

Examiner's report

P4 Advanced Financial Management

June 2014



General comments

In the June 2014 paper, similar to the previous exams in December and June 2013, 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. The first two questions consisted of a mixture of computational and discursive elements, and the final question was wholly discursive. This was in line with the format of the exam advice, which said that on occasion a 25-mark question could be wholly written.

The overall performance of the candidates was similar with the overall trend of examinations, but not as good as the December 2013 sitting. The main reason for candidates performing less well was the lack of detailed knowledge of the syllabus areas that were being tested. On the whole it was not evident that the exam was time-pressured. It was also evident that in the main candidates managed time adequately between the three questions.

In the P4 examination candidates should focus on the eight factors in order to maximise their chances of gaining a good pass.

1. **A sound knowledge and understanding of the entire P4 syllabus.** Although P4 has a large syllabus, evidence from previous exams, including June 2014, clearly highlights that candidates who are well-prepared, as a result of sustained study, over a long period of time, are more likely to be successful. Such a strategy results in a deep understanding of the subject and also of the current issues in financial management. On the other hand, last minute intensive study, attempting to spot questions or topics and relying on hints is a strategy that is unlikely to yield success. The June 2014 paper required candidates to have a thorough knowledge of a range of syllabus areas.
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.
3. Good answers **provided a balanced answer for all parts of each question**, whether the part required discussion or calculations or both. Markers consistently commented that scripts which answered all the questions reasonably, even with small errors, were more likely to pass compared to scripts which left parts of questions or whole questions unanswered, even where the answers to other questions were good. Make sure that you can answer all requirements of the question before selecting it.
4. **Good time management is vitally important.** The overall opinion of the marking team for the June 2014 paper was that the candidates continued to manage their time adequately. Given that question 1 is a long 50-mark question, good time-management skills are essential.
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 in 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 disappointing that many candidates did not pay enough attention to the presentation and structure of their answers, and as a result, they failed to gain many professional marks.

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?**

Specific Comments

Question One

This was the 50-mark compulsory question and it was essential that the candidates managed the volume of information provided, in order to provide coherent and detailed answers.

The scenario in question one was of a company considering two proposals: the first on setting-up a treasury function and the second on setting-up new branches in different countries as a way of reducing costs and responding to customer needs. The requirements of the question asked candidates to demonstrate how a treasury function would manage foreign exchange and interest rate risk, compute and discuss the duration of a loan, discuss whether or not actively undertaking the management of risk could be beneficial, and the agency issues of setting up branches in different countries.

The answers to the different parts of the question were variable. In part (a) many candidates could apply hedging principles using forwards, futures and options. However, a notable number of candidates tried to provide results of the hedge, which was not necessary. Calculating the basis continues to cause difficulty for some candidates. And many candidates offered little in the way of advice, limiting their answer to a recommendation, but with little discussion in support. From the poorer responses it was evident that some candidates did not expect this topic to be part of the 50-mark compulsory question and hoped to avoid risk management altogether. Given the frequency with which this topic is tested; this is a high risk strategy and should be avoided.

Part (b) required candidates to demonstrate how a simple interest rate swap would operate. This part was not done well by many candidates. It seems that this area was not expected to be tested and therefore candidates were ill-prepared for it. As mentioned already, in order to achieve a comfortable pass in the P4 paper, a good knowledge of the entire P4 syllabus is necessary.

Part (c) required candidates to calculate modified duration of a loan paid in equal amounts and to discuss how duration can be used to measure the sensitivity of the loan to changes in interest rates. The actual calculation of the duration was done reasonably well by candidates, but a surprising number of candidates did not seem to know how to use annuities to calculate the equal amounts of loan repayments. Few responses actually discussed how duration could be used to measure the sensitivity of loan to interest rate changes, although many explained what duration was and its limitations.

Part (d) (i) required candidates to discuss the value of risk management and in what circumstances risk management would be useful. Few candidates answered this part well, although there was an article in 'Student Accountant' a few years ago discussing this issue. Very few candidates recognised that individual shareholders may be able to create their own 'home-made' risk management policies more cheaply and more quickly compared to companies.



Part (d) (ii) required candidates to discuss the possible agency issues arising from setting up branches in different countries. This part was answered well by many candidates, and it was pleasing to see that not only were the issues discussed, but also the possible mitigation strategies.

Four professional marks were available for the memorandum for part (d). It was disappointing that many answers could not frame a memorandum adequately and gained few professional marks. A minority of scripts tried to construct a memorandum for the full question, instead of focussing on part (d). Given that a number of scripts were awarded marks in the high 40s, gaining all the professional marks would have enabled these scripts to gain a pass mark.

It is important that answers to all the questions focus on good layout, structure, presentation and neatness (including legibility). Such an approach shows the markers that the candidate understands the topic area(s) and makes awarding marks a straightforward process.

