



# Examiner's report

## Advanced Financial Management (AFM)

December 2019

The examining team share their observations from the marking process to highlight strengths and weaknesses in candidates' performance, and to offer constructive advice for future candidates.

### General Comments

The examination was a three hour fifteen minute exam which was in two sections. Section A consisted of a 50-mark compulsory question. Section B consisted of two compulsory questions of 25 marks each. All three questions in this examination contained a mixture of computational and discursive elements. The marking scheme includes four professional marks which were awarded in Section A.

In this Advanced Financial Management (AFM) exam, at Strategic Professional, all three questions are compulsory. It was pleasing to see that only a few candidates did not attempt, at least in part, all the questions set. The compulsory questions format seems to enable candidates to maximise their time more efficiently in answering the examination questions.

On the whole, the examination results were lower than most recent sittings. As explained later in the report many candidates did not perform well enough in sufficient of the question parts which made it difficult for them to achieve a pass.

AFM exams test a range of syllabus areas and often more than one topic area of the syllabus in a single question. Candidates need to be able to apply knowledge and skills learnt, to the requirements of each question part. Application of knowledge to the scenario laid out in the question, is essential to pass this exam. It follows that any discussion or evaluation must relate to the context of the scenario set out in the question.

This is an optional exam which builds on the knowledge and skills examined in the Financial Management exam. At this advanced stage, candidates are required to demonstrate their ability to read and quickly digest comprehensive and detailed questions, apply relevant knowledge and skills, and exercise professional judgement expected of a senior financial adviser, in recommending or making financial management decisions that are likely to affect the entire business organisation. For example, Section A normally sets out a complex business scenario in the form of a case study which requires candidates to demonstrate their ability to understand, deal with and communicate strategic issues that a senior financial manager or advisor may be expected to encounter in his or her career. As an illustration, the Section A question in this exam, tested a candidate's ability to provide sound advice, supported by relevant computations where applicable, in a coherent report, on a number of risk management issues. It also included a discursive exploration of other treasury and risk management issues.

Like a senior financial person at work, a candidate is expected to read a business brief in the form of an exam question and decide on a relevant methodical approach to meeting the brief's objectives, making notes where necessary. Senior management work under tight deadlines, and hence prioritising and good time management is crucial to performing well, under examination conditions.

Business reports and proposals are expected to be succinct, professionally written, and easy to read with clear headings and conclusions. A candidate, who does not demonstrate this approach, will fail to earn the full professional marks that are available in question one.

The hallmark of a good piece of written work is evidenced by a reasoned structure, narrative discussions that are relevant and in sufficient detail, and clear and easy to follow numerical workings supported where appropriate by brief notes. This examination also included a significant amount of technical content dispersed across the questions, to test a candidate's ability to perform them. Invariably, candidates will be expected to assess the findings of the technical computations within the context of the question's scenario.

Professional skills are relevant across all Strategic Professional exams. This exam specifically rewards professional skills in question one, but candidates should realise that they also underpin good performance throughout the exam. Requisite core skills include why information in scenarios will impact upon the discussion and evaluation asked for, understanding the viewpoints of those interested in the subsequent decisions and communicating recommendations clearly and concisely.

The main reasons for candidates performing less well were:

Lack of detailed knowledge of parts of the syllabus areas and thereby not answering all parts of questions fully. Many candidates were not able to answer some questions comprehensively because they had not studied that area of the syllabus and study guide in sufficient depth;

A lack of ability to apply their knowledge to a specific scenario. Questions are designed to test the application of knowledge and candidates who try to answer questions with knowledge they have rote learned will always perform less well than candidates who take time to think, and apply their knowledge to the actual scenario and question posed.

Poor time management. Sometimes candidates spent too much time in carrying out relatively simple calculation tasks or discussed one area repeatedly without considering a range of relevant areas;

Failing to respond fully to all the question requirements or take account of details in question scenarios that establish the parameters of the answer. Candidates must read question scenarios carefully and pay particular attention to the wording in the question requirements. These are skills that question practice will help develop;

Inadequate structure to the numerical and written answers. Not structuring question one, part (b) in a report format and thereby not gaining all the professional marks;

Presenting the discursive answers in brief bullet-point format, often in incomplete sentences, as statements and not as discussion-based, analytical, or evaluative, narrative. Such answers will not earn many marks;

Focussing more on either the numerical parts or the discursive parts of a question, instead of taking a balanced approach. In order to pass, a balance between undertaking calculations and providing discursive narrative is necessary;

Not reading the requirements of the question and therefore answering the question incorrectly. It is also important to note that the answers provided should be relevant to the question asked. General answers which do not relate directly to the scenario are unlikely to attract many marks;

Failing to take account of the marks available when answering written questions, thereby providing detailed answers for a relatively minor part, but very brief answers for a question where more marks are available.

