F9 Examiner’s report
September 2016

Introduction

Performance at the September 2016 diet was good and there were some excellent individual performances.

Overall, candidates were well prepared for this examination in financial management, and 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 testing questions of 2 marks each, for a total of 30 marks, Section B contained three scenarios consisting of 15 objective testing 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.

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. This is especially important given the format of the examination outlined above.

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.

Candidates need to be more precise in presenting answers, in particular to numerical questions, in Section C. All workings should be shown in this section and should be presented with the same neatness of presentation as the main schedule of figures. Furthermore, the requirement should be read carefully. For example, a requirement to ‘evaluate whether’ a company should pursue a particular course of action should bring about a candidate’s response which concludes with a decision or recommendation based upon the overall effect of the action, which will need to consider the net financial effect.

In response to requirements in Section C requiring a discussion or explanation, candidates should address the question asked and not the one they’d have liked to have been asked (or was asked in an earlier diet). For example, a requirement to ‘critically discuss’ an issue should include an appreciation of the different aspects of the elements involved, which may include both the advantageous and disadvantageous aspects.

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 testing questions as possible. Sources for these questions may include the pilot paper and any published past exam papers and questions available from various publishers. 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 principles and illustrates how all parts of the F9 syllabus can be tested.

Example 1

Drumlin Co has $5m of $0·50 nominal value ordinary shares in issue. It recently announced a 1 for 4 rights issue at $6 per share. Its share price on the announcement of the rights issue was $8 per share.

What is the theoretical value of a right per existing share?

A $1·60
B $0·40
C $0·50
D $1·50

The *correct response* is as follows:

B

Current shares	5.00m	at	$8.00	=	$40m
New shares under 1 for 4	1.25m	at	$6.00	=	$7.5m
Total shares after rights issue	6.25m				$47.5m

Theoretical ex rights price $47.5m / 6.25m	=	$7.60
Current price	=	$6.00
Value of a right		$1.60
Value of right **per share** $1.60 / 4	=	$0.40

The *incorrect responses* are as follows:

A

A significant number of candidates incorrectly opted for option A $1.60, where the final step to arrive at the theoretical value of a right per existing share has not been done.

The other incorrect responses, C $0.50 and D $1.50, were chosen by some candidates and were arrived at as follows:

C

$0.50 is the value of the cum rights price minus the subscription price, then divided by 4.

($8.00 - $6.00) / 4 = $2.00 / 4 = $0.50

D

$1.50 is the subscription price of the new shares divided by the number of existing shares.

$6.00 / 4

Example 2

In relation to an irredeemable security paying a fixed rate of interest, which of the following statements is correct?

A As risk rises, the market value of the security will fall to ensure that investors receive an increased yield
B As risk rises, the market value of the security will fall to ensure that investors receive a reduced yield
C As risk rises, the market value of the security will rise to ensure that investors receive an increased yield
D As risk rises, the market value of the security will rise to ensure that investors receive a reduced yield

This is a question which tests the candidate's awareness of the relationship between the yield and the market value of a security.

The *correct response* is as follows:

A

As risk rises, the investor needs to receive an increased yield in order to compensate for the higher level of risk. If the irredeemable security pays a fixed rate of interest, an increased yield is achieved when the market value of the security falls, as the interest will then comprise a higher percentage of the market value.

The *incorrect responses* are as follows:

C

A significant number of candidates incorrectly gave C as their response rather than the correct response of A.
This is not correct as, given a fixed rate of interest, a rise in the market value will cause yield to fall, which will not compensate investors for the higher levels of risk.

B is incorrect as a reduced yield will not compensate investors for the higher levels of risk.

D is incorrect as, whilst a reduced yield is consistent with a rise in the market value of a security given a fixed rate of interest, a reduced yield will not compensate investors for the higher levels of risk.

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 testing questions as possible using the sources listed above.

Each of the three Section B scenarios is followed by five objective testing 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 better in Section B than they did in Section A, but should continue to prepare for the examination by expecting individual objective testing questions in Section B to be from any part of the syllabus.

Section C (questions 31-32)

Candidates in general performed well on the calculation-based questions such as 31a, 31b and 32a, and also on discussion question 31c. Candidates in general did not perform as well on discussion question 32c. 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 32b.

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. For example, a requirement to evaluate a decision, when calculations are an essential part of that evaluation, should conclude with a consideration of the value of the net benefit or cost, as well as a statement about the decision.

Furthermore, some candidates try to answer the question that they think is there, rather than the one that actually is there. For example, when asked to critically discuss an issue, it is important to do more than simply list the methods relevant to that issue. A discussion, which may include examining the positive and negative aspects of the method, is desired.

More positively, at this diet many candidates seemed to spend an appropriate amount of time on each part of the questions.

Question 31

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

Part (a) asked for an evaluation of whether an early settlement discount should be accepted. This was generally done well and many candidates scored full marks here.

