

# Examiner's report

## P4 Advanced Financial Management

### March 2016



#### Introduction

This exam paper consisted of two sections. Section A contained a compulsory question for 50 marks. Section B contained three questions of 25 marks each, from which candidates had to answer two questions. All three questions in Section B for this examination consisted of a mixture of computational and discursive elements.

This is an advanced level optional paper which builds upon the knowledge and skills examined in Paper F9, Financial Management paper. At this advanced stage, candidates will be required to demonstrate their ability to read and digest quickly, comprehensive and detailed questions, apply relevant knowledge and skills and exercise the professional judgement expected of a senior financial person, in recommending or making financial management decisions that are likely to affect the entire business organisation. For example, Section A normally sets out a complex business scenario in the form of a case study that requires candidates to demonstrate their ability to understand, deal and communicate about strategic issues that a senior financial manager or advisor may be expected to encounter in his or her career. As an illustration, the Section A question on this exam paper tests a candidate's ability to provide sound advice supported by relevant workings, in a coherent discussion paper which sets out the potential implications of financing a large project via a change in dividend policy and the sale of a foreign equity investment. Like a senior financial person at work, a candidate is expected to read a business brief in the form of an exam question here, carefully, take notes and decide on a relevant methodical approach to meeting the brief's objectives. Senior management work under scheduled deadlines, and hence prioritising and managing your time is crucial to performing well under examination conditions.

Business reports and proposals are expected to be succinct, professionally written and easy to read with clear headings and conclusions. A candidate who does not demonstrate this approach in writing the report or discussion paper, will not earn the full professional marks that are available here in Question 1.

A good piece of written work is evidenced by a reasoned structure, narrative discussions that are relevant and in sufficient detail and clear, easy to follow numerical workings supported where appropriate by brief notes. Achieving it in this exam will ensure a candidate is on track to passing it.

This examination also includes a significant amount of technical content dispersed across the questions, to test a candidate's ability to perform them. Invariably, a candidate will be expected to assess the findings of the technical computations within the context of the question's scenario. The comments below will reflect the above points.

#### Specific Comments

##### Question One

This was a compulsory 50-mark question. The question's scenario was complex and required candidates to undertake a number of detailed calculations and discuss the issues thereon. Therefore, it was essential that the candidate managed the volume of information provided effectively, in order to provide coherent and detailed answers.

Question one required candidates to examine the potential strategic impact on a company's business when it proposes to finance a large investment project by utilising more from its profits earned, hence altering the company's current stable dividend policy and selling off a large foreign equity investment.

Question 1 a) required candidates to explain how exchange rate fluctuations caused by differential inflation rates across countries, may lead to economic exposure. Candidates struggled to explain how this purchasing power parity relationship may affect a company's cash flows, a topic area which was introduced in the F9 paper.

Question 1 b) required candidates to prepare a discussion paper outlining advice on the impact of a significant capital investment project upon the expected financial valuation of the company taking into account the financing of this project via reducing its dividends in the near future together with the sale proceeds from of a large foreign equity investment.

The question part 1 b) i) requiring candidates to estimate the company's dividend capacity was fairly well answered.

For part b) ii) as it was an investment sale in foreign currency, candidates were expected to apply the hedging techniques inferred from the question, and choose the most appropriate strategy, given the nature of this transactions exposure and its risk. Knowledge of hedging using forward contracts is at F9 level, yet quite a number of candidates were unable to apply the right forward exchange rate. A significant number of candidates were confused when confronted with the different base currencies used for forward and futures contracts. Candidates who applied the correct hedging techniques and succinctly discussed their hedging choices were able to earn high marks.

For part b) iii) an issue that candidates found difficult was trying to glean from question that they were required to apply the dividend valuation model in valuing the business. Many candidates were not able to see and extract the information relating to the dividend valuation model. Also, the expected dividend flows over a relevant time period is discounted to determine the estimated business value. Here, candidates struggled to determine the dividend flows before and after the proposed large project is undertaken. Hence this part of the question was not satisfactorily answered.

