Examiner’s report

P4 Advanced Financial Management
September 2016

General Comments
This exam paper is in two sections. Section A consisted of a compulsory question for 50 marks. Section B consisted of three questions of 25 marks each, from which candidates had to answer two questions. All three questions in Section B for this examination consisted of a mixture of computational and discursive elements.

This is an advanced level option paper which builds upon the knowledge and skills examined in F9, Financial Management. At this advanced stage, candidates will be required to demonstrate their ability to read and digest quickly, comprehensive and detailed questions, apply relevant knowledge and skills and exercise the professional judgement expected of a senior financial person, 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 that 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 on this exam paper tests a candidate’s ability to provide sound advice supported by relevant workings, in evaluating the financial viability of an international investment project with the added option of extending it.

Like a senior financial person at work, a candidate is expected to read a business brief in the form of an exam question here, carefully, take notes and decide on a relevant methodical approach to achieve the brief’s objectives. Senior management work under tight deadlines, and hence prioritising and managing your time 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 in writing the report or discussion paper, will fail to earn the full professional marks that are easily available here in Question 1.

In this exam, too many written answers were poorly structured and therefore markers found it difficult to determine what is being discussed or argued. Additionally, many candidates tend to generalise and write all that they know about a particular topic area, rather than focus their answer to the question posed. Answers that score high marks are characterised by a reasoned structure, narrative discussions that are sufficiently detailed, clear and relevant to the question asked and easy to follow numerical workings supported where appropriate by brief notes. Achieving this in a P4 exam will ensure a candidate is on track to passing it.

This examination also includes 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 comments below will reflect the above points.

Specific Comments

Question One
This was a compulsory 50-mark question. The question's scenario was complex and required candidates to undertake a number of detailed calculations and discuss the issues therefrom. Thus, it was essential that the candidate managed the volume of information provided effectively, in order to provide coherent and detailed answers.

This question required candidates to evaluate an international investment proposal for a large first phase trial project funded by a regional authority with the possibility of a privately funded second phase if the first phase was successful.

Question 1 a) required candidates to explain how real options can impact on conventional net present value calculations. The flexibility afforded through the different types of real options was well pointed out. However, few candidates adequately explained how real options may add value in capital investment decisions.

Part b) of the question required candidates to prepare a report that provides a reasoned recommendation of the maximum bid for the first trial phase after producing estimates for the net present value of the first and second phases based on the assumptions applied.

The question part b) i) required a forecast of an organisation's free cash flows in a specified currency and to determine the proposed first phase trial project's net present value. Although this part of the question was well answered, quite a few candidates struggled to apply their F9 knowledge in using incremental inflation rates and determining the balancing allowance as part of the free cash flow calculations.

For part b) ii), candidates were required to apply option pricing theory to value the second phase project. It was pleasing that many candidates knew how to use the Black-Scholes option pricing model in a strategic investment decision, a topic area that was covered in two recently published P4 technical articles. However, it was disappointing to note that a small number of candidates knew what all the input variables should be and a few candidates did not realise that options will not be exercised when their calculations showed negative values.

Part b) iii) required a discussion of the assumptions made and to provide a reasoned recommendation of a possible maximum bid for the first phase trial project. Therefore, this part of the question assessed whether candidates were able to discuss the reasonableness and limitations of the assumptions that were made. Many candidates merely stated the various assumptions used without discussing their reasonableness and limitations in the context of the question, and therefore did not obtain many marks. It is also important to realise that the report's objective is to eventually provide a reasoned recommendation, and not merely calculating the present value estimates.

Four professional marks were available for presenting part b) in a report format. It was disappointing to see few candidates earned the full four marks available for a report that had a title heading, a brief introduction of its objectives, appropriate use of appendices and a conclusion with reasoned recommendation. Some candidates omitted to produce their part b) answer in a report format, other reports lack structure and presentation and therefore earned few professional marks.
Part c) required a discussion about where the company should set up its production facilities and

the impact of the financial difficulties in the market where the project's products are sold. Candidates, who scored high marks, articulated the potential difficulty in obtaining private finance; the risk of economic exposure caused by a weak Euro currency; and the risks if manufacturing was relocated to the product's market.

Question Two

This question required candidates to discuss the impact of the different dividend policies that companies may adopt and explain how a company's valuation based on the dividend valuation model compares with its market value.

Part a) was quite well answered with most candidates being able to identify the dividend policy adopted as well as discussing their merits and drawbacks. Candidates who achieved high marks demonstrated their ability to apply their knowledge to the companies in the question instead of generalising about the theoretical relevance or irrelevance of dividend policies.

Part b) was unsatisfactorily answered as many candidates produced valuations based on one and not two growth rates as required. In addition, few candidates were able to analyse why the company's value derived from the dividend valuation model can be quite different from its market value.

Question Three

This question required candidates to evaluate a business reorganisation scenario and make a reasoned recommendation based on financial and other issues, as to which of the unbundling strategies proposed should be adopted by the company.

Part a) required candidates to define management buy-in (MBI) and its benefits and drawbacks. Candidates answered this question part satisfactorily, although a few candidates defined a management buy-out (MBO) instead.

Part b) required candidates to produce valuations based on the different unbundling strategies proposed and to discuss the factors that may determine which unbundling strategy the company should choose, before making a reasoned recommendation. The first two parts of this question where candidates were asked to produce an estimate of the valuation based on restructuring and MBI proposals, were well answered. However, many candidates made no attempt or an unsatisfactory analysis of the factors that may affect the board's choice of the unbundling strategy.

Question Four

This question was the least satisfactorily answered of the three option questions. It required candidates to demonstrate their knowledge of how a swap can be used as a tool to manage interest rate risk. It also required candidates to calculate the amounts payable or receivable based on forecast forward rates that were determined from current annual spot yield curve rates.

In part a) of the question, candidates were required to calculate the amounts payable or receivable annually from the swap arrangement. Candidates were further required to calculate the company's interest payment liability based on two different yield curve rates. Most candidates were not able to estimate the forward rates and hence this part of the question was unsatisfactorily answered even though there was a technical article available, covering this topic area. Candidates had great difficulty too in calculating the company's interest rate payment liability due to a lack of knowledge and understanding of how an interest rate swap works.

In part b) of the question, candidates were asked to advise what should be the current value of the proposed swap. Only a small number of candidates realised that a swap rate is priced by a lending institution so that its present value is zero to the buyer of the swap at the time the swap deal is agreed. The answers were quite disappointing considering the fact that the P4 technical article mentioned above, demonstrated this zero outcome by working through a numerical example.

Part c) of the question required candidates to discuss the benefits and disadvantages to the company by not undertaking a swap. Given the relatively large number of marks available for this part of the question, candidates who scored highly, discussed several benefits and disadvantages instead of one or two.