

Examiner's report

P4 Advanced Financial Management December 2016

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

General Comments

This examination consisted of two sections. Section A contained a compulsory 50-mark question. Section B contained three 25-mark questions 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 F9, Financial Management. 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 and communicate about 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 one in this examination tested a candidate's ability to provide sound advice supported by relevant workings, in a coherent report, on the impact of divestment and further investment on a company's costs of equity and capital, and on its financial statements.

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 easily 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, a candidate will be expected to assess the findings of the technical computations within the context of the question's scenario.

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. This was particularly relevant to this examination, where many students were not able to answer the questions comprehensively because they had not studied that area of the syllabus and study guide in sufficient depth;
- ii) Poor time management. Too much time spent in carrying out relatively simple calculation tasks;
- iii) Inability to perform basic arithmetic calculations;
- iv) Not structuring question one, part (b) in a report format and thereby 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, analytical or evaluative narrative;
- vi) Focussing more on either the numerical parts or the discursive parts of a question, instead of a balanced approach;
- vii) 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;
- viii) Not using time effectively to plan a strategic approach to tackling the examination and to choose the optional questions wisely.

Specific Comments

Question One

This was the 50-mark compulsory question where the case study scenario focused on corporate risk: its compensation and the rationale for its management.

Part (a) of the question asked candidates to explain how business risk and financial risk were related, and how risk mitigation and risk diversification can be part of a company's risk management strategy. A number of candidates provided good answers for this part, and were able to explain business risk, financial risk and risk diversification well. However, many candidates found it difficult to find the association between business and financial risk, and a significant number of candidates found it difficult to explain risk mitigation. Answers given by candidates for this part suggest that many candidates do not study why the management of risk is a fundamental part of an organisation's financial management strategy in sufficient depth.

Part (b) of question one required candidates to assess and evaluate the impact of a divestment as suggested by one director or the impact of additional investment as suggested by another director on the costs of equity and capital, and on the financial statements. Initially, this part required candidates to be able to calculate the current cost of equity and capital, based on market values of equity and debt, and using the capital asset pricing model and rating agencies' assessment of risk. Candidates were then required to reassess the costs of equity, debt and capital as the divestment and additional investment changed the capital structure, the financial risk and the business risk of the company. A comprehensive knowledge of asset betas and how these changed under the different scenarios was required. Candidates found adjusting asset betas, when to adjust asset betas and determining the market value of debt to be the most difficult aspects of this part. Candidates also found it difficult to assess how profits changed due to more or less interest payable as a result of changes in capital structure, and how profits changed due to the extra investment or the divestment. Generally the impact on the statement of financial position resulting from these changes was done quite well.

It was pleasing to see that many candidates commented well on their results within the report requirement of part (b) of the question. Many candidates structured the report well, with clear headings, introductions, conclusions and use of appendices.

Part (c) of question one required candidates to discuss why a risk management system should consider each risk and then take appropriate action. This part gave candidates the opportunity to contextualise their knowledge from part (a) and their findings from part (b) to provide a rationale for how the company in question one should formulate its risk management system. Answers to this part tended to be general and not specific. Better answers for this part related the discussion to the question scenario.

Question Two

This was a 25-mark optional question and it was a popular choice.

In part (a) candidates were required to calculate the impact of hedging a currency exposure using futures markets and over-the-counter options. There were some good answers to this part and many candidates achieved high marks for the futures hedge. However, a significant number of candidates did not tackle the over-the-counter options hedge correctly. Common errors included identifying the option as a put and not a call, and trying to calculate the number of contracts for the option, although this is only applicable to market traded products. Reasonable comments on the results were made by candidates.

Part (b) asked candidates to compare over-the-counter options with exchange-traded options. This part was relatively straightforward but was not done well, with many candidates comparing options with futures. This demonstrated a lack of basic knowledge of derivative products and it was evident that many candidates did not study for the exam in a deep and sustained manner.

Part (c) asked candidates to explain and calculate the impact of daily mark-to-market price movements. It also asked candidates to consider the impact on the margin account resulting from the daily mark-to-market movement. This part was done well by many candidates, although candidates were able to explain the process better than performing the calculations. The easier approach was to calculate the tick movement every day and then multiply by the tick value and the number of contracts, instead of trying to get to the total daily profit or loss in one go.

Question Three

This was a 25-mark optional question on a potential acquisition and defence against it. Part (a) was a discursive question which asked candidates to discuss the interests of the CEO and the shareholders of the company differ, using agency theory. On the whole this part was done well with many candidates achieving full marks. Unsatisfactory answers did not refer to agency theory.

Part (b) asked candidates to evaluate the maximum price payable for an acquisition under two different scenarios. The approach candidates were expected to take was to estimate the value of the combined companies using free cash flows and inclusive of benefits arising from improved PE ratios and improved annual synergy benefits, and then compare this to the original values of the two companies as separate entities. The responses to part (b) were mixed. Candidates who understood the approach to be taken produced clear, succinct answers. However, many candidates did not understand what was required or the approach to take. These candidates provided computations which were not relevant to the question and gained few marks.

Part (c) asked candidates to consider the legitimacy and effectiveness of different defence tactics. This was generally answered well by many candidates, although the effectiveness of the different defence tactics could have been answered better.

Question Four

This was a popular question and parts of it were answered well.

In part (a) candidates were asked to evaluate an investment and to calculate and comment on its duration. The evaluation of the project using net present value was done well by the majority of candidates, although a number of candidates made minor arithmetical errors when calculating inflation and increments in working capital. Duration was only correctly calculated by a relatively small number of candidates, although most did comment on it correctly.

Part (b) asked candidates to estimate by how much the selling price of the product would need to fall by, before the project's net present value reduced to zero. Few candidates did this part correctly and a significant minority of candidates missed it out completely. This was surprising since it was the sensitivity analysis technique which was required. It appears that the main reason for the unsatisfactory performance in this part is because it was considered to be a small area of the syllabus and because of this many candidates did not study it at all. Some candidates attempted to calculate the internal rate of return instead, perhaps misreading the requirements of the question and focussing on the words 'zero net present value' only.

Part (c) required candidates to discuss net present value and other measures of short-term and long-term performance. This part was done quite well, although many answers did not cover long-term and short-term measures in sufficient depth. Instead they talked about other methods of investment appraisal such as internal rate of return and modified internal rate of return.

Conclusion

To sum up, candidates need to be able to apply their understanding and knowledge of advanced financial skills to pass the P4 examination. Sustained study, over a long period of time, is an essential pre-requisite for success. In this examination, 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.