



Examiner's report

F9 Financial Management

December 2016

General Comments

Overall, candidates were reasonably well prepared for this examination in financial management, and performance at the December 2016 diet was good. There were some excellent individual performances. I would like to offer my congratulations to those candidates who have achieved a pass at this diet, but also my commiserations to those who didn't do so.

General Paper Comments

The examination consisted of three sections.

Section A contained 15 objective test questions of 2 marks each, for a total of 30 marks, Section B contained three scenarios consisting of 15 objective test questions of 2 marks each, for a total of 30 marks and Section C contained two questions of 20 marks each, for a total of 40 marks.

Given the format of the examination outlined above, candidates need to be aware that they require knowledge of the entire syllabus and will not be successful if they simply rely on 'question spotting' a few selected areas for study.

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 should manage their own learning well and not be totally reliant on a single textbook or revision course for their knowledge.

In Section C, where there are two questions of 20 marks each, it continues to be of importance for candidates to be precise in presenting answers. In these 20 mark questions, all workings should be shown and should be presented with the same neatness of presentation as the main schedule of figures. This applies equally to candidates sitting either the paper based examination or the computer based examination (CBE).

In the CBE, having the use of a spreadsheet does not remove the need to show the build up to, for example, an internal rate of return (IRR) or to show the detail of a cost of equity calculation, nor does having the ability to type an answer remove the necessity to write professionally with good use of the English language. In too many cases, written answers were poorly structured with both grammatical and typographical errors.

Section A (questions 1-15)

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 as many objective test questions as possible. Sources for these questions may include the specimen exam and any published past exam papers and questions available from approved content providers. These questions should be carefully reviewed as to how each of the correct answers was 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 the principles of hedging techniques for interest rate risk and illustrates how all parts of the F9 syllabus can be tested.

Example 1

Swap Co is due to receive goods costing \$2,500. The terms of trade state that payment must be received within three months. However, a discount of 1.5% will be given for payment within one month.

Which of the following is the annual percentage cost of ignoring the discount and paying in three months?

- A 6.23%
- B 9.34%
- C 6.14%
- D 9.49%

The *correct response* is as follows:

D

If the discount is accepted, the company must pay \$2,462.50 at the end of one month.

Alternatively, the company can effectively borrow the \$2,462.50 for an additional two months at a cost of \$37.50.

The two-month rate of interest is therefore $37.50 / 2,462.5 \times 100 = 1.5228\%$

The annual equivalent rate (AER) = $(1 + 0.015228)^6 - 1 = 0.0949$ or 9.49%

This was achieved only by a minority of candidates.

The *incorrect responses* are as follows:

A

This is incorrect since the two-month interest rate has been treated as a three-month rate by being raised to the power of four (effectively the one month delay in payment has been ignored).

The annual equivalent rate (AER) = $(1 + 0.015228)^4 - 1 = 0.0623$ or 6.23%

B

This is incorrect since the two-month rate of interest based upon the discounted price has not been calculated, and instead the 1.5% discount given has been used.

The annual equivalent rate (AER) = $(1 + 0.015)^6 - 1 = 0.0934$ or 9.34%

C

This is incorrect since it combines the errors of A and B above.

The annual equivalent rate (AER) = $(1 + 0.015)^4 - 1 = 0.0614$ or 6.14%

Example 2

Which of the following statements about interest rate risk hedging is correct?

- A An interest rate floor can be used to hedge an expected increase in interest rates
- B The cost of an interest rate floor is higher than the cost of an interest rate collar
- C The premium on an interest rate option is payable when it is exercised
- D The standardised nature of interest rate futures means that over- and under-hedging can be avoided

This is a question which tests the candidate's awareness of hedging techniques for interest rate risk.

The *correct response* is as follows:

B

The cost of buying an option alone (such as a floor) is lower than for a collar. Under a collar, the buyer can buy an interest rate cap and simultaneously sell an interest rate floor, thus limiting the cost for the company, since a premium is received for the option sold.

This was answered correctly only by a small proportion of candidates.

