

Examiner's report

P4 Advanced Financial Management December 2014

The ACCA logo consists of the letters 'ACCA' in a white, bold, sans-serif font, centered within a solid black square.

GENERAL COMMENTS

In the December 2014 paper, similar to the recent exams, 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 questions consisted of a mixture of computational and discursive elements.

The overall performance of the candidates was lower than the recent trend of examinations, but in line with the P4 examinations since December 2010. The main reasons for candidates performing less well were:

- i) Complexity of question 1 (c);
- ii) Poor management of time;
- iii) Not structuring question 1(c) into a report format and not gaining all the professional marks;
- iv) Lack of detailed knowledge of parts of the syllabus areas, answering only parts of some questions focussing either on the numerical parts or the discursive parts instead of a balanced approach;
- v) Not using the reading time effectively to plan a strategic approach to tackling the paper and to select the optional questions wisely;
- vi) Presenting the discursive answers in brief bullet-point format, often in incomplete sentences, as statements and not as discussion-based narrative.

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

1. **Having a sound knowledge and understanding of the entire P4 syllabus.** Although P4 has a large syllabus, evidence from previous exams, including December 2014, 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, attempting to spot questions or topics and relying on hints is a strategy that is unlikely to yield success. The December 2014 paper required candidates to have a thorough knowledge of a range of syllabus areas, including those that had been tested in recent past examinations, such as swaps.
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. Less satisfactory answers tended to give more general responses rather than answers specific to the scenario.
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 was that candidates who got 'bogged down' in the complexity of question 1(c)(i) and (c)(ii), and therefore did not devote enough time to the optional questions and to the easier parts of question one, were less likely to succeed in gaining a pass mark. On the other hand, candidates who devoted enough time to answering each question and each part of each question were significantly more likely to succeed.
5. **Answer the question set (all of the question set and no more).** This will help with time management.



Satisfactory answers and scripts did this effectively. Areas where this was done less well are highlighted in the comments for each question below. It is important that in 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 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.

Many candidates' scripts had marks of between 40% and 49%. If these candidates had structured their answers well and thereby gained all the professional marks, as well as adopting a good time management approach, and giving a balanced answer to all parts, of all questions, then these scripts could have gained a pass mark.

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 compulsory question. The question's scenario was complex and part (c) of the question required candidates to perform a number of calculations. Therefore, it was essential that the candidates managed the volume of information provided effectively, in order to provide coherent and detailed answers.

Question one asked candidates to initially examine whether the strategic aims of a privately-owned company of diversification and of acquiring under-valued companies were valid and why it was being forced to sell one of its companies before pursuing further acquisitions. The question then asked candidates to provide a value of the company being sold both to the seller and the acquirer, incorporating synergic benefits. The question also asked candidates to comment on the financial impact of a project being considered by the target company. Candidates were asked to evaluate the impact of the sale using their computations in the form of a report.

Many candidates found the calculations required in this question difficult and appeared to spend a significant amount of time on them. This created pressure on them to complete the rest of the requirements of the question in less time and also the structure of the report was often unsatisfactory. This meant that candidates failed to gain many of the easier marks available for discussing the assumptions and the majority of the professional marks.

Part (a) of the question asked candidates to discuss the validity of the company's acquisition strategies and of pursuing under-valued companies. Whilst a number of candidates recognised that equity holders can undertake diversification quickly and cheaply compared to the company, few considered that given that the company was privately-held, in this case a diversification strategy by the company through acquisitions may be valid. Some candidates confused systematic and unsystematic risks, which is surprising at this level. Many candidates



discussed synergy benefits in relation to under-valued companies but few discussed the attributes necessary for the strategy to work.

Part (b) was done well by many candidates and many scripts gained three or four marks out of the four. In the main candidates recognised that there was concern about monopolistic powers of the company, how these could be damaging and why selling the company would reduce these concerns. Less satisfactory answers to this part thought that the concern was political to the company owned by a foreign power.

Many candidates made a reasonable attempt at determining the initial values of Avem Co and Fugae Co in part (c) (i), by calculating the growth rate of Fugae Co and applying the price to cash flows ratio. However, few candidates were then able to take this forward and calculate the gain to each of the two companies. A surprising number of candidates did not appear to understand the difference between cash flows and corporate value, often adding the two together.

