

Examiner's report

P4 Advanced Financial Management

June 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 and better than the previous sitting.

In section A, question one consisted of 35 marks and question two consisted of 25 marks. Four professional marks were allocated to question one. 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 the question. 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, or in a minority of cases not answering 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. It is important to make a reasonable attempt at each question and each part of each question.

It is imperative that candidates learn to manage their time effectively through practicing past exam questions under timed and examination style conditions. It was also evident that well-structured answers enabled candidates to manage their time more effectively. For example, questions one and two 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 and application. This was especially evident in questions 1(ii), 2(a), 2(b), 3(a), 3(b), 4(c) and 5(b). Candidates need to be aware that they need knowledge of the entire P4 syllabus, even though it is a large syllabus. Candidates need to know the syllabus well in order to apply knowledge from it 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 exam 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 of the entire syllabus, including section G which requires knowledge and understanding of current issues. 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. Proper time management between questions and 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 provide a value per share of an unlisted company (part (i)); estimate the gains to the target unlisted company's equity holders and the predator company's equity holders based on synergies, a modified PE ratio and different payment methods (part (ii)); and work out the value of a follow-on real option (part (iii)). The discussion part required candidates to discuss the values and gains with and without the project to both sets of equity holders, and the assumptions made (part (iv)). This question contained four professional marks available for well-structured answers presented in a report format.

Generally this question was done adequately. Many candidates made good attempts at all the parts and, apart from part (ii), gained reasonable marks. 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.

Part (i) was generally done adequately. A significant number of candidates calculated the growth rate, although some misread the question, and read the growth rate information as: 'by 25%' instead of 'to 25%'. In a number of responses, when calculating the free cash flow to firm, errors were made such as including interest and when calculating the tax impact. Many candidates did not deduct the debt value from the free cash flow to get to the value per share. Some candidates did not divide the total value by the number of shares to get a share price.

A significant number of candidates found difficulty with part (ii) and especially with obtaining a value for the combined company based on combined company earnings, which included synergies and a modified PE ratio. This is a fairly standard method of obtaining the value of the combined company and it was expected that most candidates should have been able to do these computations at P4 level.

Although a few numerical errors were made, which gave an incorrect answer for the option, in most cases high marks were achieved for part (iii).

Responses to part (iv) were mixed. Some good answers covered all the requirements and got the majority of the marks, even if the discussion centred on incorrect numerical answers. However, not all candidates considered the impact on both companies' equity holders. Many responses only considered the impact on Nente Co's equity holders and/or did not consider the impact of the option. Fewer marks were given to these responses.

Question Two

Question two, part (a) revolved around the impact of changes in financing of a company and how the impact of changing financial structure affected the financial position, earnings per share and the gearing of the company. The answers to this part tended to be varied. Candidates, who presented the changed financial position and calculated the changes in earnings for each proposal, which were then incorporated into the calculations of EPS and gearing, gained the majority of marks. However, overall this part of the question was not done well.

Many responses tended to discuss or try to explain the changes and therefore gained fewer marks. Many responses did not consider the impact on interest of increased or reduced debt financing, and therefore did not incorporate the impact into the profit after tax and the financial position. In a notable minority of responses, candidates did not calculate the EPS and gearing correctly. Such responses gained few marks.

Question two, part (b), tested what securitisation was and the key barriers to Ennea Co undertaking the process. This part was done poorly by most candidates. Few responses gave an adequate explanation of the securitisation process, often confusing it with what leasing was and/or assuming securitisation meant providing asset security or collateral for a loan. Very few responses considered the barriers to Ennea Co in any detail. It was evident that many candidates adopt a revision strategy where they try to spot questions or topics which would be asked in an exam, and considered securitisation as a relatively minor topic which was unlikely to be examined. Candidates should avoid such a strategy, as any part of the syllabus and study guide can be examined. Question two, part (b) was not a difficult question, and knowledge of securitisation, and the ability to apply that knowledge to the question would have gained the majority of the marks.

Question Three

Question three was by far the least popular and the less well-answered of the option questions. Part (a) required the candidates to calculate the variable amounts received and the fixed amounts paid by Sembilan Co to Ratus Bank based on forward rates. A number of candidates incorrectly included the 60 basis points, which is part of the original loan contract but would not be part of the swap; and some answers used the spot rates instead of the forward rates. It is surprising that the responses contained basic errors when there was a recent article in the Student Accountant on how a swap contract can be valued based on forward rates and a fixed rate. Few candidates could explain why the fixed rate was lower than the 4-year spot rate.

In part (b) many responses gave explanations, rather than a demonstration, that the payment liability did not change. Many of the explanations lacked adequate detail. The requirement 'Demonstrate' means that the candidates should show, by examples or otherwise, that the payment does not change whether interest rates increase or decrease. Few managed to do this with any clarity.

Part (c) was generally done well, with many candidates achieving high marks for the discussion, making a variety of theoretical and practical points.

Question Four

This question was the most popular of the option questions. In part (a) the question required candidates to determine an appropriate cost of capital for two projects in a new industry. Most candidates made a reasonably good attempt at determining the cost of capital, although few candidates were able to calculate the asset beta of other activities and therefore the component asset beta. A small number of candidates used an average of equity and debt weightings, and where this was done correctly, appropriate credit was given. Many responses did not give reasons for the approach taken and thereby did not achieve some relatively easy marks.

Part (b) required the candidates to compute the internal rate of return (IRR) and modified internal rate of return (MIRR) of one project and compare these with the given figures for another project, in order to recommend which project to select. Most candidates did this part well and even where both IRR and MIRR gave the same answer due to earlier errors, reasonable explanations were given. However, a significant minority of responses did not calculate IRR correctly and/or gave incorrect explanations, which would not be expected at P4 level.

Few responses calculated the annual and five-year value-at-risk figures in part (c), and very few provided explanations of the values obtained. Like part (b) of question two above, it seems that candidates are not studying parts of the syllabus that they consider to be relatively small parts and unlikely to be tested. As stated above, given that questions will cover a range of areas within the entire syllabus, adopting such a strategy is not recommended.

Question Five

This question was also a popular choice from the option questions. Part (a) of the question which asked candidates to discuss the key risks and issues of setting up an international subsidiary was done well and many responses gained high marks for this part. However, responses got relatively fewer marks for the mitigation of the risks and issues. Nevertheless, generally high marks were achieved in part (a).

On the other hand, few responses were able to provide adequate responses to part (b). The first requirement of part (b) asking for an explanation of dark pool trading systems was relatively easy and again, similar to question two, part (b) and question four, part (c), it seems that candidates are not studying parts of the syllabus that they consider to be relatively minor and at the fringes of the syllabus. As stated above, given that questions will cover a range of areas within the entire syllabus, such a strategy is not recommended. Very few responses correctly identified how dark pool systems may affect Kilenc Co.