Examiners' report

P4 Advanced Financial Management
June 2009

General Comments
The examination consisted of two compulsory questions and three optional questions from which the candidate was required to answer two. The compulsory questions are designed to be synoptic in nature covering a number of different issues from the syllabus and reflecting practical concerns. The compulsory questions are more focused on the application of specific skills or in the general understanding of contemporary themes and topics.

The large majority of candidates answered four questions. The strategy with this paper, as was evident in previous sittings, was to take basic techniques from the financial management and the accounting syllabus and apply them to practical problems confronted by the practicing financial manager. As in previous papers a high mark weight was given to those parts of questions that the average candidate should have been able to complete with a smaller fraction of marks available for candidates who are able to perform at a higher level. As before the paper offered approximately 50% of the marks for the discursive element and 50% for the analytical component. Again question 4 was wholly discursive.

Excellent answers were presented by many for all four questions and high marks were achieved by many candidates. There was clear evidence however, that significant proportions of candidates were not prepared for the paper, were not sufficiently practiced in the basic techniques of finance and had little understanding of how markets in financial products operate. Candidates should be aware that P4, like other professional papers, requires an extensive period of study and practice to achieve competence. In this paper, 'question spotting' and reliance on relatively short intensive courses are unlikely to lead to success. Working prior papers is good practice in developing speed and efficiency in answering questions but are not necessarily a good guide to what is likely to come up subsequently.

Specific Comments

Question One
This question focused on a key skill of the senior financial manager in dealing with, and correcting, project appraisals undertaken by others but which contain conceptual errors. The project appraisal was presented net of the effects of tax but where a number of errors and omissions had occurred which needed to be corrected. The question then required the appraisal to be completed and estimates to be undertaken of the sensitivity of the project to changes in capital expenditure, the project's discounted payback and its duration. The technical content of this question (apart from the estimate of the 'duration') should have been familiar from the F9 level.

Common errors were:

- Incorrect adjustments for depreciation, fixed costs and interest charges. In correcting the cash flows the simplest approach is to calculate, for each adjustment, its impact post tax and to either add or deduct the resulting figure from the project post tax cash flow. This saves many steps in the calculation of the revised cash flow.

- Correctly calculating the written down value of the capital equipment at year 6 and estimating the resulting tax effect upon the cash flow in year 6.

- Simple addition and subtraction mistakes.

- Confusing discounted and ordinary payback both in the calculation and the statement of assumptions.

- Incorrect calculation of the duration and lack of understanding of the significance of the technique.

Question Two
This question focused on the problem of unbundling, where a business attempts to gain advantage for its shareholders by disposing of non-core business or, in this case, the sale of a proportion of the firm's property portfolio. In simplified form, this question is one that confronts many businesses and was drawn from the recent experience of a major UK retail chain. Two options were presented in the question, one where the proceeds were used for reinvestment and the second where they were to be returned to the investors. The first part of the question entailed a series of corrections to the statement of financial position and the earnings statement under both options. The second part required an assessment of the unbundling and sale upon the risk of the business. Here the question examines a common problem in unbundling where the impact upon the risk (and hence the value) of the business is not properly quantified and considered.
The techniques required to handle this question are straightforward although care was needed in working out the cost of capital and in particular the cost of equity capital if the unbundling proceeds.

Good candidates were able to make the necessary adjustments to the financial statements under either option effectively. However, the substantial majority were not able to do this and lost the opportunity to win a substantial proportion of the marks available.

Common errors in the question were:

- Incorrect handling of the value released by unbundling and the necessary correction to both the called up share capital and the retained earnings account.

- Incorrect or missing calculations of the revised earnings figures taking into account the savings in interest, the impact of the revised property rent and the additional return generated by the new investment under option 1.

- Failure to recognise the need to calculate a retail beta for the unbundled business. The firm's current beta consists of both retail and a property beta. The calculation entails the estimation of the firm's current asset beta and the asset beta for the property sector. From this the unbundled asset beta can be estimated.

In handling a question of this type it is important to work through the stages carefully spending some time on how the process of answering and presenting to the examiner can be simplified.

Question Three
This was a straightforward question in the application of the net present value technique upon a variable cash flow and finding the equivalent constant cash flow by dividing by the sum of the discount rates used. In this case, a plain vanilla currency swap is a mechanism for translating a variable currency flow into one using a fixed forward rate thus providing stability to the firm's cash flows. It is a method, like all swaps, of converting a cash flow in one form into another. Calculating the terms of the swap is an exercise in simple discounting.

The first step entailed finding the present value of the variable flows arising if the payments for the goods concerned are made using the forward exchange rates quoted in the question. Given that the cash flows are monthly, the forward interest rates used (which are quoted in annual terms) must be converted to their monthly equivalent for discounting purposes. The constant exchange rate required is then obtained by dividing the present value of the variable currency flows by the sum of the discount rates.

Few candidates recognised the simple nature of the problem and attempted a variety of procedures using the interest rate parity formula. This question illustrates the importance of analysing the nature of the problem presented and then applying the simplest tools available to do the job. Some candidates recognised the need to

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calculate the present value of the future variable currency flows but then took a simple average to determine the constant currency rate.

Common errors were:

- Not analysing the nature of the problem and using simple discounting in its solution.
- Not converting the annualised forward rates for discounting to their monthly equivalent.
- Not using the sum of the discount rates (the monthly equivalent of an annuity) to calculate the constant fixed swap rates.

Question Four
Many candidates attempted this question and in many cases presented answers that were well informed and thought through. In this question the examiner was looking for answers that identified the core issues particularly where an ethical concern was raised.

Common errors were:

- Not recognising that offering bribes and 'side payments' is an ethical issue and a practice which is not acceptable within the profession irrespective of local custom.
- Whilst noting that insider trading might be involved, not recognising that in this case the agent might be able to claim that if the information was in the public domain then dealing in the company's options is not insider dealing.
- Not recognising that hedging is not an appropriate means of dealing with translation risk.

Question Five
This question is in large measure based upon single period capital rationing material drawn from the F9 syllabus but focusing on two issues: first, the problem of non-divisibility and second, the estimation of the maximum interest rate payable to secure short term finance. Current credit difficulties underlie the importance of the mastery of this topic in sustaining corporate investment plans when short term failure in the market occurs. The first part of the question required candidates to identify the priorities for investment using the net present value per dollar outlay ratio to rank the projects. Simple adjustment of the ordering that resulted given the non-divisibility of project PO801 then led to a revised ranking using the available capital in the most value efficient way.

The second part of the question targeted the estimation of the opportunity cost of capital where capital is rationed for one period only. This figure is given by the NPV/$ ratio for those projects not taken up with the currently available finance. The implied additional interest rate that results is the maximum that can be serviced in the short term and the project remain viable.

Common errors were:

- Errors in calculating the NPV/$ for each project.
- Incorrect estimation of the internal rate of return on the project cash flows taken up in the optimal plan.

Identifying the internal rate of return on the projects not taken up as the maximum rate for additional financing. This is the rate for additional finance over the life of the plan. A higher rate is possible providing repayment of the additional capital is paid within the twelve month period that rationing is expected to last.