

# Examiner's report

## P4 Advanced Financial Management

### December 2011



#### General Comments

The structure of the paper was similar to past papers with two compulsory questions in section A, consisting of 64 marks in total, and three 18-mark questions in section B, of which candidates had to do two, for the remaining 36 marks.

The overall performance of the candidates was satisfactory.

In section A, question one consisted of 39 marks and question two consisted of 25 marks. Four professional marks were allocated to question one. Both questions required candidates to undertake computations and discussion. In section B, question five was wholly discursive, while questions three and four consisted of a mixture of computational and discursive elements.

Excellent answers were obtained from candidates who applied their knowledge to the scenario given in the question. The presentation of such answers was good, with clear labelling and structure and workings. Successful candidates attempted all the parts of the questions and managed their time well between questions.

Like the previous sittings, there was evidence in this sitting of some candidates employing poor time management techniques and not answering all the parts of a question, or in a minority of cases not answering a question at all. There was evidence that some candidates spent too long on question one and then had to rush through the option questions. A number of such candidates failed marginally even though the questions they had answered fully were of a pass standard. It is important to make a reasonable attempt at each question and each part of each question.

It is imperative that candidates learn to manage their time effectively through practicing past exam questions under timed and examination style conditions. It is also evident that well-structured answers enabled candidates to manage their time effectively. For example, question one was long and complex, and good time management augmented by clear presentation and structure to the answers resulted in high marks being achieved.

Some candidates showed poor preparation for the exam in terms of their knowledge and application. This was especially evident in questions two and three, and to some extent in question five. Candidates need to be aware that for P4 it is expected that they develop their knowledge and the ability to apply that knowledge. In a number of cases candidates failed to achieve a pass mark due to lack of knowledge and not being able to apply that knowledge to the scenario in the question.

The P4 paper has a large syllabus and numerous technical areas. Candidates need to know the syllabus well in order to apply knowledge from it to the question scenario. A consistent, sustained study approach augmented by question practice and reading around the subject is much more likely to achieve success, as opposed to a last-minute intense study approach and attempting to question-spot.

Poor performance was also evident where candidates did not read the content and requirements of questions fully. Answers need to be directed at the scenario in the question, general answers do not gain many marks.

#### Specific Comments

##### Question One

This question involved a company considering an international investment and required candidates to consider relevant cash flows, opportunity costs, inflation, exchange rates, adjusted present values, and financing side effects. It was essential that a structured approach was taken when answering the first and main part of the question.



The second and smaller part of the question asked candidates to consider other factors, including the possibility of a change in government and its implications on the company, before the final decision was taken. Some good responses considered this part before the first part and gained high marks.

On the whole, good answers inflated the cash flows correctly, calculated the taxation impact and converted the Gamalan cash flows into dollars just prior to calculating the present values. Although not many candidates got all the other relevant cash flows correct, the better answers made a good attempt at calculating these. Effective use of appendices and workings added to clarity. Many answers made a good attempt at the initial calculations.

Poor responses attempted to convert cash flows into dollars too soon and/or attempted to calculate the weighted average cost of capital, which is not correct for an APV computation. This approach led to unnecessary errors and also took a lot more time. Errors were also made in calculating inflation, additional contribution, tax shields and subsidy benefits.

It was also disappointing that a number of responses did not provide a conclusion or recommendation, explain the assumptions (as opposed to merely stating them) and not answer part (ii) in detail. Many answers focussed on the change of government without considering other business factors. Answering these in sufficient detail would have resulted in high marks being achieved for the discursive element of question one. It was also very important that candidates attempt to maximise the professional marks they achieved by providing a good structure to their answer and employing a report format.

### **Question Two**

This question asked candidates to explain and employ hedging techniques to manage interest rate risk. In part (a) candidates were asked to discuss the main advantage and main disadvantage of using interest rate collars instead of options when hedging interest rate risk. This part was generally done well with most candidates correctly identifying and discussing these. However a small number of candidates focussed on options and not on collars.

Part (b) required candidates to use derivative products (futures, options and collars) to hedge interest rate risk. Generally this part was done adequately by many candidates, especially when assessing futures and options, but only a few candidates employed collars properly. In some cases, hedging using collars was ignored completely. A number of candidates found it difficult to calculate the number of contracts and the basis. A few candidates got confused between basis and basis risk, and incorrectly assumed that because the question referred to no basis risk, this meant that there was no basis. This is a fundamental error and should not really occur at this level.

It was frustrating, given that there was a recent article in the Student Accountant on interest rate hedging, that there were still a significant number of poor responses when employing futures and options.

The responses to part (c) were mixed. Candidates who knew about basis risk, explained it well, but did not then consider how it would impact the recommendation in part (b).

### **Question Three**

Parts (a) and (b) of question three asked candidates to calculate the value of bonds based on the particular yield curve and then consider how issuing a bond at a discount or a higher coupon would affect the company. In order the answer part (b) properly, candidates would have needed to calculate the coupon payable if the bond were

issued at par. Part (c) asked candidates to explain four criteria used by credit rating agencies and what factors would be used to assess each category.

Question three was the most popular question but it was also the least well done of the three option questions. Most candidates did not employ the yield curve correctly in assessing the value of the bond in parts (a) and (b), or in calculating the coupon payable in part (b). This was especially disappointing given that an article on this area appeared in the Student Accountant. It is important that candidates study and fully understand the articles in the Student Accountant, so that they can apply the principles explained and discussed, to particular scenarios in questions in examinations.

The inability of most candidates to correctly employ the yield curve to calculate the prices and coupons of the bonds meant that the discussion in part (b) was little more than very superficial.

Part (c) was generally done adequately although answers for industry risk and earnings protection were weaker than the answers for financial flexibility and company management.

#### **Question Four**

This question was the most popular and probably the best answered of all the questions on the paper with many candidates gaining a high proportion of the marks for their answers. The question consider a management buy-out, and forecasting future earnings of the new company in order to assess the possibility of future breaches in debt covenants, implications of the breaches, and how to tackle these.

Generally part (a) was done well and many responses gained high marks. Some responses discussed the benefits to the management team and not just Proteus Co, which was not asked for. Part (b) was done well, when candidates knew that they had to calculate the future earnings, in order to calculate the future level of equity and therefore the debt-equity ratio, to assess whether or not it would be breached. It was surprising that many answers included payment of debt capital within earnings, before calculating retained earnings. This is clearly incorrect and resulted in an incorrect debt-equity ratio being calculated. In part (c), most answers clearly identified possible actions that could be taken if the covenant was breached, but few discussed the implications of such a breach.

#### **Question Five**

Question five was the least popular question of the three optional questions, which is unlike previous sittings. It seems that many candidates did not study this area of the syllabus specifically and therefore could not answer the question.

Normally, where this question was attempted, it was done well. Quite a number of candidates were able to discuss what TBL reporting involves, giving relevant examples of proxies and how TBL reporting helps management to focus on improving financial strength of the company. However, some candidates repeated points that had previously been made, gaining few marks.