For part b) iv) candidates were required to discuss issues relating to the proposed project's financing methods that need to be further considered. Although some candidates discussed the possibility of using other financing sources like debt and external equity, many missed discussing about the relevance and implications of using dividends, as a source of financing. Therefore this part of the question was not answered unsatisfactorily.

Four professional marks were available for preparing the answer to part b) in the form of a discussion paper. It was disappointing that many candidates did not draft their answers in a discussion paper format, with a title heading, a brief introduction of its objectives, clearly headed workings and concluding comments. Some candidates did not follow a discussion paper format at all and the overall structure and presentation was unsatisfactory and therefore gained few

professional marks. Candidates give themselves the best chance of passing the examination if they obtain all the professional marks.

### **Question Two**

This was a 25-mark optional question which required candidates to apply the adjusted present value technique to a proposed investment project that entails a significant change in the company's financial structure

Part a) of the question dealt with the application of relevant cash flows which were then discounted at the equity cost of capital to arrive at the base case net present value for the project. The base case net present value is then adjusted for the various financial side effects to result in the project's adjusted present value followed by a recommendation whether to accept the project or not. This part of the question was quite well answered. Candidates, who did not do as well, made an errors in determining the incremental working capital, ignoring the timing delay in tax payments, miscalculating the financial side benefits and applying an incorrect equity cost of capital.

Part b) of the question required a discussion of shareholders' concerns about the project and its proposed financing. This part of the question was unsatisfactorily answered by candidates with many struggling to discuss beyond a concern or two.

### **Question Three**

This was a 25-mark optional question which required candidates to demonstrate their understanding of the rationale behind pursuing a partnership merger and how such mergers may be valued.

Part a) of the question required candidates to discuss the arguments to support or otherwise, why these two partnership firms should merge. Candidates, who applied sensible reasoning within the context of this merger scenario, did well. Those candidates whose discussion was based on mergers in general, scored fewer marks.

Candidates were asked in part b) of the question, to apply their knowledge and produce business valuations from specified valuation bases, for a firm prior to its merger. This part of the question was answered unsatisfactorily. Some candidates were not able to make the appropriate discounting calculations. A number of candidates would have received more marks if they had gone on to discuss about the additional information required, drawing their knowledge from having read business journals and magazines widely.

Part c) of the question required candidates to discuss the potential effect on the terms of the merger when a significant part of a pre-merger firm may not join the merged firm. Candidates who did well were able to demonstrate reasoned discussion, based on the information provided in the question.

### **Question Four**

This was a 25-mark optional question which required candidates to demonstrate their knowledge of how real options strategy using the Black Scholes pricing model, can add to investment appraisal decisions by considering the value of flexibility in response to uncertainty. Also required was to explain the impact of specific risk factors in option theory. A discussion about the relevant issues

which governments face in attempting to obtain funding from international financial institutions completes this question.

Part a) of the question was satisfactorily answered. It involved calculating using the Black Scholes pricing model and discussing the valuation therefrom, of an investment project with potentially significant future opportunities. As pricing models are based on assumptions about the real world, many candidates discussed this aspect quite well including the other relevant factors that may affect the investment decision.

Part b) of the question required candidates to explain the meaning of an option's rho and how interest rate changes affect the appraisal of the investment. This part of the question was quite well answered by candidates.

Part c) of the question was not as well answered. Quite a few candidates did not demonstrate sufficiently that they have understood the role, importance and impact of international financial institutions within the context of a globalised economy.

### **Conclusion**

To sum up, candidates need to be able to apply their understanding and knowledge of advanced financial skills to pass the P4 paper. Sustained study, over a long period of time, is an essential pre-requisite for success. In this paper, successful candidates demonstrated this clearly, while candidates, who did not achieve a pass, did not demonstrate sufficient understanding and knowledge of the syllabus areas examined. In addition to this, well-presented and well-structured answers, directly addressing the requirements of the question, and reading the questions and planning answers appropriately, are essential requirements for success.