Many candidates also started part (c) (ii) well, by determining the Reka Co's asset beta, but then found it difficult to calculate a project specific asset beta and equity beta. A surprising number of candidates used the cost of equity as the discount rate instead of a risk-adjusted cost of capital, with no adequate explanation or justification.

The majority of candidates found it difficult to determine the expected value of the project based on conditional probabilities in part (c) (ii). Errors were made in calculating the net present value due to errors in timing of cash flows, incorrectly applying probabilities to the initial cost of \$42,000,000, and in applying the percentage figures. Very few candidates were able to recognise that Lumi Co's offer would have value where the tourist industry does not grow as well in the first year. Many candidates tried to apply the Black-Scholes Option Pricing model to calculate the value of Lumi Co's offer on the basis that it was a real option, even though no standard deviation figure was provided. Some candidates, incorrectly, assumed that a probability figure was a standard deviation figure. In a few cases, Lumi Co's offer price was not discounted.

Few candidates went beyond repeating the answers from parts (c) (i) and (c) (ii) in response to part (c) (iii). A minority of candidates did not even do this and merely asked the report's readers to refer to the appendices. There were easier marks to gain in part (c) (iii) by discussing the assumptions made but many candidates failed to discuss these assumptions. This meant that the majority of candidates did not gain many marks for their answers to part (c) (iii).

Four professional marks were available for the report for part (c). It was disappointing that many answers could not frame a report adequately and gained few professional marks. Given that a number of scripts were awarded marks in the higher 40s, gaining all the professional marks would have enabled these scripts to gain a pass mark.

It is important that answers to all the questions focus on good layout, structure, presentation and neatness (including legibility). Such an approach shows the marker that the candidate understands the topic area(s) and makes awarding marks a straightforward process.

Question Two

This was a 25-mark optional question which asked candidates to recommend a hedging strategy for a borrowing using interest rate options and swaps, to discuss whether a centralised or a decentralised treasury function would be more beneficial, and comparing futures contracts and a Salam contract. This was a popular question and was done reasonably by many candidates. However, a significant number of candidates were not sure how to approach answering the requirements of the hedging strategy part. It is surprising that even though questions on hedging appear with frequency on the P4 paper, many candidates are not able to approach these types of questions correctly.

Part (a) asked candidates to use traded options and over-the-counter swaps to hedge the cost of a borrowing exposure for interest rate fluctuations. On the whole, many candidates were able to gain a number of marks for their approach to hedging using options, even though small calculation errors were made often. It is surprising to note that many candidates attempted to calculate the unexpired basis even though it was provided in the question. Most candidates correctly identified that put options were required (although a minority opted to purchase calls). Some candidates could not calculate the number of contracts required based on the exposure period and the type of options. A number of candidates did not undertake detailed calculations for both options but instead provided justification of choosing one over the other based on cost. Full credit was given where this was done correctly.

Many candidates found the calculations related to swaps more difficult, and made errors in the calculations here. Some candidates did not identify the comparative advantage correctly and therefore chose the wrong type of borrowing initially. It seems candidates may not have expected swaps to be tested. It is not advisable to try to predict which topics would be tested in an examination and instead the entire syllabus should be studied in detail in order to gain a good mark.

In many cases, the discussion and recommendation were not presented in detail and often candidates did not gain many discursive marks related to part (a). Many scripts also did not provide a well-structured answer to part (a) and therefore gained fewer marks.

Part (b) asked candidates to discuss how a centralised treasury department would increase value for the company and reasons for decentralising the treasury department. On the whole this part was done well and most candidates provided detail responses to both, although slightly better answers were provided for decentralising the treasury department.

Part (c) asked candidates to discuss the key differences between a Salam contract and futures contracts. Answers to this part were variable. Some candidates gave little more than a description of Islamic finance and what is forbidden under it, with very little on futures contracts. The better answers considered futures contracts in detail and used the information provided in the question on Salam contracts to construct a good discussion.

Question Three

This was a 25-mark optional question which asked candidates about a free trade area and benefits of being in this to a company and a recommendation, with justification, of which project to undertake using internal rate of return (IRR), modified internal rate of return (MIRR) and value at risk (VAR) computations. Also required was the legal risk of undertaking a project outside the company's current trading area. This was a popular question and was generally done well.

