

Examiner's report

P4 Advanced Financial Management June 2011



General Comments

The structure of the paper was similar to past papers with two compulsory questions in section A, consisting of 66 marks in total, and three 17-mark questions in section B, of which candidates had to do two, for the remaining 34 marks.

The overall performance of the candidates was satisfactory.

In section A, question one consisted of 36 marks and question two consisted of 30 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 sitting, 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. 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.

Candidates need to bear in mind that it is easier to obtain marks at the start of a question rather than towards the end of a question. It is imperative that candidates learn to manage their time effectively through practicing past exam questions under timed and examination style conditions.

Some candidates were poorly prepared for the exam in terms of their knowledge and application. This was especially evident in questions one and two, and in the discursive parts of questions three and four. Candidates need to be aware that for P4 it is expected that they develop their knowledge and the ability to apply that knowledge. In a number of cases candidates failed to achieve a pass mark due to lack of knowledge and not being able to apply that knowledge to the scenario in the question.

The P4 paper has a large syllabus and numerous technical areas. Candidates need to know the syllabus well in order to apply knowledge from it to the question scenario. A consistent, sustained study approach augmented by question practice and reading around the subject is much more likely to achieve success, as opposed to a last-minute intense study approach and attempting to question-spot.

Poor performance was also evident where candidates did not read the content and requirements of questions fully. Answers need to be directed at the scenario in the question, general answers do not gain many marks.



Specific Comments

Question One

The first four parts of question one required candidates to evaluate whether a proposed acquisition was beneficial financially by valuing the target and then the combined company using free cash flows to firm. Candidates were then asked to discuss the limitations of the method used, the assessment whether the capital structure could be maintained or not, and the implications to the *valuation method* of the change in the capital structure.

The final part of question one asked candidates to assess whether or not paying excess cash as dividends was a suitable defence tactic or not.

Part (i) was generally done quite well. Most candidates were able to present adequate free cash flows to firm figures both for the target and the combined company. However, common errors included: putting interest in the cash flows, which is incorrect as it is imputed in the WACC; making errors in the growth rate of sales revenue which needed to be estimated over a period of three years, not four; and errors in determining a suitable discount rate for the combined company using asset betas and combining these.

Good answers were given for part (ii) with a number of candidates identifying a range of weaknesses of the valuation model used. For future revision, candidates should study the range of factors from the model answer, because in some candidate responses the discussion range was limited.

Parts (iii) and (iv) were answered less well. Many candidates were not able to calculate whether or not the capital structure could be maintained or not. It is not enough to state this without adequate application to the question scenario. The answer of the implications of the change in the capital structure, to the valuation method used, was poor in most cases. Answers tended to discuss capital structure changes generally (not required) rather than the implication to the valuation method.

Part (v) was answered well when candidates focussed on the particular defence tactic. Poor answers included other defence tactics, which was not required by the question.

Question Two

This question, part (a), required candidates to use derivative products (forwards, futures and options) to hedge exchange rate risk of a dollar receipt and to advise the company on which product to employ. In part (b), the candidates were asked to estimate additional finance required for an investment, given that the dollar income could be invested for two months. Here the candidates needed to estimate a future spot rate in six months time. Finally in part (c) candidates assessed whether or not the project was worthwhile. Here candidates had to convert the cash flows into Euro by predicting future exchange rate based on expectations theory.

Overall this question was not done well. In part (a) many candidates presented adequate calculations of the cash flows using different derivative products but failed to advise adequately. For example, although options are generally more expensive they do provide more flexibility. And forwards may be cheaper but they do carry a greater risk of default. And so on.

In some cases candidates had difficulty in calculating an estimate for the basis remaining and occasionally candidates tried to use money market hedges although information was not provided in the question to employ this technique.

Part (b) was adequately done although few candidates calculated and employed a future spot rate to assess the future amount required.

Few attempts were made to calculate future spot rates based on purchasing power parity for part (c) and some answers just discounted the project in the local currency rather than in Euro.

Question Three

This question was the least popular question of the optional questions.

Part (a) required candidates to estimate the Macaulay duration of two bonds. This part was done adequately although very few candidates calculated the gross redemption yield and use this as the discount rate.

Whilst most candidates knew the techniques of a duration computation, part (b) asked candidates to discuss the usefulness of duration as a measure of risk (sensitivity). On the whole, this part was done less well, with few candidates demonstrating an understanding of duration in terms of bonds and interest rates, and even fewer discussed the limitations of duration, including its inability to deal with convexity and changes in the shape of the yield curve.

Question Four

In part (a) this question asked candidates to apply the Black-Scholes Option Pricing (BSOP) model to a real option. Most candidates were able to determine the value of the option inputting relevant figures into the BSOP formula, but few candidates were able to identify the correct P_a and P_e variables.

Part (b) asked candidates to discuss the results achieved in part (a). Some candidates recognised that the value of the real option obtained in part (a) is not an actual value, but rather it indicated the extent to which future uncertainty and volatility of returns makes it worthwhile to continue to monitor and nurture the project. That is, to identify that the value of a project that does not need a “now or never” decision. However, a significant number of students did not identify and discuss real options but merely talked about financial options in a general sense.

Question Five

This question was the most popular and probably the best answered of all the questions on the paper with many candidates gaining a high proportion of the marks for their answers. It asked candidates to consider the business



reasons and ethical considerations of a new business venture. It also asked candidates to consider how negative issues may be mitigated.

Answers that gained fewer marks did not give many points or lacked adequate discussion because they were in note form. Some answers considered the issues but not how these could be mitigated. Repetition of the same point or points gained few or no additional marks.

Overall though, the majority of the candidate responses gained over half marks and some responses gained over 70% of the total marks for this question.