

Examiner's report

P4 Advanced Financial Management

December 2013



GENERAL COMMENTS

In the December 2013 paper, similar to the previous exam in June 2013, there was one 50-mark compulsory question in section A, which also contained four professional marks. This was followed by three 25-mark questions in section B, out of which candidates had to choose two. All the questions consisted of a mixture of computational and discursive elements.

The overall performance of the candidates was better than previous exams, with the pass rate being markedly higher than the June 2013 examination. It is hoped that the improved performance will continue in future examinations.

In the P4 examination candidates should focus on the eight factors in order to maximise their chances of gaining a good pass.

1. **A sound knowledge and understanding of the entire P4 syllabus.** Although P4 has a large syllabus, evidence from previous exams, including December 2013, clearly highlights that candidates who are well-prepared, as a result of sustained study, over a long period of time, are more likely to be successful. Such a strategy results in a deep understanding of the subject and also of the current issues in financial management. On the other hand, last minute intensive study, question spotting and relying on hints is a strategy that is unlikely to yield success.
2. Excellent answers were obtained from candidates who **applied their knowledge and understanding** to the scenario given in each question. This follows from point 1 above; candidates need to know the syllabus well in order to apply knowledge to the question scenario. Weaker answers tended to give more general answers rather than answers specific to the scenario (see specific comments below).
3. Good answers **provided a balanced answer for all the parts of each question**, whether the part required discussion or calculations or both. Markers consistently commented that scripts which answered all the questions reasonably, even with small errors, were more likely to pass compared to scripts which left parts of questions or whole questions unanswered, even where the answers to other questions were good. Make sure that you can answer all requirements of the question before selecting it.
4. **Good time management is vitally important.** The overall opinion of the marking team for the December 2013 paper was that the candidates managed their time better than in previous sittings and it was felt that this was main reason for the improved pass rate. In June 2013 candidates tended to spend too long on question one and then not leave themselves enough time for the section B shorter questions. It was pleasing to see that in the December 2013 paper, many candidates appeared to spend a reasonable amount of time on each question.
5. **Answer the question set (all of the question set and no more).** This will help with time management. Good answers and good scripts did this effectively. Areas where this was done less well are highlighted in the comments for each question below. It is important that questions, both the requirements and the narrative of the scenario, are read carefully. Irrelevant answers, not related to the requirements (and the scenario), will score few, if any, marks.
6. **Legible, well presented and well structured answers often get high marks (and these will also help you manage your time better).** The presentation of answers achieving high marks was good, with clear labelling and structure and workings. 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. It was disappointing that many candidates did not pay enough attention to the presentation and structure of their answers, and as a result, they failed to gain many professional marks.

7. **Don't just read the Examiner's report and file it away. Internalize it and emulate the approaches, techniques and good practice it suggests.**
8. **Do a quick check; does your numerical answer make sense?**

SPECIFIC COMMENTS

Question One

This was the 50-mark longer compulsory question and it was essential that the candidates managed the volume of information provided, in order to provide coherent and detailed answers.

The scenario in question one was of a company considering an international investment in a country which is likely to reduce protectionist measures in the near future. The requirements of the question asked candidates for a discussion of the role of the World Trade Organisation (WTO) and possible impact on the country of reducing protectionist measures; the financial impact of an international investment; the financial impact of a real put option; and discussions about additional business risks and assumptions made.

On the whole, question one was done well by many candidates and many scripts earned over half the marks. However, a sizable number of candidates spent far too long on this question to the detriment of the rest of the paper. Good time management, an ability to work under pressure and making a reasonable attempt at all the requirements of all the questions are the key ingredients for success. Therefore, doing one question well, even if it is the longer question, but not doing the others well, is unlikely to yield a good mark.

Part (a) asked candidates to discuss the role of the WTO and the impact on the country of reducing protectionist measures. Most candidates performed well in this part and some very good answers were given especially for the discussion of benefits and drawbacks relating to the reduction in protectionist measures. The discussion of the role of the WTO was done less well, with some answers suggesting that it raised financial capital and provided financial help to countries and to companies, which is not correct.

Part (b, i) asked candidates to provide an estimate of the project's value, and involved inflation, taxation and exchange rate considerations. A large number of candidates achieved a good mark for this part. It was pleasing to see candidates using the purchasing power parity to predict future exchange rates and applying inflation rates and taxation to the project correctly. However, common errors included starting to apply inflation from the incorrect year, not taking account of the balancing allowance adjustment, incorrectly adding an additional 5% tax when the amounts were converted into dollars and making numerical errors in their calculations.

Part (b, ii) asked candidates to recognise that the second company was effectively offering a real put option when offering to buy the project in two years. Candidates were required to apply the Black-Scholes Option Pricing model to assess the value of the put option and the change in the value of the project as a result. This part was done well by the majority of the candidates, but only a few candidates got the correct present value of the underlying asset. Some candidates failed to recognise that this was a put option or that it was real option at all. A small number of candidates were not able to determine $N(d_1)$ and $N(d_2)$ correctly, having obtained d_1 and d_2 .

