

# Examiner's report

## P4 Advanced Financial Management

### June 2017

#### General Comments

This exam paper 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 exam paper tested a candidate's ability to provide sound advice supported by relevant workings, in a coherent report, on the impact of a proposed acquisition which considered synergy benefits, how these were distributed to the acquirer firm shareholders and target firm shareholders, under different payment methods and the impact on dividends if cash is used as a payment method.

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 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 like compounding when calculating inflation;
- 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 exam time wisely to structure answers well and to select from the three optional questions in Section B of the exam.

### Specific Comments

#### Question One

This was the 50-mark compulsory question where the case study scenario focused on acquisitions, valuation using free cash flows, estimating synergy benefits, assessing synergy benefit distribution between the two companies' shareholders and assessing the impact on dividends, where the acquisition payment was to be made by cash.

Part (a) of the question asked candidates to discuss reasons why acquisitions were not successful and what the acquirer in this case should do, to ensure success of the proposed acquisition. This part was done well by the majority of candidates and the many good answers addressed both parts of the requirement. In some cases, candidates suggested that acquisitions are not successful due to shareholders not approving of the acquisition, displaying some confusion of the acquisition process.

Part (b) of question one required candidates to evaluate the impact of a proposed acquisition, payment of the acquisition and impact of a cash payment on dividends and dividend policy.

Part b) i) asked candidates to estimate the value of an unlisted target company based on free cash flows and then estimate its value with synergy benefits based on the PE ratio. Although a number of candidates provided good answers here, some responses displayed confusion between free cash flows to firm (FCFF) and free cash flows to equity (FCFE). Since the cost of capital was given but not the cost of equity, candidates needed to estimate the FCFF first and then deduct debt to get to FCFE. Some responses started with the profit after tax figure instead of the profit before interest and tax, not recognising that the cost of capital already includes the cost of debt within it, and therefore interest payable should not be included. Some candidates tried to apply the synergy benefits to the combined company, although the question narrative said that it was only applicable to the target company. It could be that some candidates were trying to apply techniques relating to past questions, to a scenario which was different.

Part b) ii) required candidates to distribute the synergy benefit between the acquirer and the target in order to estimate the share-for-share exchange ratio. This part was not done well. Many responses divided the shares using the ratio provided, instead of the synergy benefits. Many responses did not include the synergy benefit when determining the share-for-share offer. A number of candidates did not attempt this part at all. It seems that many candidates could not apply the knowledge and understanding of acquisitions to a scenario, which required deeper learning of a commonly tested area in P4, rather than just surface learning. It is important for candidates to recognise that success at P4 requires sustained study, over a period of time. It is unlikely that surface learning will result in success.

Part b) iii) required candidates to estimate the percentage gain in value resulting from the synergy benefits to the acquirer and the target firms based on cash offer and on share-for-share offer. This part was not done satisfactorily either. Few candidates were able to apply techniques tested in previous examinations to this scenario.

Part b) iv) required candidates to discuss the assumptions made in the estimations and the likely reaction of the two companies' shareholders to the cash and the share-for-share offers. Where candidates were able to discuss their results to the foregoing parts well, even if errors had been made previously in the calculations, they gained good marks. Fewer marks were achieved by candidates who did not know how mergers and acquisitions play out

in practice. Again, sustained study rather than surface learning would have resulted in success, together with reading the financial press widely.

Part b) v) required candidates to estimate the dividend capacity of the acquirer in order to estimate the funds available for the cash offer. This part was done reasonably well by candidates. Common errors included not taking interest into account before calculating the tax paid (which was needed to be done here due to the impact of the tax shield), not taking into account of the additional tax and withholding tax payable by the subsidiary company.

Part b) vi) required candidates to discuss implications of a reduction in dividends in order to pay for the acquisition. This part was done reasonably well by many candidates, although many responses were not tailored to the scenario and were more general in nature. Such responses failed to gain the very high marks.

In terms of professional marks, a significant number of candidates did not provide a reasonable structure in their answer, nor put the answer to part b) in a report format. These marks are relatively easy to obtain and a well-structured response would provide candidates with a useful framework within which to provide a response. Such an approach will result in a much higher chance of success with the P4 exam.

### **Question Two**

This was a 25-mark optional question and it was the less popular choice of the three questions.

In part (a) candidates were required to calculate the value of a bond and its yield to maturity when the credit rating of the bond changed. Initially candidates were expected to estimate the yield curve of a government bond. This part was not done well by many candidates, although this topic was covered in a technical article in Student Accountant. Candidates were then required to estimate the equivalent corporate yield curve based on different credit spreads. Using this, candidates were then expected to estimate the value of the bond. These areas were generally done well by candidates and most responses achieved good marks here. Finally candidates were asked to estimate the yield to maturity of the bond. Although some responses did this well, many responses did not know how to estimate the yield to maturity using the internal rate of return methodology. Credit and marks were given for approaches which took similar approaches to the one above.

Part (b) asked candidates to discuss the factors could have affected the credit rating of a company. This part was generally done well, with most candidates providing a good discussion of financial and non-financial factors, and referring these back to the company.

Part (c) asked candidates to discuss the impact a fall in the credit rating would have on a company's ability to raise finance and on its shareholders' returns. This part was also generally done satisfactorily, with good discussion provided by candidates, although the impact on shareholders' returns was perhaps discussed a little less well.

### **Question Three**

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

In part (a) candidates were required to evaluate the financial acceptability of establishing manufacturing operations overseas and it involved undertaking an international investment decision. The question tested candidates' ability to inflate cash flows, apply capital allowances and taxation correctly, and apply correct treatment to working capital. It also involved translating cash flows between the home currency and overseas currency, additional tax payable in the home country, and the impact of additional contribution and of lost contribution. It also involved a discussion of the assumptions made. On the whole this question was done well by the majority of candidates.

Common errors included inflating cash flows incorrectly, including working capital as part of tax allowable expenses, translating cash flows between the overseas country and the home country incorrectly or at the wrong point.

Part (b) asked candidates to discuss methods of transfer price and to make a recommendation thereon. This part was not done well, although for candidates who knew this topic, it was fairly straightforward. It would seem, therefore, candidates who did not answer this part at all or did not provide strong answers, because of a lack of knowledge. This is possibly because transfer pricing is considered to be a small part of the syllabus and many candidates did not study it fully. In order to prepare for the P4 paper properly, candidates need to study the full syllabus in depth.

#### **Question Four**

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 an expected loan in the future using futures, traded options and collars on traded options, and then to provide a discussion of the results. This part was done well by many candidates. It is pleasing to see that the performance on risk management questions continues to improve.

Common errors which candidates should avoid in future are not calculating the basis correctly because they counted the number of months incorrectly, being unable to calculate the premium on options and making errors in computing the final result of the hedge.

Part (b) asked candidates to discuss the advantages and drawbacks of traded options with over-the-counter options. In many cases, very good responses were provided for this part. However, a significant number of candidates listed the advantages and drawbacks of options generally or did not compare traded options with over-the-counter options. In a minority of cases, candidates could not distinguish between the two or compared options with futures.

Part (c) asked candidates to explain the significance of the delta and how a delta hedge would be undertaken and using it to assess the impact of a change in interest rates. Many candidates were able to explain the delta and the majority of these could explain its significance. However, fewer in number then went on to demonstrate how a delta hedge would be undertaken and its impact when interest rates change.

#### **Conclusion**

To sum up, 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.