Often seen errors included a failure to understand the reduction in trade payables and its effect on the financing cost, in that paying suppliers earlier in order to accept a discount is a relevant financing cost to the company in question as it brings about an earlier than usual cash outflow.

Some candidates chose to address the issue in question by calculating an annual equivalent percentage cost of the discount and then comparing it to the overdraft percentage rate. Such a relative approach to this problem, rather than the calculation of absolute values, was inappropriate as there was a further cost involved in the calculation, namely an administrative cost.

The evaluation of whether to accept an early settlement discount should include a consideration of the net effect of such a decision, as well as a recommendation.

Part (b) asked for an evaluation of whether to adopt an economic order quantity (EOQ) approach to ordering a component. This was generally done well and many candidates scored full marks here.

Errors seen often included the incorrect calculation of the EOQ by using the value of annual sales and not using the annual demand in units and also, in the calculation of holding cost, the failure to divide by 2 in order to use the average level of inventory.

In a similar vein to part (a), the evaluation of whether to adopt an economic order quantity approach should include a consideration of the net effect of such a decision, as well as a recommendation.

Part (c) asked for a critical discussion of how the company in question could improve the management of its trade receivables. In general, this was done quite well.

Candidates were, in the main, stronger on points relating to collection of amounts owed rather than on points relating to credit analysis or credit control. For example, there was a strong prevalence of discussion around early settlement discounts (possible due to part (a)) and on the factoring of trade receivables. Discussion was relatively weaker in areas such as the monitoring of trade receivables, for example via an aged receivables analysis or via a credit utilisation report.

Most of the relevant points got included, nonetheless, by many candidates. Many responses could have been improved, however, with a fuller explanation of points made, especially in light of the question requirement for a <u>critical discussion</u>. For example, in a discussion about the use of a factoring company, it was insufficient to state only that the use of such a company improves management of trade receivables. A better discussion would have talked through the benefits of such an arrangement in terms of improved cash flow, as well as the cost in terms of the interest charged for sums advanced as well as the factor's fee. A further consideration which could have been mentioned here was the effect of the use of a factoring company on the relationship with customers.

Question 32

This longer-form question comprised two parts, totaling 20 marks.

Part (a) was from the investment appraisal part of the syllabus. Many candidates did very well on this part, which required them to calculate the net present value (NPV) of a planned investment over 4 years. There were many high marks scored and it is evidently a section of the syllabus which candidates both study and practice well. Technical areas, such as the calculation of the benefits of tax allowable depreciation, were generally done well.

There were several areas which could be improved upon. Firstly, some candidates failed to recognise a sunk cost, and hence incorrectly included it as part of the value of the initial investment. In a related point, it is difficult to understand how some candidates place the initial investment at the end of year one, when the question clearly stated that it is payable at the start of the first year of operation.

An area requiring further study is that of the requirement for, and use of, working capital in discounted cash flow calculations. As with the initial investment, it was clearly stated in the question that investment in working capital is required at the <u>start</u> of the first year of operation. This is at ‘Time 0’ and not ‘Time 1’. Also, an understanding of how to deal with changing working capital needs attention. For example, if more working capital is needed in year 2 than in year 1, then the relevant cash flow is the change in working capital, in this case a negative cash flow, and not the new total working capital. An additional issue needing improvement is how to account for working capital recovery.

Finally in respect of part (a), candidates must recognise that inflation rates affecting individual items of revenue and cost are usually stated on a ‘per year’ basis. This means that, for example, a year 4 selling price needs to be inflated by four year’s worth of inflation. Some candidates were inflating items of revenue and cost by only one year’s inflation when such items, in years 2, 3 and 4, had been the subject of more than one year’s inflation.

Part (b) was from the business finance part of the syllabus. Candidates were asked how the decision being made in respect of the new product launch in part (a) could be assisted by the capital asset pricing model. This brought about the least satisfactory responses in Section C.

The discussion should have centred on how the company’s new product launch is into a business area which differs from company’s existing business operations. This should have led into a discussion about how this would render inappropriate the company’s current WACC, and lead to a discussion about a project specific discount rate.

The small quantity of very good answers were then able to explain the need to use an equity beta from a proxy company and an explanation of <u>why</u> there is a need to ungear and regear the equity beta as well as how to do this. The regeared beta can then be inserted into the CAPM formula to provide a project-specific cost of equity, which can then itself be used to calculate a project-specific WACC.

Unfortunately, in most cases this was not satisfactorily answered. Too many responses simply took the formulae provided in the question paper and tried to construct an answer out of these, for example by defining the component parts of each formula. Answers such as this scored little, if any, marks. Furthermore, a number of responses contained a discussion of the difference between systematic and unsystematic risk, which, again, did not directly address the requirement.

For future reference, candidates need to develop a better understanding of why the current WACC may not be appropriate and an improved knowledge of business risk and financial risk, including how and why they are reflected and adjusted for in the calculation of the different beta values.