

Examiner's report

P4 Advanced Financial Management

December 2012



General Comments

The structure of the paper was similar to past papers with two compulsory questions in section A, consisting of 60 marks in total, and three 20-mark questions in section B, of which candidates had to do two, for the remaining 40 marks.

The overall performance of the candidates was satisfactory but the pass rate was a little lower than the previous sitting.

In section A, question one consisted of 33 marks and question two consisted of 27 marks. Four professional marks were allocated to question two. 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 each of the questions. 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. In a small number of cases some candidates did not answer a question at all. There was evidence that some candidates spent too long on one or some questions, then had to rush through the other questions. A number of such candidates failed marginally, even though the questions they had answered fully were of a pass standard, because they did not attempt all the questions. It is important to make a reasonable attempt at each question and each part of each question and good time management is essential. This can be done through candidates practicing past exam questions under timed, examination conditions. It was also evident that well-structured answers enabled candidates to manage their time more effectively. For example, questions one and three had parts which were long and complex, and good time management supported by clear presentation and structure to the answers resulted in high marks being achieved.

Some candidates were poorly prepared for the exam in terms of their knowledge, understanding and application. This was especially evident in questions 1(b), 2(ii), 2(iii), 2(iv), 3(a), 3(b), 4(a) and 4(b). Candidates should be aware that they must have a good understanding and knowledge of the entire P4 syllabus. Candidates need to know the syllabus well in order to apply knowledge to the question scenario. A consistent, sustained study approach, supported by question practice and reading around the subject is much more likely to achieve success. It is highly unlikely that a strategy based on a last-minute intense study approach and attempting to question-spot will be successful. This has been proven to be case in every P4 examination so far.

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

In summary, a number of common issues arose in candidate's answers:

- A lack of knowledge and understanding of the entire syllabus. This can be put right for future examinations through a strategy of sustained study, instead of last minute intensive preparation and trying to spot questions and/or topic areas. A good knowledge of current issues is also essential;
- Failing to read the question requirement carefully and therefore providing irrelevant answers which score few, if any, marks. Question requirements and the information in the scenario need to be read with care;



- Poor time management between questions, some candidates spent far too long on some questions and this put them under time pressure to finish the remaining questions. Good time management between questions and in parts of questions is essential;
- Not learning lessons from earlier examiner's reports and thus making the same mistakes. Many of the same comments are made repeatedly in the examiner reports;
- Illegible handwriting and poor layout of answers. It is very important to plan and structure answers properly. Good, clear handwriting is essential. Adopting these good practices will also enable candidates to get the majority of the professional marks available.

Specific Comments

Question One

Question one required candidates to calculate and comment on how the cost of capital of a company changes when it sells part of the business, to comment on the results and to explain any assumptions made (part (a)); discuss whether the market value of equity would remain unchanged after a part of the business is sold (part (b)); and to explain what a demerger was, and the possible benefits and drawbacks of a demerger as opposed to selling part of the company (part (c)).

Overall this question was done adequately. Many candidates made good attempts at all the parts and, apart from part (b), gained reasonable marks. The presentation of the answers was varied, with some answers being presented well, but in others the information was in different places and not structured in a clear manner. In long questions, good presentation provides clarity of thought and indicates to the examiner that the candidate understands the topic area well.

Part (a) was generally done adequately. Most of the candidates calculated the initial cost of equity correctly, although a small minority confused the market risk premium with return on the market. Most candidates calculated the initial cost of debt correctly, but a few tried to estimate it using NPV and IRR which was not correct. Although many candidates estimated the market values of equity and debt correctly, a significant number assumed that the book value of debt was the market value of debt, and that free cash flows were the market value of equity.

Most candidates were aware that they needed to estimate a revised beta, once a part of the company was sold. However, a significant number found it difficult to un-gear the beta, find the asset beta for the hotel services only and thereby estimate an equity beta and cost of equity. Many candidates were unclear about the approach to be taken.

A sizeable minority of candidates did not comment on the results, nor explain the assumptions made in part (a). Since about 25% of the marks were allocated for these, candidates who did not comment or explain, were not gaining the maximum marks that were available.

Although the majority of candidates attempted part (b), answers tended to focus on one to two points which were repeated. This resulted in limited depth and/or range of the answers provided and therefore few candidates gained more than half marks.

Many good answers were provided for part (c) and it was pleasing to see that many candidates could apply their knowledge and understanding of demergers, and the benefit and drawbacks of demergers. However, a sizeable minority of candidates were of the opinion that once a company was demerged, it would remain part of the same group, which is not the case.

Question Two

Question two was focussed on transactions, translation and economic exposure related to foreign currency risk and its management. Part (i) asked candidates to explain the type of exposure the company faced in each situation. Part (ii) required candidates to apply two over-the-counter (OTC) derivative products to manage transactions exposure. Part (iii) required candidates to assess the translation gain/loss due to the devaluation of a currency. Part (iv) required candidates to discuss how economic exposure, that the company faced, could be managed. Overall, this question was done less well compared to question one.

