



# Examiner's report

## P4 Advanced Financial Management

September 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. The first two questions in Section B for this examination consisted of computational and discursive elements, and the final question was wholly discursive. This was in line with the advice given that on occasion, a 25-mark optional question could be wholly discursive.

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 will be required to demonstrate their ability to apply relevant knowledge and skills and exercise the 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, question 4 of this exam paper tests candidates' understanding of the different stakeholder groups' conflicting interests and the benefits for stakeholders in adopting an integrated reporting approach to the development of a business organisation's financial strategy.

The overall performance of the candidates was similar to June 2015 and in line with the overall trend of recent examinations. The main reasons for candidates performing less well were:

- i) Not reading the requirements of the question and therefore answering the question incorrectly. This was particularly relevant to question 1 b) i), question 2 b) and question 4 c);
- ii) Unsatisfactory time management. Too much time spent in carrying out relatively simple calculation tasks including an inability to use appropriate rounding for calculations;
- iii) Inability to perform arithmetic calculations;
- iv) Not structuring question 1) b) into a report format and not gaining all the professional marks;
- v) Written answers that were lacking in structure. For example, it was difficult to determine in question 3 b), whether some of the written answers were about advantages or disadvantages, assumptions or risks;
- vi) Presenting the discursive answers in brief bullet-point format, often in incomplete sentences, as statements and not as discussion-based narrative;
- vii) Lack of detailed knowledge of parts of the syllabus areas, focussing either on the numerical parts or the discursive parts instead of a balanced approach;
- 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. The question scenario was complex and required candidates to undertake a number of detailed calculations and discuss the issues thereon. Therefore, it was essential that the candidate managed the volume of information provided effectively, in order to provide coherent and detailed answers.

Question one required candidates to examine specific financial management issues relating to a partial privatisation of a wholly state owned company.

Part a) of the question asked candidates to distinguish between two free cash flows valuation methods. Generally, many candidates produced a good answer to this part of the question. Weaker answers defined the different free cash flows without going further to discuss how they are applied in valuing corporations.



Part b) of the question required candidates to write a report to the board of directors about what its estimated discounted share price will be when the company is listed, based on the free cash flow to organisation valuation model, and to assess the accuracy of the estimated discount share price calculated. The candidates were then asked to advise the board on the financial implications in choosing one of two options in raising the new bonds on listing, and finally to discuss possible agency issues that may arise with introducing debt capital and a change in equity ownership mix in a partially privatised company.

Part b) i) which required candidates to apply the valuation model to estimate the discounted share price was quite well answered. However, a number of candidates failed to pick up marks because they were unable to calculate sales growth correctly; mistakenly assumed the additional working capital was a tax deductible expense and selecting the free cash flow figure incorrectly to determine the present value of the company beyond the four years forecast period. A number of candidates wasted time in calculating the cost of capital which was already given in the question. Reading the narrative and requirements in a question carefully and correctly will save time which can then be spent to answer other questions.

For part b) ii), many candidates wrote well about the assumptions behind the figures produced and earned enough marks to pass this part of the question. Few candidates however, discussed about implications relating to the theoretical aspects of the valuation model.

For part b) iii), the majority of candidates found it difficult to determine the future spot yield rates, value the bonds issued at a premium or calculate the appropriate coupon if the bonds were to be issued at par value. A number of candidates did not read the narrative part of this question carefully, and used AA credit bond rating instead of A credit bond rating in calculating the spot yield rates. A significant number of candidates revealed a lack of basic financial knowledge in stating that bonds issued at a premium raised more financial capital than those issued at par. Only a few candidates were able to compare costs of the two bond options sensibly and offer advice accordingly. On the whole the answers to part b) iii) was unsatisfactory given that an article on this topic area was published in a recent Student Accountant article.

Many candidates discussed the possible agency problems in part b) iv) between the management and shareholders generally instead of addressing the specific agency issues raised between debt capital providers and equity owners as well as the impact on minority shareholders in a state controlled company.

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 satisfactory and therefore gained few professional marks.

Part c) of this question required candidates to assess the company's bond exposure to interest rate changes using the Macaulay duration and modified duration, and explain why the actual bond value differed from its theoretical value. Although the majority of candidates made a reasonable attempt at calculating the Macaulay duration in part c) i), only a few candidates were able to calculate or use the modified duration to determine the theoretical value of the bond. Therefore, very few were able to explain the difference between the bond value predicted by the Macaulay duration and its actual value as required in part c) ii). Candidates who earned high marks in part c) ii) explained well the relationship between interest rate change and change in bond value.



