

Examiner's report

P4 Advanced Financial Management

December 2015



General Comments

This exam paper consisted of two sections. Section A contained a compulsory question for 50 marks. Section B contained three questions of 25 marks each, from which candidates had to answer two questions. All questions in the examination consisted of both computational and discursive elements.

This is an advanced level optional paper which builds upon the knowledge and skills examined in Paper F9, Financial Management paper. At this advanced stage, candidates are required to demonstrate their ability to apply relevant knowledge and skills, and to exercise the professional judgement expected of a senior financial adviser, in recommending or making financial management decisions that are likely to affect the business organisation. For example, question 1 of this exam paper tests candidates' understanding of corporate acquisition and divestment, and the impact on the acquirer firm, the target firm and on the equity holders of these firms.

The overall performance of the candidates was in line with the overall trend of recent examinations. The main reasons for candidates performing less well were:

- i) Lack of detailed knowledge of parts of the syllabus areas and leaving whole or parts of questions unanswered because of this;
- ii) Poor time management. Too much time spent in carrying out relatively simple calculation tasks;
- iii) Inability to perform arithmetic calculations;
- iv) Not structuring question 1) b) into a report format and not gaining all the professional marks;
- v) Presenting the discursive answers in brief bullet-point format, often in incomplete sentences, as statements and not as discussion-based narrative;
- vi) Focussing either on the numerical parts or the discursive parts instead of a balanced approach;
- vii) Not reading the requirements of the question and therefore answering the question incorrectly.
- viii) Not using the reading time effectively to plan a strategic approach to tackling the paper and to choose the optional questions wisely.

Specific Comments

Question One

This was the 50-mark compulsory question based on the valuation of an unbundling and an acquisition, together with defence tactics that could be employed by the target and regulatory issues. The question's scenario was complex and required candidates to undertake a number of detailed calculations and discuss the issues thereon. Therefore, it was essential that candidates managed the volume of information provided effectively, in order to provide coherent and detailed answers.

Part a) of the question asked candidates to distinguish between unbundling through a sell-off and through a management buy-in. Most responses considered these methods, but many candidates confused a management buy-in with a management buy-out.

Part b) of the question required candidates to write a report to the board of directors about the valuation of the unbundling through a sell-off using a P/E ratio multiplier and an acquisition using free cashflows, where a cost of capital had to be estimated initially. Candidates were then required to estimate the financial impact of taxation savings and savings made through redundancies, but also to discuss the non-financial impact of these actions.

The majority of candidates were able to estimate the value of the target firm using the free cash flows method. The common error here was to estimate the value of the whole target firm, instead of just the part that was acquired and not the part that was sold off. A number of candidates were able to estimate the combined company's cost of capital and use it to determine the present value of the free cash flows. A number of



candidates were also able estimate an appropriate P/E ratio and use this to value the part of the company that was sold-off. A number of candidates correctly estimated the value created from tax savings and redundancies made, but many then took these to perpetuity. The narrative of the question set a time limit for these savings at four years.

A number of candidates also attempted to add the premium to the value that they had calculated instead of on the current market value of Anatra Co. This meant that while these candidates could undertake the calculative process, they did not fully understand the mergers and acquisition process in practice. Some candidates attempted to deduct the value of debt, instead of adding it to get to the corporate value, when calculating the additional value created from the acquisition process.

The written parts of the report asked candidates to discuss the approach taken, the estimates made and the key factors to consider in relation to the redundancies and tax savings. In many cases, in terms of the approach taken and estimates made, the written elements tended to be explanatory rather than discursive, and therefore did not gain the full marks here. The key factors part was done quite well, with many candidates identifying and offering advice on the ethical and reputational dilemmas involved.

Four professional marks were available for the report for part b). Many candidates did not draft their answers in a report format, with a brief introduction, appendices and conclusion. Some candidates did not follow any report format and the overall structure and presentation was not neat and therefore these candidates gained few or no professional marks.

Part c) of this question required candidates to discuss whether disposing of assets would be a feasible defence strategy by the target firm. Many candidates made some good points here in their discussion and recognised that this may involve a controversial disposal of 'crown jewels'. But relatively few answers gave a balanced discussion, not considering what companies may do with the cash generated from moving away from non-core areas, such as for example; distributing these funds as special dividends.

Part d) of this question asked candidates to explain three takeover regulatory conditions. This part was less satisfactorily done compared to other parts, with many candidates showing that they had little knowledge of regulatory conditions and/or mixing their knowledge of different conditions. This suggests that a number of candidates did not study the full P4 syllabus and became stuck on a relatively straightforward question.