Part (b, iii) asked candidates to discuss the additional business risks and the assumptions made in calculating the amounts in (b, i) and (b, ii). The majority of candidates were able to state some of the assumptions made but there was very little meaningful discussion of these. The responses to additional business risks were patchy.



Some very good answers were given with a discussion of a range of business risks, which were contextualised to the scenario. But equally, in a number of cases, business risks were mixed with financial risks, some business risks referred back to the scenario and were not additional, and often the risks were stated but again without any meaningful discussion. In a number of cases the discussion tended to be general instead of being related to the scenario.

Four professional marks were available for the report for part (b). Many answers gained the majority of these marks, having a well-structured and neat answer, with good use made of appendices and presenting the answer in a report format. However, as in June 2013, in December 2013, a significant number of scripts had poorly structured and disjointed answers. Just having a title of 'Report' is not sufficient to gain any professional marks. The layout, structure, presentation and neatness (including legibility) are the important factors. Given that a number of scripts were awarded marks in the high 40s, gaining all the professional marks would have enabled these scripts to gain a pass mark.

Question Two

This was a 25-mark optional question on interest rate hedging and on the delta.

Part (a) looked at hedging an investment that was going to be made in a few months' time using interest rate FRAs, futures and options. Responses to this part of the question were mixed. Some responses were able to demonstrate hedging using the three products and making a sensible and considered recommendation albeit with numerical errors.

Other responses made more fundamental errors like going short in futures, purchasing put options or choosing the incorrect contract month (June instead of March), and therefore limiting the number of marks that were awarded. Few responses were able to calculate the basis correctly. A number of responses chose the incorrect FRA rate. The discussion of the outcomes tended to be general, as opposed to specifically relating to the scenario, and therefore the recommendation tended to be general as well. At this level it is important for candidates to recognise that contextualised discussion and conclusion will result in higher marks.

The presentation quality of the responses tended to be mixed. Some candidates' answers were presented well, while others were presented in a haphazard way without any coherent flow. This made it very difficult for markers to award marks. This approach taken by some candidates was surprising given that there were recent articles in the Student Accountant on risk management and given that the learning providers' manuals provide approaches to answering these types of questions in significant detail.

Responses to part (b) of question were generally weak. Few candidates did more than state what the delta was. It seems that many candidates did not expect any of the Greeks to be tested, given that the gamma was tested recently. Trying to predict the topics that are likely to be tested and not studying everything in detail is not a strategy that is recommended.

Question Three

This was a 25-mark optional question on a potential acquisition and the financing of the acquisition.

Part (a) was done reasonably well with most candidates determining an appropriate discount rate and correctly discounting the cash flows to obtain the corporate value and the value to the equity holders. Common, smaller, errors included not converting the asset beta into the equity beta; deducting tax from the free cash flows; growing cash flows from the wrong year and not recognising that the debt value has to be deducted from the value of the company to find the value attributable to equity holders. Often assumptions were stated but not discussed.

Part (b) was not done well by many candidates. Few candidates could estimate the reduction in value to the equity holders of the acquiring company when the premium paid was increased. A sizable number of candidates who chose question three left part (b) unanswered. It is important that candidates ensure that they can answer



all parts of a question before selecting it as one of their options. Again, given that many candidates, who do not achieve a pass, only fail to do so by a few marks; shows how important it is that all parts of a question are attempted properly.

Part (c) was answered reasonably well by many candidates but again weaker answers tended to state, rather than provide a discussion of the possible financing methods. A number of candidates suggested using Islamic finance to finance the acquisition, but unless a specific asset or asset group can be identified to match with this form of finance, it is difficult to see how this can be an appropriate source of finance. The finance source(s) should be appropriate to what it is needed for. Therefore, again, contextualisation to the scenario is important.

Question Four

This was a 25-mark optional question on divestments, demerger and a new joint venture relationship, involving the provider of Islamic finance. This question was attempted by fewer candidates relative to questions two or three, but not markedly so.

Part (a) of question four required candidates to advise whether a divestment sale, made as a going concern or made through the sale of the assets of the business, would result in a greater borrowing capacity by the new, downsized company. Many candidates made a reasonable attempt at calculating the financial impact of each of the two options but few candidates were then able to calculate the impact on the debt capacity and the additional funds available to the downsized company.

Part (b) of question four required candidates to discuss whether or not a demerger was more appropriate than a sale. Few candidates were able to give responses beyond a general discussion of demergers and many candidates did not relate their answers to the scenario. Very few candidates discussed the impact on the debt capacity for the downsized company if it undertook a demerger instead of a sale as its divestment option.

Part (c) of question four asked candidates to distinguish between Musharaka and Mudaraba contracts based on the tenets of Islamic finance, and then to discuss the impact on the relationship between the companies, if the bank issuing the Islamic finance, was also involved in the venture. The discussion between using Musharaka and Mudaraba contracts was generally done well and it was pleasing to see that candidates had paid due attention to the additions to the P4 syllabus under section G. However, few candidates could then discuss the implications on Nubo Co, of the relationship between Pilvi Co and Ulap Bank.

Conclusion

Overall, reasonable attempts were made on all the questions and this seems to have resulted in an improved pass rate. 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, continue to be the necessary requirements for success.