Examiners' report

P4 Advanced Financial Management
December 2008

This was the third examination of this subject under the new syllabus. This paper introduces topics 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 30 mark questions 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. This paper offered 46 – 50 marks for the discursive elements of the paper and 50 - 54 marks for analysis using numerical techniques. In all elements of the paper a high level of professional skill and presentation was expected, this was explicitly recognised by 4 professional marks associated with the two compulsory questions.

As in previous P4 examinations, all but a small minority of candidates attempted four questions. As before a significant number of candidates presented excellent answers and demonstrated a high level of technical and professional skill. These candidates also exhibited high levels of efficiency in the way 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 across the syllabus, (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 the substantial marks that 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.

As with previous papers the examiner has allocated the bulk of the marks to the more straightforward elements of the paper. Within the two compulsory questions a relatively small percentage of the available mark has been allocated to technically advanced topics.

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. In particular, Student Accountant provides an excellent source of examination relevant articles written by the examiner and others covering topical issues.

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 question was well answered by many candidates. The question focused upon an investment appraisal for a substantial construction project to build a hotel in East London to gain business from the 2012 Olympics. Although the construction and returns would be generated in the UK, net receipts would be repatriated to Dubai where the hotel company is based. Apart from forecasting the relevant cash flows for the construction and return phases of the project, corporation tax and currency effects also had to be modelled into the decision. Both the net present value and the modified internal rate of return techniques were required to complete the formal part of the analysis.

This question was generally answered well although a number of points arose where further marks could have been won:

1. In a question such as this accuracy in projecting cash flows is vital. The model answer outlines the cash flow timings best represented by the question however other interpretations on timings were acceptable if properly justified.
2. When calculating tax effects it is important to follow the requirements of the tax regime outlined in the question. It is important to note that it is only the tax saved on capital allowances which represents a relevant cash flow. The allowance itself does not form part of the cash flow forecast.
3. Well prepared answers were based upon a clear and well organised cash flow projection where the examiner could easily recognise the relevant numbers and the basis upon which they were prepared. At this level it is assumed that candidates are familiar with the basic financial calculations (for example discounting and currency projection) and excessive detail in the computation of numbers is not required. The level of detail should be sufficient to show the nature of any assumptions used and the source of the numbers used.

The second part of the question required the estimation of the net present value and the modified internal rate of return. The majority of candidates performed these calculations well. Considerable time can be saved by using the formula for MIRR shown in the question as this uses components of the NPV calculation and does not require the projection of terminal values. The model answer attributes the benefits of the capital allowances to the investment phase of the project on the basis that these would almost certainly accrue to the firm irrespective of the success of the project in the return phase. Candidates who made different but reasonable assumptions were given full credit.

In preparing answers to a question such as this it is important to recognise that providing a numerical solution to the question whilst a necessary component of a good answer is not sufficient. The overall requirement to produce a report means that an effective written explanation of the significance of the steps undertaken is necessary for a good answer. Good candidates demonstrated an ability to convince as well as communicate in the preparation of their reports.

Question 2
This question focused upon the financial implications of a debt refinancing proposal. Many of the elements of this question are covered in the F9 Financial Management syllabus. The lengthiest computational part involved ungearing and regearing beta to establish a revised cost of equity following an expansion in debt by the company. This is an important manipulation in corporate finance because it focuses on the impact of changes in financial structures on the equity investors' exposure to market risk.

Many candidates did not perform well on this question and were not able to capitalise on the marks available for the basic calculations of the cost of equity, debt and weighted average cost of capital. Some candidates appreciated that a substantial proportion of marks could be won from parts (a) and (d) of the question alone and that the technically challenging part (c), in particular, could be included as an approximation with very little loss of marks.

Particular points to note are as follows:

1. Care must be taken in calculating the costs of the debt and equity capital and that a reasonableness test should be applied as a check on the answer. First, the weighted average cost of capital always falls between the cost of equity and the cost of debt; second, the cost of debt finance is invariably less than the cost of equity.
2. Terms such as: LIBOR, basis points, credit risk, and equity risk premium are standard terms within finance and their meaning must be understood. Many potentially good answers were undermined by misapprehension of the meaning of such terms.
3. It is important to follow the wording exactly and answer the requirements as set. Part (d), for example required a comparison of the proposed means of raising finance with alternative means of debt finance. Answers did not earn credit which discussed equity sources of new capital.

Question 3
This question examined the probability of default and the way that a bank, in assessing the interest rate it would charge on a loan would use that probability estimate. The issues and techniques involved in this question were discussed in the Student Accountant (August, 2008).

In assessing default the bank will seek to establish the risk that a 'cash out' will occur and its monthly interest will be unpaid. The key variable involved in the assessment is the monthly volatility of cash flows. Well prepared candidates who had read the relevant article in Student Accountant and had familiarised themselves will similar volatility based topics such as Value at Risk and portfolio analysis (F9) did not have had any problems with the calculations involved. The technically correct answer is as shown in the published model answer although variants where the annualised volatility before interest was calculated were given substantial credit.

The discussion part of the question (b) carried half the marks available and although a detailed computation of the interest charge is shown in the model answer a clear written justification based upon more qualitative issues were given substantial credit.

A feature of this question was its reliance on very basic skills in financial mathematics: the conversion of annual to monthly equivalent rate of interest, the transformation of a standard deviation measure of volatility from a monthly to an annual basis, and the use of standard normal tables. This reinforces a point that at professional level we are assessing the skills developed through the qualification as a whole as well as the new material contained within the P4 syllabus.

Question 4
This essay based question was attempted by the large majority of candidates. Many answers were well written and covered at least some of the points outlined in the model answer. Good answers presented a balanced appreciation of the issues presented by the question which reflected pressures that some major retailers around the world have faced from investors. It is important in questions such as this to focus upon the active verb in the question (discuss) and the range of the question.

An underlying issue in corporate decision making such as that described in the case is the 'Law of Unintended Consequences': the impact of the unintended and usually undesirable consequences of any given course of action is inversely related to the degree of forethought and planning that proceeds action being taken. Share option schemes can create perverse incentives, unbundling can transform market risk (and hence value) and so forth. Rarely are outcomes straightforward and the well balanced answer recognised (a) the diversity of issues involved and (b) the likely consequences that might follow. Candidates who focused attention solely on the strategic, or the financial or the ethical issues at the expense of others did not earn high marks on this question.

Question 5
This question is a straightforward examination of short term interest rate risk management using futures and options. The majority of candidates attempted this question and some exceptionally good answers were produced. A feature of the question was its use of conventional terminology and quotes. Futures quotations show both an open and a settlement figures. Many candidates appeared to be unfamiliar with standard market terminology although the majority selected the latter (correct) figure as the basis of their subsequent calculations. Many candidates found difficulty in identifying the correct futures contract and that they needed to sell sufficient contracts (80) to cover the exposure period.

As with other questions in the paper, careful calculations, the application of the 'reasonableness' criterion when reviewing workings and well written answers generated high marks. Part (b), whilst only attracting 6 marks represented a straightforward opportunity to discuss material that is well rehearsed in the study guides. Few candidates appreciated the dangers inherent in the use of derivatives and in particular the risk of inadvertent leverage in swap agreements.