### **Question Two**

This was a 25-mark optional question which required candidates to advise on the use of multilateral netting to settle inter-group foreign exchange transactions. Also required was the selection of the most appropriate choice from two hedging strategies when investing in a future receivable.

This was a popular question and was reasonably well done by candidates especially in part a) of this question. However a significant number of candidates were not able to determine in part b), the net receipt or effective interest rate in hedging the future receivable. Even though questions on hedging are regularly tested for P4, a number of candidates are not able to attempt these types of question satisfactorily.

Candidates were required in part a) to apply multilateral netting based on the US dollar as the settlement currency and then calculate the inter-group transfers according to the settlement instructions. The currency conversion and netting exercise was generally done well. However, a number of candidates did not read the question carefully and used Euros instead of dollars as the currency of settlement. Other candidates made simple calculation errors. A number of candidates did not follow the settlement instructions given in the question and hence earned fewer marks than if they had read the question more carefully.

In part a) ii), most candidates were able to answer satisfactorily, although in a number of cases the problems raised were not adequately explained.

Candidates were required in part b) to recommend a hedging strategy when investing in a future receivable, based on the choice of two hedging methods. Answers to part b) were mixed. Candidates who had invested the time and effort to understand and apply hedging techniques earned high marks.

However a lot of the answers were unsatisfactory. A number of candidates wasted time dealing with a futures hedge which was not asked for in the question. A significant number of candidates also were not able to choose the correct options hedge or consider its outcome. Very few candidates demonstrated the knowledge to calculate the effective cost of the collar hedge with many candidates not answering much beyond identifying what the collar hedge is, and whether or not the options would be exercised.

### **Question Three**

This was a 25-mark optional question which required candidates to assess a financial reconstruction scheme and evaluate the likely agreement by all finance providers to the suggested reconstruction scheme.

In part a), many candidates were able to produce a good answer to all three parts which required preparing projected financial statements in the reconstruction scheme, and indeed, quite a few candidates received full marks. It is worth reminding candidates that occasionally as in this part of the question, there are marks available for relatively straight forward calculations without needing to apply complex techniques, when they use the information in the question carefully.

Part b) was unsatisfactorily answered by the majority of candidates and some did not attempt this part of the question. Many answers described the company situation in a general sense instead of discussing why the refinancing scheme would be acceptable or not acceptable to the various finance providers. A significant number of candidates only discussed some and not all of the finance providers. Other answers ignored the implications of the proposed reconstruction scheme in part a). While this part of the question did ask for assumptions to be stated, quite a few candidates did this to the exclusion of actually answering the question. A bit more time and



effort spent by candidates in carefully reading the narrative may have steered them to addressing what this question asked.

#### **Question Four**

This was the least popular 25-mark optional question which required candidates to discuss the difficulties in reviewing a company's financial strategy where there are conflicting interests between stakeholder groups. Also required was a discussion of the advantages for stakeholders in adopting the principles of integrated reporting approach in developing the company's financial strategy.

In part a), candidates were required to discuss the difficulties which the finance director may face when reviewing the company's financial strategy. Many answers focussed on one particular area or point and hence limited their ability to earn marks. In addition, many of the difficulties raised by candidates seemed more operational than strategic.

Candidates were required in part b) to discuss issues to consider in deciding whether to adopt the approach which the chief executive proposes in dealing with the company's suppliers. Although this was perhaps the easiest part of this question, many candidates failed to discuss more than one or two issues to earn high marks. Equally, many candidates did not restrict their answers to discussing about the financial benefits; ethical and practical issues raised in the proposed approach but instead wrote about other issues where few if any mark could be given. Again, this emphasises the importance of directly addressing the requirements of a question to gain marks.

In part c), candidates were required to discuss the advantages to stakeholder groups in adopting an integrated reporting approach to the development of the company's financial strategy. Many candidates answered well about the impact on stakeholder groups but in reality, they had limited knowledge of integrated reporting. This was clearly evident when few candidates mentioned about the various capitals that integrated reporting is concerned with and the need for integrated reporting to be concise to help focus management's attention on what was most important. A number of candidates also wrote about disadvantages to stakeholders which meant time and effort was wasted as no credit or mark could be given.

#### **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.