The *incorrect responses* are as follows:

A is incorrect as an interest rate floor can be used to hedge an expected decrease in interest rates.

C is incorrect as the premium on an interest rate option is payable when you take out the protection. This is non-returnable whether or not you make use of the protection.

D is incorrect as the standardised nature of interest rate futures means that they cannot always be matched with specific interest rate exposures. Hence, over- and under-hedging cannot be avoided.

Further guidance on this topic is available via the technical article, “Hedging techniques for interest rate risk”, available on the ACCA website.

Section B (questions 16-30)

In common with Section A, it was very pleasing to see that almost all candidates attempted all of the questions. Also, as with section A, candidates preparing for the next examination of F9 are advised to work through as many objective test questions as possible using the sources listed above.

Each of the three Section B scenarios is followed by 5 objective test questions which, whilst based upon the scenario, can come from any area of the syllabus. As with Section A, future candidates should aim to revise all areas of the F9 syllabus, rather than attempting to ‘question spot’.

In broad terms, candidates performed slightly worse in Section B than they did in Section A, and so should continue to prepare for the examination by expecting individual objective test questions in Section B to be from any part of the syllabus.

Candidates should be aware that objective test questions can test the application of knowledge in a theoretical as well as a numerical way. For example, it is not sufficient to rely on the fact that formulae are provided in the question paper for the Fisher formula and for purchasing power parity and interest rate parity. It is important to know the purpose for which they are used as well as how they are used. Responses to a question on this topic suggest that many candidates did not know this.

Section C (questions 31-32)

Candidates in general performed well on the calculation-based questions such as 31a and 32a, and also on discussion question 31c. Candidates in general did not perform as well on discussion questions 31b and 32d. There were many reasonable attempts at most parts of the two questions, but there were also some scripts with parts not attempted. This particularly seemed to affect 32d, which, in many cases, would have been the final part which a candidate could have attempted.

At the risk of stating the obvious, candidates need to address the particular requirement of the question. In other words, the requirement should be read carefully and answered directly. For example, a requirement to 'discuss ways in which the risk of a project can be assessed' is not about how we assess projects themselves but about how we assess the risk associated with them.

Candidates should also avoid the pitfall of trying to answer the question they'd have liked to have been asked (or was asked in an earlier diet). For example, some candidates seem determined to bring in a discussion about M&M theory, at the first opportunity, within a question where the WACC is being calculated and some also wished to make use of the asset beta formula provided in the examination paper at the first mention of 'risk'.

It is essential to read the question requirement carefully in any examination in order to understand clearly what you are being asked to do. In particular, it is important to recognise that a requirement may contain two parts, for example, a requirement to "calculate the NPV of a project AND comment on its financial acceptability" displays two separate elements.

In this example, a comment must be more than simply stating "accept" or "reject" the project, as this is lacking in justification. A suitable response would be "the NPV is positive and so the investment project is financially acceptable" or the opposite if the figure work suggests otherwise.

Furthermore, when asked to discuss an issue, it is important to do more than simply list the features relevant to that issue. A discussion, which may include examining the positive and negative aspects of the method, is what is required in such a case.

Candidates should also spend an appropriate amount of time on each part of the questions. When asked to explain the meaning of two different terms, for which there is a total of 4 marks available, it is reasonable to assume that there are 2 marks available for each term. Candidates simply writing all that they know about the topic in general may score marks somewhere in their answer, but are using up precious time by not being more selective in what they write in response to the requirement.

Question 31

This longer-form question was from the business finance part of the syllabus and comprised three parts, totaling 20 marks.

Part (a) asked candidates to calculate the weighted average cost of capital (WACC) of a company, given four different sources of finance. This was done well in the majority of cases.

Common errors in this part included not recognising the fact that, in the cost of equity calculation, the equity risk premium was provided in the question and hence it was incorrect to treat it as though it were the market rate of return and subsequently deduct from it the risk-free rate of return. Other errors included the absence, or incorrect calculation, of the cost of preference shares (often by failing to recognise their market value) and/or the bank loan (often by failing to calculate the after tax percentage).

