Examiner's report
P4 Advanced Financial Management
June 2013

ACCA

GENERAL COMMENTS

The structure of the P4 paper has changed from previous exams. In the June 2013 paper, there was one 50-mark compulsory question in section A, which also contained four professional marks. This was followed by three 25-mark questions in section B, out of which candidates had to choose two. All the questions consisted of a mixture of computational and discursive elements.

The overall performance of the candidates was comparable to previous exams
All excellent answers contained of eight common factors that led to high marks, and these are detailed below and have also been pointed out in previous examiner reports.

1. A **sound** knowledge and understanding of the entire P4 syllabus. Although P4 has a large syllabus, evidence from previous sittings clearly highlights that candidates who are well-prepared, as a result of sustained study, over a long period of time, are likely to be successful. This would involve a deep understanding of the subject and also of the current issues in financial management. On the other hand, last minute intensive study, question spotting and relying on hints is a strategy that is unlikely to yield success. For example, few candidates could answer question 3(c) on option gamma or question 2(b) on applying the EVA and PE ratio methods to valuing an acquisition. It would seem that candidates were not adequately prepared for these areas as possibly they were not expected to be tested.

2. Excellent answers were obtained from candidates who **applied** their knowledge and understanding to the scenario given in each question. This follows from point 1 above; candidates need to know the syllabus well in order to apply knowledge to the question scenario. Weaker answers tended to give more general answers rather than answers specific to the scenario. For example, in question 2(a) better answers specifically related possible synergy benefits to the narrative in the question. Similarly in questions 4(a) and 1(b), better answers were related to the scenario.

3. Good answers provided a **balanced answer for all the parts of each question**, whether the part required discussion or calculations or both. Make sure that you can answer all requirements of the question before selecting it. For example, it seems that in this paper candidates got 'tempted' by a relatively easy 2(a), asking for types of synergy, and therefore selecting it, but then finding that they could not answer parts 2(b) and 2(c).

4. **Effective time management is critical.** More so than in previous sittings, there was clear evidence in this exam of candidates employing poor time management techniques and spending too long on question 1 and especially question 1(a, i), and then having to rush through the other questions. Some candidates only answered two out of three questions. Many such candidates, because they did not attempt all the questions, failed marginally, even though the questions they had answered fully were of a pass standard.

    It may be that the change to a large 50-mark question may have impacted some candidates' time management strategies negatively, but this needs to be addressed quickly and effectively. My recommendation is that candidates practice exam-style, 50-mark questions under timed, examination conditions.

    Furthermore, I would suggest that candidates are mindful of their time management in the exam. For example, some candidates were having difficulty with obtaining a relevant discount rate in question 1 (a, i) and it was taking too long. In this case, they should take a sensible guess and move to part a, ii. When being assessed, candidates will always get credit for their answer, if their approach and discussion thereon are correct, even though an earlier error results in an incorrect final answer. Unfortunately spending a lot of

time on question 1 (a, i), meant that some candidates ran out of time subsequently.

5. **Answer the question set** (all of the question set and no more). This will help with time management. Good answers and good scripts did this effectively. Areas where this was done less well are highlighted in the comments for each question below. It is important that questions, both the requirements and the narrative of the scenario, are read carefully. Irrelevant answers, not related to the requirements (and the scenario), will score few, if any, marks.

6. Legible, well presented and well structured answers often get high marks (and these will also help you manage your time better). The presentation of answers achieving high marks was good, with clear labelling and structure and workings. It is very important to plan and structure answers properly. Good, clear handwriting is essential. Adopting these good practices will also enable candidates to get the majority of the professional marks available.

    It was also evident that well-structured answers enabled candidates to manage their time more effectively. For example, questions 1 and 2 had parts which were complex, and good time management, supported by clear presentation and structure to the answers, resulted in high marks being achieved.

7. Don't just read the Examiner's report and file it away. Internalize it and emulate the approaches, techniques and good practice it suggests.

8. Do a quick check; does your numerical answer make sense? For example, an acquisition premium of over 1,000% in Q3(b) would be extremely unlikely and therefore you would check again your calculations.

SPECIFIC COMMENTS

Question One
This was the first time a 50-mark longer compulsory question has been set and it was essential that the candidates managed the volume of information provided well in order to provide coherent and detailed answers. On the whole, question one was done well by many candidates and there were many scripts which earned well over half the marks. However, it seems that many candidates spent far too long on this question to the detriment of the rest of the paper. Good time management, an ability to work under pressure and making a reasonable attempt at all the requirements of all the questions are the key ingredients for success. Therefore, doing one question well, even if it is the longer question, but not doing the others well, is not likely to yield a good mark.