This question contained four professional marks available for well-structured answers presented in a report format. The presentation of the answers was varied, with some answers given in report style, but many candidates answering the question without paying due attention to what a report should contain. Answers which gave a report title but then did not structure the answer appropriately gained few professional marks. The same point has been made in all examiner reports, good presentation and structure is essential to gain a good pass, and professional marks are relatively easy to gain.

Part (i) was done well, with the majority of candidates able to explain the exposure the company faced in each case. Credit was given for explanation of the exposure faced even if it was not named. However, just stating the name of the exposure with no explanation gained few marks.

Part (ii) was done adequately but many candidates were not able to estimate the four-month forward rate correctly (many estimated the annual forward rate). Also, in the case of OTC options, many answers did not calculate the opportunity cost of the premium. Most candidates attempted to make reasonable recommendations and offer alternative hedging strategies. However, like part (b) in question one, the range and depth of the advice was limited.

Part (iii) was generally done very poorly. Common mistakes were not converting the currency into Euros, not getting the exposed percentages correct and not comparing the amounts before and after the devaluation in order to estimate the translation loss. Relatively few responses were able to discuss whether and how translation exposure should be managed. It seems that whereas many candidates knew what translation exposure was, few were able to apply measurement techniques to assess this in the question scenario.

Part (iv) some reasonable responses were obtained for this part, but again there was a lack of discursive depth to this part.

Question Three

Part (a) of question three required candidates to calculate the percentage gain on a target company's share price using three different acquisition methods and to comment on the results. With the cash offer, a significant number of candidates failed to calculate the earnings per share of the acquiring or target companies correctly. With the share-for-share offer many responses did not account for the synergies created. The majority of candidates were not able to calculate the value of the bond offer. A small minority of the candidates did not give the gains as percentages, but as amounts, although percentages were specifically asked for. It was surprising that many candidates failed to get many marks for this question especially when a similar question had been set in a recent P4 examination. It could be that candidates did not expect the same topic to be examined again so soon and decided not to study this area. Candidates should bear in mind that any topic area from the entire P4 syllabus can be tested in an examination. Recent examination of a topic area does not preclude it from being tested again soon after.

Some reasonable responses were given in part (b) of question 3 but a sizeable number of candidates thought that minority share holders could never be forced to sell their shares, and fewer but significant minority of candidates thought that offering a higher price to some shareholders was acceptable. Both of these assertions are incorrect

within the EU Takeovers Directive. A significant minority of responses did not attempt to produce answers for either or both proposals and thereby failed to gain any marks for part (b). When selecting a question, candidates should ensure that they answer all parts of a question adequately in order to achieve a comfortable pass.

Question Four

Part (a) of question four required candidates to calculate the net present value (NPV) of a project and the sensitivity of the selling price. A sizeable number of candidates made basic errors in the NPV calculation with respect to timing of flows and not being able to calculate the present value of an annuity. Additionally many candidates were unable to calculate the sensitivity of the selling price. Both these areas are part of the F9 syllabus, as well as the P4 syllabus. It was therefore surprising that few candidates got the majority of the marks available for this part.

Part (b) required candidates to formulate a multi-period capital rationing model. Very few candidates were able to do this successfully. Many responses tried to calculate the acceptance of projects based on profitability index, which would be used for single-period capital rationing, rather than recognising that this was a multi-period capital rationing problem. There was also some evidence which suggested that candidates did not understand what the word 'formulate' meant, although it is used in the study guide.

Part (c) required candidates to explain the output results from a linear programming solution. The majority of candidates provided good answers for this part and gained majority of the marks.

Part (d) required candidates to explain the need to apply capital rationing and the features of a capital investment monitoring system. Many candidates provided good answers for this part and gained majority of the marks; although few responses distinguished between soft and hard capital rationing, and recognised that soft capital rationing may be as a result of hard capital rationing.

Question Five

Part (a) of the question asked candidates to explain the role and aims of the IMF, and the impact of IMF intervention, on the company. Generally this part was done well by the majority of candidates who chose this question. There was clear evidence that many candidates had read the article in the Student Accountant. The main weakness in responses to this part was that sometimes focus was put on either of the two requirements but a balanced narrative was not given. Overall, this part was answered well.

Part (b) asked candidates to explain why the company, as a mid-price retailer, was affected more than companies operating at the high price-end and the low price-end. This part was again done well.

Part (c) asked candidates to discuss the risks and how the reduction in quality control costs would impact the company. In the main, answers tended to focus on a few narrow points, rather than a broader range of possible risks and impact. As a result relatively few responses obtained more than half to two-thirds of the marks.

Conclusion

Overall, reasonable attempts were made at questions one and five, but questions two, three and four were done less well. Attempts to pass by undertaking short intensive study and trying to spot questions and/or topic areas is unlikely to result in success. Good presentation and structure of responses; good application of time management; answering all parts of a question; and knowledge and understanding of the entire P4 syllabus and study guide, are the necessary requisites for success.