As noted above, where candidates need to do several workings in order arrive at a figure, for example, the calculation of the cost of redeemable loan notes via the IRR method, it is vital that each stage of the calculation is shown. It is not good practice to solely state the cost of debt percentage as a result of the output of calculator work.

Part (b) asked for an explanation of the terms business risk and financial risk. This was unsatisfactorily attempted. Many candidates totally missed the point of this question and went into a great variety of irrelevant discussion about the business environment and detailed explanations about CAPM.

Very few scripts mentioned that business risk in financial management relates to the variability of shareholder returns which arises from business operations, whilst financial risk relates to the variability of shareholder returns which arises from the way in which a company finances itself. The former should have led into a discussion about operational gearing, whilst the latter should have preceded a discussion about financial gearing.

Part (c) required a discussion of the key features of a rights issue as a way of raising equity finance. There were many good answers here. Most candidates had the fundamental idea that existing shareholders have a right to be offered new shares before they are offered to other buyers and that the rights issue price is at a discount to the share price following the announcement of the rights issue.

A little more precision was needed on some other points. For example, a rights issue means that there is no change in the balance of ownership and control in a company but this is providing that existing shareholders buy the shares to which they are entitled, the latter condition often being missed by candidates.

Question 32

This longer-form question was from the investment appraisal part of the syllabus and comprised four parts, totaling 20 marks.

Part (a) asked candidates to calculate the NPV of a project and comment on its financial acceptability. This was generally done well, with many candidates scoring full marks. Common errors arise due to not reading the information in the question properly, such as that regarding the timing of the cash flow associated with taxation or when the initial investment is made. Also, where inflation is stated as being per year, this means that the inflation accumulates year upon year so that, for example, a year 4 variable cost per unit needs to be inflated by four years' worth of inflation.

As already stated, candidates need to say more than “accept” or “reject” in order to meet the criteria for a comment about financial acceptability.

Part (b) asked candidates to determine an optimum investment schedule given limited capital investment funds and divisible projects, two of which were mutually exclusive. Whilst there were many correct answers, too many incorrect answers were seen. Common errors included taking the trial and error approach associated with indivisible projects, calculating the profitability indices for the projects but then not knowing what to do with them and providing schedules which included both of the mutually exclusive projects, the latter of which seems to suggest a lack of understanding of the term ‘mutually exclusive’ (some candidates were even treating such items as complimentary pair and not as substitutes).

In part (c), the reasons for hard and soft capital rationing occurring needed to be discussed. There was a mixed bag of answers here. There were many good answers, but also answers lacking in detail.

Most candidates understood the notion of hard rationing being associated with external factors and soft rationing associated with internal factors. This statement, though, needs to be precise. Stating that hard rationing is the use of external finance and soft rationing being the use of retained earnings is not correct.

Also, precision in discussing the reasons is required. When stating that hard capital rationing is due to banks being unwilling to lend, a discussion should follow incorporating the reasons for this, such as government imposed bank lending restrictions or that the bank views the company as too risky due to its existing level of indebtedness.

Part (d) produced the weakest candidates' responses in Section C. The requirement was to discuss the ways in which the risk of an investment project can be assessed. Whilst some candidates correctly identified probability analysis and CAPM as suitable ways in which to do this, even these responses often neglected to discuss the ways correctly and in sufficient depth.

The weakest outcomes here simply misinterpreted the requirement and seemed to ignore the risk factor, instead writing in general terms about simply how to assess projects with detailed, irrelevant discussions about ARR, payback and NPV. IRR also featured often, yet incorrectly, as a method with which risk can be assessed.

The most common error was to discuss sensitivity analysis as a way in which risk can be assessed. This is not the case. Sensitivity analysis is a method of analysing the uncertainty surrounding a project. Future candidates should be fully aware that risk and uncertainty, whilst studied together, are distinct from each other. Risk uses



past relevant experience such as assigning probabilities to outcomes, whilst uncertainty is where there is little past experience and, as such, it is difficult to assign probabilities to outcomes.