### **Comment on individual questions**

#### **Question One**

This was the 50-mark compulsory question in which the case study scenario focused on a number of risk management areas. As well as the technical calculations the scenario tested the ability to advise and explain with regard to risk management issues.

In part a) candidates were asked to discuss key changes that would be required if a treasury department was to be run as a profit centre instead of a cost centre. This question part was not answered well and in many scripts this question part was often left blank or largely blank. Many candidates answered the question they were hoping for – what are the advantages or disadvantages of running the treasury function as a cost centre or a profit centre and/or should the treasury function be centralised or decentralised? Candidates who were prepared to think and flex their knowledge to the actual question posed could earn good marks but only a few candidates were able to do this.

In part b) i) candidates were asked to calculate the impact of undertaking multilateral settlement. This question part was generally very well answered and many candidates earned full marks. Only a small minority of candidates were unable to make any real attempt at the multilateral settlement.

Part b) ii) asked candidates to hedge an amount payable using both a money market hedge and an exchange-traded futures hedge. Candidates normally answered this part satisfactorily and a good number of candidates earned full marks. Common errors in the money market hedge were the use of the wrong interest and/or exchange rates. Common errors in the exchange-traded futures hedge included failing to state whether the futures were to be bought or sold and failing to correctly calculate the number of contracts needed.

Part b) iii) required candidates to hedge some future expected borrowings using both an FRA and exchange-traded options. Answers were a bit more variable here but once again candidates generally performed satisfactorily and a good number of candidates earned full marks. Most candidates were able to select the correct FRA but not everyone was able to demonstrate the impact of the FRA clearly. With regard to the exchange-traded options most candidates were able to determine that put options were required and when they would be exercised or lapsed. While a good proportion of candidates were able to complete the calculations successfully many struggled to correctly calculate the number of options required as they failed to account for the period that the amount was to be borrowed for. Equally many students struggled with the calculation of the premium and the gain generated when the option was exercised.

A significant minority of candidates appeared not to have given hedging sufficient priority in their studies and hence were not able to make a reasonable attempt at either part b) ii) or part b) iii).

In part b) iv) candidates were required to give advice based on their previous calculations. Although some candidates struggled with the instructions given as to the order of payment to be used in the multilateral settlement, most candidates were able to earn enough marks to achieve a pass in this question part. A significant number of scripts limited their advice to which hedging method to use based on cost alone. Better scripts also mentioned some other advantages or disadvantages of the hedges under consideration. In fact, a number of candidates spent too long on this question part given that only five marks were available.

Part b) v) asked candidates to explain delta and gamma risk, with further elements of the requirement relating to OTC options. This question part was also not answered well and in many scripts this question part was often left blank or largely blank. A number of candidates were able to define delta and gamma risk correctly but few candidates made good attempts at the remaining parts of the requirement. Candidates must try to answer all elements of a requirement if they are to be successful.

Part b) required the answer in a report format to which the professional marks were attached. While many candidates did present their answers in a report format, and thereby gained the majority of or all the professional marks; a substantial minority of students did not address this requirement fully or at all and hence failed to earn some very easy marks. Too many reports failed to include a conclusion which precluded the candidate from earning all the professional marks.

Part c) asked candidates to discuss the validity of a statement regarding whether or not it is worth a company actively managing its risks. Once again this question part was also not answered well and in many scripts this question part was often left blank or largely blank. Candidates were often able to discuss how diversification would reduce unsystematic risk and the fact that investors may not be well diversified and markets are unlikely to be perfect in reality. However, few candidates discussed the importance of risk management in making cash flows more stable and certain, and dealing with external risks that are not inherent to the business.

## **Question Two**

This was a 25-mark compulsory question which initially required an investment appraisal calculation. Further technical calculations were required and the question also asked for explanations of a number of issues related to appraisal investment.

Part a) asked candidates to evaluate an investment appraisal. This required an investment appraisal calculation as well as the calculation of sensitivities and value at risk. While the NPV calculation was generally done well there were some common errors. Candidates generally failed to recognise that when a project generates a taxable loss a tax credit will arise. Equally a number of candidates made timing errors on the working capital cash flows, or failed to recognise that it is the change in the working capital need that becomes the cash flow. The calculation of the sensitivities was unsatisfactory. Most candidates failed to recognise all the cash flows that would change as a result of a change in a particular variable. Hence when calculating the sensitivity to initial investment the tax savings on that investment should also have been included. Equally when calculating the sensitivity to the unit selling price it is the post-tax revenue and the working capital cash flows (which were based on revenue) which should have been included. While many students ignored the value at risk requirement many of those that did attempt it were able to earn the one mark available. However many scripts failed to adjust for the fact that, while the annual

standard deviation was given, the project was for a period of four years. Finally a significant number of candidates failed to assess their results against the criteria specified and hence lost two potentially straightforward marks.

