



Examiner's approach

Paper P4

Paper P4, *Advanced Financial Management* allows candidates who aspire to senior roles – such as chief financial officer (CFO) or senior financial adviser – to learn and apply the relevant knowledge and capabilities that these positions demand. By successfully completing Paper P4, candidates will demonstrate an ability to handle the key problems and opportunities faced by the modern CFO or senior financial adviser, such as the management of capital structure, sourcing finance, optimal investment decision making, and risk management – all within the context of rapidly changing, global financial markets. In addition to their technical skills, this paper gives candidates an opportunity to demonstrate important managerial and ethical skills.

The principles underpinning Paper P4 are introduced and developed in Paper F9, *Financial Management*. In Paper F9, essential basic elements have been developed: investment appraisal, cost of capital, estimation and decisions on capital structure, sources of finance, dividend policy, working capital management, and valuations. Paper P4 explores these areas, but at a more advanced level, and considers problems and issues (many derived from real situations) relevant to the highest-level financial management of an organisation.

Key to the long-term success of an organisation is its ability to invest in successful projects, and Paper P4 examines situations where future contingencies, taxation issues, and international considerations apply. For many organisations, the most significant investment decision is whether or not to acquire a competitor. Candidates must, therefore, demonstrate a high level of strategic awareness of the issues involved in such a decision, as well as the technical problems of valuing a target whose acquisition will affect the overall value of the organisation.

Success in business often means taking risks, but the successful business manager must understand the level of risk the organisation is actually taking, and how it can avoid non-core risk which is not fundamental to its business model. The senior finance manager is intimately concerned with the financial aspects of risk taking, how that risk can be moderated and, in some cases, eliminated through both operational and strategic risk management techniques. The technical risk aspects and techniques introduced in the Paper F9, *Financial Management* syllabus are developed and applied, while the wider concepts of risk management examined in Paper P1, *Professional Accountant* are further explored in Paper P4.

Unfortunately, in business, things can go wrong. The margin between success and failure is often paper thin. Only a small minority of firms survive five years from start-up, and only a handful of the firms formed 50 years ago survive today. As a result, the finance manager will inevitably confront issues of reorganisation and turnaround, and therefore these topics form an important part of the syllabus.

Finance managers need more than a battery of theories and techniques to succeed – they also need a deep understanding of the context in which they work. As a consequence, candidates will be expected to demonstrate up-to-date understanding of the macro-economic environment and the operation of these international institutions that govern both trade and the operation of the financial markets.

To be successful at this level, candidates must be able to demonstrate an integrated understanding of the subject. Naturally, candidates must have a high degree of expertise in management and particularly in financial reporting gained from their study of Paper P2, *Corporate Reporting*. International Financial Reporting Standards (IFRS), for example, require a sound knowledge of the use of the present value concept and the valuation of derivative positions. Modern accounting standards also present challenges in the valuation of organisations where complex provisions, deferred taxation, or pension fund liabilities are involved. The finance manager must also be aware of the impact their decisions will have on the presentation of the organisation's financial performance through its published accounts.

The aim and main capabilities

The aim of Paper P4 is to apply relevant knowledge and skills, and to exercise professional judgement as expected of a senior financial executive or adviser, in taking or recommending decisions relating to the financial management of an organisation.

The realisation of this aim will mean that candidates can demonstrate the key skill required of any successful professional, namely making sound decisions. Good decision making requires the application of good judgement. Judgement requires the careful weighing up of evidence that is often partial and incomplete. The right decision must be made without the help of a simple algorithm, and in the face of an array of criteria – some technical and some ethical – which may be in conflict and may not be clear cut.

Paper P4 is designed to prepare candidates for senior financial management roles and responsibilities. This means that a candidate will need to demonstrate a broad range of capabilities in assessing, evaluating, and explaining a wide range of high-level financial issues. Candidates must also be able to demonstrate the ability to put the various financial techniques already learned into context.

Key elements of the syllabus

Tutors and examiners are often asked to identify the most important aspects of the syllabus. In the Paper P4 syllabus, the emphasis placed on the main capabilities shown in the relational diagram in the *Syllabus* will be well balanced, and assessment will tend to be similarly weighted. Candidates must be able to demonstrate sound ethical and professional judgement across the syllabus. In any area assessed, there may be an ethical dimension introduced or explored. Therefore, the first section of the syllabus – role and responsibility towards stakeholders – is critically important.

One of the features of the Professional level papers is the awarding of ‘professional marks’. These are marks allocated not for the content of an answer, but for the degree of professionalism with which certain parts of the answer are presented. They will usually be awarded in Section A (the compulsory part of the exam paper) and will total between four and six marks.

It may be, for example, that one requirement in Section A asks you to present your answer in the form of, say, a letter, a presentation, a memo, a report, briefing notes, or similar. Some marks will be awarded, in addition to the content of the answer, for the form of the answer. This might be for the structure, content, style and layout, or the logical flow of arguments in your answer. You should assume that if the question asks for a specific format of answer that some marks will be awarded for an effective presentation of that format.

Pilot Paper

The *Pilot Paper* is indicative of the way that future papers will be set, and the standard that will be expected. Section A, worth 60 marks in total, will normally consist of two compulsory 30-mark questions. These questions are designed to test candidates’ ability to bring together both financial judgement and technical skill. Question 1 looks at a potential acquisition and takes candidates through the preliminary steps of valuing a company that does not have quoted share capital. There are comparators, but as they are differently geared, candidates will need to make the necessary adjustments to use the quoted data. The valuation problem is not straightforward and candidates need to be able to work through a stepped approach to the problem.

Question 2 appears to be quite straightforward; a company may have a substantial currency exposure and needs to think through its hedging alternatives. One obvious alternative is to use forex options, but working through the Grabbe variant of Black–Scholes reveals that this is an expensive way of dealing with downside risk. The question requires candidates to examine other alternatives. It is as much about the ability to think through the alternatives as it is about being able to work quickly and efficiently with the option-pricing model.

The final three questions in Section B carry 20 marks each, and candidates must choose two. One question will focus exclusively on the managerial or ethical dimensions of the finance manager’s job. In Question 5, the newly appointed CFO, keen to make a good start with his new organisation, faces an ethical dilemma; how to respond

to a request from the CEO to disguise his intentions about the future disposal of his stake in the company. The other two questions both deal with key issues of concern to their respective companies. In Question 3, candidates are asked to advise a board of directors on an appropriate review procedure for large capital investments. The company is concerned about its cash recovery – but is payback good enough? The question allows candidates to explore a range of other appraisal techniques and to discuss their usefulness for senior decision makers. The key here is not just theoretical validity but also the clarity and credibility of the techniques recommended. Finally, Question 4 explores the difficult problem of rebalancing a company's cost of capital, trading off both tax and default risk. With this question, the cost of debt capital is very important, as well as the problems of how to finance a capital expansion in China.

In summary, candidates will notice a significant change in the emphasis of this paper compared to Paper 3.7, *Strategic Financial Management*. Candidates will be expected to demonstrate a keen awareness of the issues confronted by senior management, and questions will be technically demanding – not just in an analytical way. Each exam paper will allow candidates to demonstrate that they can apply the skills developed – through both their study and their professional training – to the role of the senior manager in an organisation.

Bob Ryan is examiner for Paper P4