5m x 0·005 = $22,500
Net saving = $30,000 – $22,500 = $7,500

D *Cost of discount not deducted*
Reduction in receivables = $4·5m x 30/360 x 0·35 = $131,250
Interest saved = $131,250 x 8% = $10,500

Example 2

Which of the following statements describes the main objective of financial management?

A Efficient acquisition and deployment of financial resources to ensure achievement of objectives
B Providing information to management for day-to-day functions of control and decision-making
C Providing information to external users about the historical results of the organisation
D Maximisation of shareholder wealth

This is a seemingly straightforward question from Syllabus area A which appears within the opening lines of most financial management textbooks.

The accepted definition of financial management is that given in:
A, "Efficient acquisition and deployment of financial resources to ensure achievement of objectives".

A number of candidates incorrectly gave D as their response. This is the overall, primary objective of a profit seeking organisation which would not be relevant to a not for profit organisation, but financial management is still relevant to a not for profit organisation.

B, "Providing information to management for day-to-day functions of control and decision-making", is the definition of management accounting.

C, "Providing information to external users about the historical results of the organisation", is the definition of financial accounting.

Section B

Candidates in general performed reasonably well on the calculation-based questions. Candidates in general did not perform as well on discussion questions. There were many reasonable attempts at most of the five questions, but there were also too many scripts with whole questions not attempted. Candidates struggled with question 3.

As has been said before, it is essential to read the question requirement carefully in any examination, in order to understand clearly what you are being asked to do. Some candidates did not do this and as a result included irrelevant material in their answers. For example, some candidates discussed centralisation generally in question 1b when the question asked about centralisation of a specific function.

It is also important to manage your time carefully in the examination and to plan your answers to discussion questions if you can. You should therefore avoid writing too much for the marks offered, for example some candidates gave long, irrelevant answers to question 4b, such as discussing M& M theory.

Question One

Question 1a required candidates to numerically evaluate alternative ordering policies. In general, this was done well.

In question 1b candidates were asked to discuss centralised treasury management and cash control. Whilst there were good responses which discussed, for example, management of risk, fraud reduction, and better cash management, weaker responses were far too vague and referred to factors which were relevant to centralisation in general, such as economies of scale in bulk purchasing. Candidates need to address the specific requirement set.

Question Two

Question 2a required candidates to perform a company valuation using three different techniques. Many candidates were let down by a fundamental lack of knowledge here. For example, when using an asset-based valuation model, the failure to deduct liabilities from total assets is an error of principle which shows a deficiency in financial management knowledge.

Furthermore in 2a, there were a number of unsatisfactory attempts at income-based and cash-based valuation models and even an evident confusion between the two, with answers to one being applied to the other.

Some candidates did accurate total valuations but even here, they did not pick up full marks due to a lack of calculating the per share value, which was clearly asked for.

2b asked candidates to discuss cash based valuation models. Overall, there were unsatisfactory responses to this part, which, in many cases, did not discuss the issues surrounding forecasting discount rates and cash flows, and drifted into non relevant areas of profit/earnings, asset valuation and even depreciation. There were also a significant number of no responses to this part.

This, once again, demonstrated that candidates need to address the requirement set and study all parts of the syllabus.

Question Three

This was the most unsatisfactory question in terms of candidate responses, both in terms of numbers of 'no responses' to question parts and in terms of lack of knowledge when responses were offered.

There seemed to be a lack of clarity in the distinction between interest rate risk and exchange rate risk. Far too many candidates were confusing the two types of risk.

Question 3a clearly referred to managing interest rate risk. In too many cases the first calculation presented by candidates was a conversion from one currency into another, and then a discussion of spot versus forward rates. Unfortunately, this repeated a mistake made in a question in the June 2015, the examiner's report for which stated;

"In terms of examination technique, answers to this question reinforce the need for you to address the question requirement (interest rate risk) and avoid including irrelevant material (foreign currency risk, interest rate parity) in your answer."

Likewise, when question 3b asked about analysing foreign currency risk, responses sometimes contained discussion relevant to interest rate risk. Also, the requirement asked for candidates to 'analyse'. If asked to analyse, candidates must consider the information in the scenario.

Candidates' discussion of ways to hedge did often list alternative methods, but could have explained them more fully.

Question 3c required candidates to explain the four way equivalence model. Some candidates were able to recognise the need for an explanation of Interest Rate Parity and Purchasing Power Parity but needed to do more than reproduce the formulae given at the end of the question paper. Few responses properly explained the four way equivalence model.

Question Four

Question 4 presented a scenario whereby a company was financing a growth strategy via the issue of debt finance.

4a gave candidates an opportunity to display their knowledge of financial management performance indicators by assessing the impact of a debt issue on financial position, financial risk and shareholder wealth.

There were many good responses here in terms of the calculations with plentiful correct ratios based upon those suggested in the scenario and others. Amongst the common mistakes were the wrong inclusion of current liabilities as part of the debt total in the debt to equity ratios, the failure to recognise that new retained profit adds to the reserves of the company and that return on equity percentages use profit after tax.

Discursive points often failed to recognise that a range of indicators needed to be considered before a definite conclusion could be reached. For example, some candidates seemed to think that because dividend per share rises then shareholder wealth has increased, ignoring how the share price may react to an increase in debt finance. Similarly, a firm conclusion about financial risk cannot be made based upon interest cover ratios alone; rather a range of suitable indicators should be examined.

Question 4b required a discussion about the weighted average cost of capital and the circumstances under which it could be used in investment appraisal. Lots of candidates made only a generic statement such as 'when the business and financial risk remain unchanged'. A better discussion of each of the risks and, also, as to how a project specific discount rate could be found when business risk does change, would have scored more marks.

Some candidates drifted into irrelevant discussion (e.g. M&M theory, time value of money) in 4b, which scored no marks, and they spent valuable time doing so.

Question Five

Question 5 presented a scenario where a company was looking to acquire a piece of machinery and wished to determine whether leasing or buying the machine would be financially preferable.

Candidates, in general, were able to present many of the cash flows correctly. Under the buy option, most correctly inflated servicing costs (although often ignoring the tax relief upon it) and could calculate the tax saving arising from claiming tax-allowable depreciation.

As with the servicing costs above, under the leasing option, too many candidates failed to recognise the tax relief arising from the lease payments. These both illustrate a failure to apply a fundamental principle in financial management.

Similarly, candidates who did not recognise that such an evaluation needed to work out net present values of each option using discounted cash flow techniques were displaying a lack of fundamental financial management knowledge which underpins much of what is done in the discipline.

Only a minority of candidates recognised that the cost of the loan was at a before tax percentage and need to be adjusted to after tax, whilst some candidates even said that there was no cost of capital percentage given in the question!

Question 5b required candidates to explain the difference between a real terms and a nominal terms approach to investment appraisal.

Many candidates could take the Fisher Equation provided on the formulae sheet and define each of the variables. The common error seen here, and in previous diets, is the misconception that the real terms approach ignores inflation whilst the nominal terms approach includes inflation.

This statement is not correct. They both 'include' inflation but do so in different ways.

Good candidates recognised this via a discussion along the lines of "nominal cash flows which have been calculated by applying specific inflation to current price terms estimates can be turned into real cash flows by deflating them by the general rate of inflation", and then moving into a discussion about how nominal and real cost of capital percentages are linked and when each is applied.