Question Two

This was a 25-mark optional question asking candidates to estimate an adjusted present value (APV) of a project, correcting errors made to the original net present value (NPV) calculation and then consider the corrections, the approach taken and the assumptions made. This was a popular question and it was generally done well. It was pleasing that candidates approached this question in a structured and systematic manner, and the majority of the responses achieved a pass mark.

Part (a) focussed on the calculation of the APV with candidates being given the opportunity to make corrections to the original NPV calculations. This part was done well in most cases and the flexibility in marking allowed credit to be awarded for the follow-on approach even if errors were made earlier. The common errors for this part included: not inflating the cash flows by each year properly, sometimes including interest in the original NPV calculation and not as a financing side effect (or both), including working capital in the cash flows before tax and trying to determine a cost of capital that included a cost of debt as well for the base case NPV. Although many candidates knew the approach for the APV, some of the financing side effect calculations were also not done correctly.

Part (b) focussed on the comment of the corrections and explanation of the approach taken and assumptions made. This part was generally done well, although some answers did not make a sufficient number of good points to warrant a good pass being awarded. Many answers tended to repeat the points in slightly different ways and therefore got no additional marks. On the whole though, this part was also done well.

Question Three

This was a 25-mark optional question which considered an acquisition based growth strategy and the valuation of a particular acquisition, and the subsequent unbundling. This was also a popular question with the first part of the question answered well by the majority of the candidates, but parts (b) and (c) were answered less well. It seems that many candidates chose this question either because they liked the first part of the question, without considering the subsequent parts; or because they liked question four even less.

Part (a) asked candidates to discuss the company switched from a strategy of growing organically to growing through acquisitions. This part was mostly answered well, with many candidates making varied and good points in their discussion.

Part (b) asked candidates to discuss the actions a company could take to reduce the possibility of that the acquisition ends in failure. This part was done less well because many candidates did not make sufficiently varied points and many tended to repeat the points made, and therefore achieved few marks. There seemed to be a lack of a planned approach to many responses and lack of knowledge, and therefore the quality of discussion was often poorer than should have been the case.



Part (c) asked candidates to calculate the expected value generated from an acquisition, which subsequently involved unbundling of divisions through sales of assets of one of the three divisions and a spin-off of the second of three divisions. Overall this part was done less well compared to parts (a) and (b). The main reason for this is that there wasn't a clear structure to how the answer should be presented and therefore there was confusion about how best to approach the question. In many answers, there was little coherent presentation and structure to the answer, with many numbers and calculations presented in a haphazard manner. This approach did not gain many marks as it was not clear where the answer was heading and gave little confidence that the candidate knew what s/he was doing. The answer to part (c) required candidates to have a detailed knowledge of valuations, of acquisitions and of restructuring, and unfortunately in many of the answers this was not evident.

Question Four

This was a fully discursive 25-mark optional question considering various aspects of utilising options thinking in finance related decision making. This was the least popular choice of the optional questions and also the least well-done. From the answers it was evident that this question was selected by candidates either because the candidates knew the topic area well and were able to gain good marks, or because they felt that by writing a lot on the area, they would be able to gain sufficient marks to achieve a pass. Unfortunately marks were only awarded for answers which were relevant and where the answer was directed to the question asked in each part.

Part (a) asked candidates to discuss how real options thinking could be utilised in investment decisions and explain the assumptions that needed to be made. On the whole, this part was not answered very well. Whereas in past examinations candidates were asked, and could do, numerical calculations of real options, candidates this time around found discussing the concept of real options and its application particularly difficult. The explanation of the assumptions was better. It seems that candidates, in the main, had not expected discussion of real options to be asked and therefore had not prepared for this area.

Part (b) asked candidates to discuss how options thinking could be useful in determining the value of equity and default risk. The question also asked candidates to discuss how companies facing severe financial distress could have a positive value using options thinking. On the whole, this part was answered poorly by all but a minority of candidates attempting this question. It seems that candidates' knowledge of this area was very poor. It is important for candidates have a good knowledge and understanding of the entire P4 syllabus, including areas which may be conceptually difficult to comprehend. Questions will continue to be asked across the range of the syllabus areas.

Part (c) asked candidates to explain why option values are determined by different risk factors, commonly referred to as the greeks, and explain a particular greek: the vega, in more detail. This part was done a little better when compared to parts (a) and (b), but nevertheless candidates' answers tended to be limited for this part as well. Most answers listed the greeks but few explained why option values were determined by the greeks. The part on what vega determines was addressed better, but again this was in a minority of answers and not the majority. Again it is imperative that candidates have a good knowledge and understanding of all the syllabus areas.

Conclusion

Overall, a good understanding and knowledge are essential requirements for passing the P4 exam paper. In the order to gain this, a sustained study, over a long period of time, is an essential pre-requisite for success. In this paper, successful candidates demonstrated this clearly, whilst candidates who did not achieve a pass, did not demonstrate sufficient knowledge and understanding of all the topics which constitute the Advanced Financial Management syllabus.