Part b) required candidates to explain weaknesses in the investment policy's assessment of the risks associated with the project's NPV and identify how those risks could be mitigated. Very few candidates really answered the question posed and most answers discussed limitations of NPV and alternative appraisal methods instead. The question really wanted candidates to explain the weaknesses of the appraisal methods used to appraise risk, and suggest how these weaknesses could be mitigated. Hence marks on this question part were generally low for most candidates.

Part c) asked candidates to explain why the presence of real options may mean that the NPV calculated may be underestimated. Many candidates scored a few marks by identifying the real options available to the company. Other candidates earned marks by talking about time value and how NPV as a now or never analysis ignores real options. However, only a few candidates really explained why real options add value. For instance the option to delay adds value as, if the decision can be delayed, the decision can be taken once a major current uncertainty about the future cash flows has been resolved. As a result, few candidates earned really good marks on this question part.

### **Question Three**

This was a 25-mark compulsory question on restructuring. Although a few candidates did very well on this question many candidates failed to earn many marks at all. Unless such a candidate had scored very well in both previous questions this made it very hard for them to pass the exam.

In part a) i) candidates had to calculate the net cash flow that would be generated on the date that the restructuring was forecast to take place. There were six cash flows to be considered and whilst most students identified sufficient of these to earn one mark very few earned both the marks that were available. Many candidates spent time considering the cash that would be generated in the future if the restructuring took place.

Part a) ii) asked candidates to prepare a revised statement of financial position as at the date the restructuring was to take place. Most candidates performed satisfactorily here and those who calculated the equity total correctly and/or made their statements balance earned all the marks available. Having said that some candidates missed easy marks that they could have earned if they had read the question more carefully.

Part a) iii) asked candidates to advise whether or not covenants that were to be imposed were likely to be breached in the next two years. This question part was not answered well and in many scripts this question part was often left blank or largely blank. A number of candidates tried to answer this question without any supporting calculations and hence earned very few marks. Furthermore many more candidates just looked at the current situation and/or the situation immediately after the restructuring and failed to try and forecast the next two years. Once again these candidates did not earn many marks. Of those candidate that did make an attempt at this question part, few were able to forecast the future operating profits correctly, or able to calculate the annual interest payments, given that the debt was to be repaid in equal annual instalments. Symptomatic of a common problem was that many candidates calculated gearing using

debt/(debt+equity) rather than debt/equity as instructed. Candidates must ensure that they read a question carefully and follow the instructions given.

Finally, part b) required candidates to discuss whether the proposed restructuring scheme was likely to be accepted by the capital providers. Once again this question part was also not answered well and in many scripts this question part was often left blank or largely blank. This may have been due to running out of time and/or a lack of confidence in tackling the question due to having performed poorly in the previous question parts. However a reasonably capable candidate could have generated a passable answer even if they had not done well in the previous question parts. Candidates must try to develop their confidence so that they can keep going even when they find a question tough. Those students who did tackle this question part often failed to look at each of the capital providers individually and hence the points they made were often too general and insufficient for the full marks available.

### **Conclusion**

To sum up, candidates need to spend enough time studying to acquire sufficient knowledge and understanding of all areas of the syllabus. They must then practice questions so that they learn how to apply their knowledge and understanding to exam question scenarios.

In this exam too many candidates were leaving question parts blank or largely blank. Many of these candidates potentially had the required knowledge. However candidates must recognise that questions are unlikely to require simple regurgitation of knowledge. This exam is designed to be testing and candidates must develop the confidence to carefully consider the question actually posed and then flex their knowledge to answer that question. By doing this they are demonstrating their application skills which are key to success in this exam.

Trying to spot topics which will be tested is risky and not at all advisable, as all the exam questions are compulsory and several topic areas may be covered in a single question. All topic areas in the study guide and the syllabus can be considered as core and could be tested.

The consistent message is that candidates are strongly advised to attempt plenty of exam standard questions to practice and develop their knowledge and skills. This, in particular means that exam standard questions should be attempted to time and in exam conditions. Candidates' answers should then be compared with the answers provided to identify knowledge, understanding and application gaps. Candidates should then work on addressing the gaps identified. This should be done over a period of time, consistently and thoroughly.

Candidates must be able to identify what is important in scenarios, read and respond fully to question requirements and question narrative, appreciate what matters to businesses and financial stakeholders, and produce answers that are well-structured and presented appropriately in both numerical and discursive elements.