Part (a) which asked candidates to discuss the aims of a free trade area and the benefits to the company of operating within such an area, was done well by the majority of candidates. Many answers covered both aspects well, but common errors included not confusing a free-trade area with other types of international organisations, focussing too narrowly on just one aspect of a free-trade area and not considering the benefits to the company or discussing the Euro currency. Nonetheless, many answers comfortably achieved more than half marks for this part.

Part (b) asked candidates to compute the IRR, MIRR and VAR of a project and compare them to the same figures provided for another project. The net present value (NPV) of both projects was also provided in the questions. The majority of candidates provided correct calculations for the IRR and MIRR, and discussed the implications from the results well. However, some candidates calculated the NPV again and others calculated an additional NPV for the second project instead using the one provided, to calculate the IRR. Some candidates calculated several NPVs in order to calculate the IRR. These resulted in candidates wasting valuable time. Once



the calculations were performed, most candidates provided sound justifications on which project to accept based on NPV, IRR and MIRR.

The calculation and explanation of what the VAR measures proved to be more difficult. Many candidates could not calculate the VAR over the project's life (although most got the standard deviation figures) and could not explain what the figure meant. Very few candidates could link the risk aspect measured by VAR to the risk-return discussion of which project to accept.

Part (c) of question 3 was not done well by the majority of the candidates. Answers included a general discussion of risks, instead of legal risks in particular, and many answers omitted a discussion on mitigation strategies altogether. It is not clear whether this was because the candidates did not read the requirements of the question fully or whether they could not write much on legal risks due to lack of knowledge of this area and therefore decided to include discussions on other risks as well.

Question Four

This was a 25-mark optional question which asked candidates to provide a financial analysis of the performance of a company by first discussing and calculating the company's economic value added (EVATM). This question was less popular compared to optional questions two and three, which is surprising as the requirements of the question, namely: EVATM discussions, EVATM calculations, and calculations and analysis of ratios and trends, would have been covered by F-level papers and other P-level papers.

Part (a) asked candidates to discuss the advantages and drawbacks of the EVATM technique. On the whole, the majority of candidates answered this part well and most answers achieved over half marks. Some candidates framed the same aspect both as an advantage and as a drawback and therefore indicating that they did not understand the technique clearly. Less satisfactory answers received from a minority of candidates showed that they had not studied this area in sufficient detail and some stated what the EVATM was rather than discussing the advantages and drawbacks.

Part (b) asked candidates to calculate the company's EVATM over two years. Most answers achieved two to three marks out of five in this area by including and excluding some of the relevant costs. However, many answers applied finance costs incorrectly when calculating taxation and many responses calculated the capital employed incorrectly. The marking team accepted average or end-of-year capital employed figures, although start of year figures are considered to be more accurate.

Answers to part (c) were mixed. Many scripts calculated a range of ratios and trends, and went on to analyse and discuss these. A majority of candidates correctly identified that gearing was an issue and the proposal to finance the new investment using debt finance was probably not wise. Fewer candidates discussed the investment strategy of the company, which focuses on the less profitable construction business, to the detriment of the more profitable hospitals and biomedical business. Very few candidates linked the flawed investment strategy to the company's share price performance. A minority of answers stated/repeated the ratios numbers instead of: analysing possible reasons and possible consequences, or discussing the linkages between the ratios, the trends and between the ratios and the trends. At professional level, such responses will not get any marks. Occasionally no conclusion was provided. Many answers to part (c) were presented unsatisfactorily. Often answers would calculate a ratio or trend and immediately attempt to analyse it. A better approach is to calculate and tabulate the ratios and trends, and analyse the performance holistically. Some answers appeared to be limited due to candidates running out of time, indicating that good time management is very important.

CONCLUSION

Overall, a good understanding and knowledge are essential requirements for passing the P4 exam paper. In the order to gain this, a sustained study, over a long period of time, is an essential pre-requisite for success. In this



paper, successful candidates demonstrated this clearly, whilst candidates who did not achieve a pass, did not demonstrate sufficient knowledge and understanding of all the topics which constitute the Advanced Financial Management syllabus. In addition to this, neat and well-structured answers, answering the requirements of the question, and using the reading time appropriately are critical requirements for success.