The scenario in question one was of a private company considering an IPO (public listing) in order to pay off its high debts and enable it to consider taking a new project. The calculations involved providing a range of values for the equity with and without the new project, and thereby offering advice on whether to undertake the IPO or not. A smaller second part of the question asked candidates to consider ethical issues connected with the new project.

Part (a, i) asked candidates to calculate an appropriate discount rate (cost of capital) that could be used to value the company and to explain why this could be similar to the ungeared cost of equity of a competitor. The calculation required candidates to recognise and use Modigliani and Miller's proposition 2 with taxes (M&M2) formula. Reponses to this part were varied, with many giving detailed explanations and using the correct method, and equally many others giving limited explanations and not recognising that M&M2 should have been used. Poorer explanations limited themselves to business risk similarity but not explaining how repaying the debt would eliminate financial risk and therefore an ungeared cost of equity was appropriate. Errors in calculations involved the inability to use simple algebra to determine Keu even where the input factors were correct. And calculating a WACC after Keu was calculated, even though there would be no debt initially in the newly listed company.

Part (a, ii) asked candidates to undertake a valuation of the company with and without the new project and required candidates to recognise that an APV approach would be the best approach to take when assessing the value of the new project. On the whole, the majority of candidates did this part well. Common errors included taking off tax and interest from the project cash flows, which is not correct. Some answers did not calculate the terminal values of the company or the project correctly. Although minor errors were made by most candidates, flexibility in awarding marks meant that these did not detract from the quality of the answers.

Part (a, iii) asked candidates to advise whether the unsecured bond holders would be willing to become shareholders of the newly listed company. The calculations to support the advice, involved calculating the current market value of the bonds (not the book value of $40m). If the 10% of the total value of equity is greater than the current market value of the bonds, then the bond holders may consider agreeing to the equity for debt swap. This part was not done well. Few candidates could calculate the current value of the bonds, most incorrectly discounting by the coupon rate to get back to the $40m. The subsequent advice given was poor, with little insight given as to why might the bondholders accept or not accept the offer, except to say in very general terms that if the equity value was greater than the current bond value they would probably accept the offer. Many answers displayed a lack of sound understanding of the subject.

Part (a, iv) asked candidates to discuss their results, including any assumptions made in obtaining the results, additional reasons for listing and why new shares maybe issued at a discount. Stronger answers did this part well and especially the reasons for listing and issuing new shares at a discount were covered well. The answers explaining the assumptions were somewhat weaker, giving general but not scenario-specific assumptions. Few answers gave the range of possible share prices (with and without the project, with and without the discount), and therefore the discussion here was limited. A sizeable number of candidates ignored or answered this part very superficially and therefore did not gain the majority of the 12 marks.. Candidates must ensure that all parts of all questions are answered in reasonable depth and commensurate to the marks allocated for that part.

Four professional marks were available for the report for part (a). Many answers gained the majority of these marks, having a well-structured and neat answer, with good use made of appendices and in a report format. However, after a few examination sessions, where the quality of reports or formal statements had been improving, there were a larger than normal number of scripts which had poorly structured and disjointed answers. Just having a title of 'Report' is not sufficient to gain any professional marks. The layout, structure, clarity, presentation and legibility are the important factors. Given that a number of scripts were of almost a pass standard, gaining all the professional marks could have made the difference.

Part (b) required candidates to discuss the possible impact on, and the response of, the company to two specific ethical issues. On the whole, answers tackled the first issue of relocation of farmers better than the second issue of the relationship between the leaders of the country and the company. Poorer answers in the first issue often did not recognise that it was not the company that displaced the farmers but the country's leadership. For both issues, many answers did not consider both the impact on the company and its response. There was quite a bit of repetition of the question's narrative, which was not necessary and gained no marks. It seems that many candidates did not read or understand what was required, and who had undertaken what action. Some answers, very naively, suggested drastic actions such as replacing the CEO because of the relationship with the president, without recognising that in real life good relationships are essential to gaining business and embedding trust, as long as correct and transparent procedures are followed.

Question Two

On the whole, part (a) of question two was done well but parts (b) and (c) were done less well.

Part (a) asked candidates to distinguish between the different types of synergy and to identify the sources of synergy in the scenario that was given. Although many answers did not clearly link the two disparate parts of the requirement, most answers provided a reasonably good account of synergy sources and identified the types of synergy. Thus the performance for this part was generally good. Poorer answers tended to repeat the points made and/or 'identified' rather than 'distinguished' and 'discussed'. Candidates need to be aware what the requirements are asking for.

It would seem that many candidates were drawn to question two because of part (a) and then found that they had trouble doing parts (b) and (c). This is poor exam technique. The reading time at the beginning of the exam should be used wisely to ensure that all parts of the question can be answered reasonably well.

It was disappointing that parts (b) and (c) were not attempted well, given that similar areas had been tested in recent examinations.. Candidates are strongly advised and urged to study the entire P4 syllabus. Just because a topic has been tested recently does not preclude it from being tested again.

