Examiners' report

P4 Advanced Financial Management
June 2008

This was the second examination of this subject under the new syllabus. Although covering some of the technical elements of paper 3.7 under the previous syllabus, Strategic Financial Management, this paper introduces new themes of concern to the practicing financial manager in the areas of valuation, project and firm finance, the management of risk, acquisitions and disinvestment. In addition to the technical aspects of financial management, this paper also invites candidates to explore the ethical and managerial dimensions of the subject and to demonstrate reasonable professional skill in the presentation of their answers.

The examination consisted of two compulsory questions (question 1 and 2 for 28 and 32 marks respectively) and three further questions of 20 marks each from which candidates are expected to answer two. The two compulsory questions address multiple themes across the syllabus and give candidates the opportunity to gain marks through the application of professional skills in argumentation and presentation. The optional questions consist of two technically focused questions and one wholly discursive question. The two technically oriented questions also has a substantial discursive component where candidates are given the opportunity to interpret the analytical element required and demonstrate a range of higher order professional skills.

All but a small minority of candidates attempted four questions. There were a significant number of candidates who presented excellent answers and demonstrated a high level of technical and professional skill. These candidates also exhibited high levels of efficiency in the way that they addressed the technical elements of each question, were able to focus on the principal points at issue and enhanced their analysis with clear explanation of the processes they had followed, the limitations of the methods employed and any assumptions they had made.

The predominant explanation of poor performance by many candidates was (i) lack of preparation, (ii) insufficient attention to the discursive parts of questions and (iii) inefficient use of time in the examination. Questions at this level have an open ended aspect which can tempt even the well prepared candidate to spend too much time in explanation and discussion. Candidates should remember that time spent on one or more questions at the expense of others is not the best way to maximise marks and that strict time discipline is necessary to optimise their score.

In preparing for this paper it is important to bear in mind that substantial marks are available for the more discursive element of questions where candidates can demonstrate their wider professional knowledge. It is important that this element of each question is properly exploited and whilst not detracting from the demonstration of technical and analytical skill where required, due effort should be given to presenting a good understanding of the context and implications of each situation as described by the examiner. At this level, it is important to demonstrate the skills of a reflective practitioner and to this end, candidates should make sure that they are well informed of current events and have read the professional literature available to them through the ACCA and elsewhere.

As before, many candidates performed well exhibiting a good standard of written English and demonstrating a good breadth of understanding across a challenging but important syllabus.

Question 1
This was a compulsory, 28 mark question in 3 parts. The question focused on the valuation of a business for a potential flotation or outright sale. As is common with this problem in practice the key financial measures that are required to value the business are not observable and proxy measures must be estimated by using comparable company or market data.

In this question candidates were invited to combine market risk measures for the two aspects of the case company. Another company is publicly quoted and has a beta which matches two thirds of the business of Mercury Training. The remainder of its business has a beta matching that of the financial services sector. Using

the portfolio beta concept a combined beta can be estimated. However, given the different levels of gearing involved candidates faced the common problem where the risk measures for the proxies must be ungeared to create an asset beta and recombined and regeared to match the business profile of Mercury Training. Taxation is a complicating factor as this affects both the cost of debt and its weighting in the calculation of the respective asset betas.

A substantial majority of candidates understood what this question required and made a good attempt at this question. However, candidates who lost marks did not effectively explain the circumstances under which the weighted average cost of capital would be used and where the equity rate only would be used. Similarly in part (b) many candidates attempted to calculate a likely issue price but did not 'advise' the owners of Mercury Training on the range which might be negotiable in the event of an issue or sale of the business. The overall lesson for candidates here is to focus carefully on the verbs expressing what is required in each part of the question and to construct their answers in a way that clearly focuses on the requirements of the question.

Common problems or issues in the answers to this question were:

- Ignoring tax in the estimation of asset betas.
- Failure to recognise the application of the portfolio beta concept in creating a proxy estimate for the company.
- The use of long term growth estimates that were in excess of the equilibrium rate of equity return generated by the capital asset pricing model and therefore unsustainable.
- Lack of understanding of the advantages and disadvantages of private equity finance.

Question 2

This was a 32 mark question carrying 4 professional marks. The question required candidates to bring together their knowledge of the P4 syllabus and aspects of their prior financial training to assess the degree of financial distress which the company faced. Part (a) required candidates to focus on the principal causes of financial distress. Good candidates were able to clearly categorise the causes into those induced by either revenue failure or failure of cost management, or failure in the management of assets, liabilities or the firm's capital.