Question Two

This was a 25-mark optional question and it was a popular choice. Part (a) of the question required candidates to determine the net present value of a project followed by a discussion of the potential concerns which the company may have about the project. This part was done well by many candidates who selected this question and most of these answers achieved a pass mark. Common errors included inflating the sales revenue and costs incorrectly, taking the full amount of the working capital instead of the incremental amount and not realising that there was a loss in year 1, which needed to be carried forward to year 2, and set off against future cash flows. The discussion element of part (a) gained fewer marks, as a number of candidates just presented a conclusion but did not discuss the concerns around the figures in sufficient detail.

Part (b) of question two was unsatisfactorily attempted by many candidates. This question asked candidates to formulate a maximisation function based on funding limits in each of four years. Candidates were told that finding a solution was not required. Many candidates did not recognise that this was a multi-period capital rationing model and tried to use profitability index (PI) to provide a solution, and some candidates then attempted to solve the PI equation they had formulated. Neither of these approaches were correct.

Part (c) (i) asked candidates to re-formulate the function when two constraints were relaxed. Most candidates either got this part wrong due to the errors made in part (b) or did not attempt this part at all.

Part (c) (ii) was done satisfactorily by many candidates. The majority of candidates who attempted this part provided a reasonably good discussion of the types of costs involved in ensuring ethical behaviour.

It would appear that a number of candidates chose question two because of part (a), even though they could not do much of parts (b) and (c). It is important that candidates select questions on the basis that they can do all parts of a question. Leaving parts of a question unanswered can lead to a candidate failing to achieve a pass mark.

Question Three

This was a 25-mark optional question and this was also a popular choice as well.

Part (a) required candidates to hedge a Euro receipt receivable at future point in time using derivative instruments, into US dollars, and offer advice on which instrument to select. The better answers calculated the amount based on the forward rate using the direct quotation method correctly, then used the indirect method for the futures and options calculations. With regard to futures, these answers calculated the unexpired basis, used the forward rate to hedge the remaining exposure, estimated the number of contracts correctly and correctly identified that it should be short (sell) positions. With regard to options, the better answers calculated the premium correctly and correctly identified that put options needed to be purchased. Unsatisfactory answers on the other hand, confused the direct rate and indirect rate, did not calculate basis correctly and ignored the unhedged exposure without any adequate explanation. A minority of candidates could not identify the short position with futures, put options and could not estimate the number of contracts needed. Only a minority of candidates responded to the finance director's query of when would the exchange rate options become the best choice for the company. The written advice part was generally done well.

Part (b) required candidates to discuss the factors which may influence the content of guidelines on the management of risk. This part was unsatisfactorily attempted by the majority of candidates who attempted question three. It seems that many candidates were confused by what was meant by the 'content of guidelines' and what this may contain. Many candidates only focussed on the use of derivative instruments and therefore could not achieve all of the marks available for this part.

Part (c) asked candidates to discuss factors which may influence the company to set up a separate treasury department and how this could operate and be monitored. This part was done satisfactorily by many candidates. Unsatisfactory answers focussed on the factors, but did not address the 'operate' and the 'monitor' areas of this part.

Question Four

This 25-mark optional question focussed on securitisation and on Sukuk and Mudaraba contracts as alternative means of financing an investment.

In part a), candidates were required to calculate the receipts for the various tranches resulting from a securitisation process. This was then followed by a requirement to discuss how variability in rental income affects the returns from the securitisation process. The calculation was done well by the majority of candidates. The second area of this part, the discussion was done less well. It seems that a number of candidates struggle to apply knowledge to non-standard situations and scenarios. The ability to apply knowledge to non-standard situations requires a sustained study by candidates over a longer time period.

Part (b) required candidates to discuss the benefits and risks to the company of undertaking a securitisation arrangement. Candidates who had studied the reasons for undertaking a securitisation arrangement and associated risk did well, but some candidates answers demonstrated a lack of knowledge and understanding of this area.

Part (c)(i) asked candidates to discuss the suitability of Sukuk finance as a means of financing an investment and an assessment of whether it would appeal to potential investors. Part (c)(ii) asked candidates to discuss the appropriateness of Mudaraba contracts as means of financing an investment and concerns a bank may have of providing finance by this method. Part (c)(i) was unsatisfactorily attempted by candidates. A number of answers to part did not demonstrate sufficient knowledge of Sukuk finance and tended to talk about Islamic finance generally. Very few responses gave an assessment of its appeal. Part (c)(ii) was done better with a number of candidates able to provide a discussion of its appropriateness and a bank's concerns.

Conclusion

Candidates need to be able to apply their understanding and knowledge of advanced financial skills to pass the P4 paper. Sustained study, over a long period of time, is an essential pre-requisite for success. In this paper, successful candidates demonstrated this clearly, while candidates, who did not achieve a pass, did not demonstrate sufficient understanding and knowledge of all the topics in the Advanced Financial Management syllabus. In addition to this, well-presented and well-structured answers, directly addressing the requirements of the question, and using the reading time appropriately, are essential requirements for success.