Part (b) asked candidates to calculate the maximum premium (the amount of value created from combining two companies over and above the sum of the values of the two companies separately), based on the two methods preferred in-turn by the acquirer and the target. This was not done well on the whole. Few candidates knew how to approach answering this question and most tried to use the figures given in innovative but incorrect ways to get to an answer.

Part (c) then asked the percentage premium payable under each of three payment methods. Again the answers to this were disappointing, and again surprisingly so, because it is an area that has been tested recently. Some reasonable answers were provided for the cash only and the cash and shares methods of payment. The bond payment method was done less well. A common but minor error was not to provide the answer as a percentage, although this is clearly asked for in the requirements. And few answers justified the payment method that Strand Co's shareholders (the target company's shareholders) would prefer.

Future candidates are strongly advised to revise well on this area

Question Three

On the whole, the calculations required in parts (a) and (b) of question three were done reasonably well, but the discussion was done less well. Part (c) was generally poorly attempted or not attempted at all.

Part (a) asked candidates to hedge US$ cash flow payments and receipts that a UK-based company was exposed to from its subsidiary based in the USA using various hedging strategies. Generally this part was done well. Many candidates used forward rates, money markets and currency options to hedge the exposures. Common errors included not netting the cash receipts and payments, hedging more than just US$ cash flows between the two companies, and just undertaking one option hedge, without explaining why the second option contract was ignored. In many cases the advice was limited to a recommendation but without proper justification, and therefore few marks were gained. Occasionally weaker answers selected the wrong type of option (call instead of put) or the wrong forward rate.

Part (b) asked candidates to undertake multilateral netting using £ spot mid-rates and using a tabular format. Most candidates made a reasonable and successful attempt to show the result of the multilateral netting. Common errors included not using the mid-spot rates and/or a tabular format (transactions matrix). It is important that the requirements in the question are addressed to gain the maximum marks possible. Many

candidates confused the discussion required and talked about companies wanting to (or not to) undertake multilateral netting, instead of governments allowing companies to undertake it.

Part (c) asked candidates to explain the characteristics of a long call option with a high gamma value. Answers to this part were poor and few candidates were aware of what gamma is and what a high gamma meant in relation to a long call option. Fortunately, this part was only worth 3 marks, but candidates need to be aware that delta, gamma, theta, vega and rho are in the study guide of the syllabus and, can and will be examined. There also appears to be some confusion about what a long call meant. A long call is buying the right to buy an underlying asset at a pre-determined price, whereas a short call is selling the right to buy an underlying asset at a pre-determined price (and similarly for put options). Some candidates thought that a long call was referring to the period prior to expiry of the option.

Question Four

Part (a) of question four required candidates to discuss a company's current dividend, financing and risk management policies, and how these may be affected by returning retained funds to shareholders. On the whole, the discussion of the dividend and financing policies was good, with some excellent points made. The discussion on risk management was not as good. The consequences of returning retained funds reflected the quality of the initial discussion. However, weaker responses tended to be descriptive, often repeating the narrative of the question, rather than being discursive. Also many candidates failed to pick up the point that the nature of the growth of the industrial sector affects the risk management, financing and dividend policies of the company.

Part (b) required candidates to evaluate the dividend policies of possible equity investments with a view to choosing between them for treasury management purposes. Most of the candidates managed to provide a limited evaluation the dividend policies of the three companies but found it more difficult to expand on these and draw reasonable conclusions. A sizeable number of candidates were confused between stable dividends (Theta) and stable dividend policies (Omega and Kappa), and thereby demonstrating a lack of sufficient knowledge and understanding.

Part (c) asked candidates to undertake a computation of a possible change in repatriations from the company's overseas subsidiary companies, and comment thereon. Some reasonable attempts were made at calculating the current dividend capacity of the company, but few candidates then proceeded to calculate the increased dividend capacity or provide reasoned comments. Therefore not all the requirements were addressed.

Part (d) asked candidates to discuss whether a share buy-back or a special dividend was the more appropriate as a form of repatriation. Some reasonable answers were provided for this small part. The main areas of weakness were that some candidates thought that only one of these methods would provide instant cash to the shareholders or that the requirement was not to compare the two methods with each other, but to discuss the importance of returning cash to shareholders. Candidates should only answer the question set and recognise that other forms of discussion will get no credit.

Conclusion

Overall, reasonable attempts were made at parts of questions one, three and four; but question two was done less well. Attempts to pass by undertaking short intensive study and trying to spot questions and/or topic areas is unlikely to result in success. Good presentation and structure of responses; good application of time management; answering all parts of a question; and knowledge and understanding of the entire P4 syllabus and study guide, are the necessary requisites for success.