The most substantial component of marks for this question was for the analysis of the impact of the company's proposed turnaround strategy on its performance, efficiency, risk and liquidity. Many candidates recognised the need to interpret the various ratio measures that could be drawn from the accounts in the context of the proposed strategy. Many candidates, however, devoted their attention to the creation of a large number of ratios but were unable to attach any significance to them.

One aspect of this question focused on the assessment of the likely risk of failure using Altman's Z score. Good answers put the Z score into context and recognised that, for this company, the resulting score is ambiguous. Whilst the four point recovery programme referred to in the question could be financed there are significant risks. In particular, there is a significant risk that the production of the European Aircoach will be further delayed, which would have a significant impact upon the future performance of this business.

Common problems noted in answers to this question were as follows:

- Making assertions of fact about the company or its financial position that could not be substantiated by the case or by the financial measures drawn from the accounts.
- Too little attention to the more general financial ratios which could inform the analysis and too much attention to the calculation and discussion of the Z score.
- Many candidates were unable to effectively interpret the ratios they presented in terms of their significance as measures of performance, efficiency, risk or liquidity.

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- Lack of attention to the governance and ethical issues raised by the case.

Question 3
This 20 mark question focused on the creation and use of a money market hedge to eliminate Asteroid System's Swiss Franc exposure. This was not a popular question and only a minority of candidates who attempted it were able to identify the money market requirements and the procedure for setting up a hedge of this type. Whilst straightforward, the calculations focused attention on identifying the minimum Swiss borrowing rate that would make the hedge worthwhile.

The discursive parts of the question asked candidates to discuss the relative merits of money market hedging compared with hedging through the use of exchange traded derivatives. Good answers focused upon the range of hedging instruments available and that are commonly used in this type of business scenario: currency futures and forex options. The final part considered whether hedging of this type would impact upon the firm's cost of capital. Good answers recognised that this depended upon the significance of currency risk in the assessment of a firm's exposure to market risk in the case of equity and overall risk in the case of debt. Many candidates ignored this part of the question.

Common sources of error with this question were:

- Incorrect estimation of the appropriate forward rate
- Being unable to use the money market hedge in a situation where there is a remittance as opposed to a commitment in the foreign currency concerned.
- Not recognising the role of the interest rate parity relationship in determining the minimum acceptable rate for borrowing.
- Not appreciating the significance of the correlation between the domestic and the counter currency in determining the potential gains from hedging.

Question 4
This was a wholly discursive question focusing attention on the likely regulatory and ethical consequences of some unguarded remarks by a company's Chief Executive Officer concerning a potential bid. Under most jurisdictions what was said could be taken as notice of intention to bid whereas the company had neither estimated the value nor undertaken a due diligence study of the potential target.

The many good answers to this question recognised the significance of the CEO's remarks and the weak position of the company both in terms of its state of preparation for an announcement and the regulatory implications of the remarks. A small minority of candidates did not recognise that there was a problem with the CEO's comments and spent considerable space discussing ways in which the bid might be defended.

Overall, many candidates performed well on this question providing well written and well argued answers. More attention to the wider implications, and particularly those relating to the ethical issues concerning the transparency and availability of price sensitive information, would have earned greater marks.

Question 5
This was a relatively straightforward question for 20 marks on the application of the adjusted present value and modified internal rate of return techniques. Many candidates attempted this question producing answers that reflected a good understanding of the mechanics of the method but showing less understanding of its underlying principles or rationale. Unless a project (and its financing) are marginal to the firm's current position it is likely that the decision to proceed with the investment will disturb the firm's cost of capital. This will lead to a situation that an appropriate discount rate cannot be calculated before the impact of the project on the value of the firm or its gearing has been established.

Good candidates recognised that the pure cost of equity is the appropriate rate to use when discounting the nominal project cash flows. Under Modigliani and Miller capital structure hypothesis this pure equity rate will be the firms' weighted average cost of capital before accounting for the tax benefits associated with debt interest. The more difficult point is the appropriate rate for discounting the value of the tax shield on interest. Good candidates recognised that this benefit will accrue to the firm irrespective of the success of this project and should, therefore, be discounted at a risk free rate plus the firm's credit spread on borrowing.

Part (b) of the question required an estimate of the modified internal rate of return for the project. Many candidates, attempting this question, were successful in calculating the correct return given the project cash flows they had estimated.

Common errors in this question were:

- Failing to include the labour redeployment cost when projecting the project cash flows.
- Mistiming the incidence of tax on the operating cash flows and/or the tax benefits attaching to the capital allowances available on the capital expenditure.
- Omitting to calculate the tax implications arising from the eventual sale of the equipment.
- Discounting the nominal cash flows using an equity cost of capital incorporating an equity beta.
- Discounting the nominal cash flows using a weighted average cost of capital.