

Examiner's report

P4 Advanced Financial Management

March 2017

General Comments

This exam 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. Two of the three questions in Section B for this examination consisted of a mixture of computational and discursive elements. The other optional question was wholly discursive.

This is an advanced level option examination 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 from this examination tests a candidate's ability to provide reasoned advice supported by relevant workings, in evaluating the financial impact of a company's re-organisation strategy and its consequences on the company's stakeholders.

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 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.

This examination included a significant amount of technical content 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.

Answers that score high marks show a reasoned structure, appropriate narrative discussions that are succinct, 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.

The main reasons for candidates performing less well were:

- i) Not answering parts of questions due to a lack of detailed knowledge of the syllabus areas. Many candidates were not able to comprehensively answer the questions attempted because they had not used resources such as study texts, to learn and understand that area of the syllabus in sufficient depth;
- ii) Poor time management. Too much time spent in carrying out relatively simple calculation tasks or writing much on what essentially is only a single point;
- iii) Inability to perform basic arithmetical calculations;
- iv) Written answers that were poorly structured. As an example, it was difficult to identify in some answers to Question one, part a) whether advantages or disadvantages were being discussed;
- v) Presenting discursive answers in brief, bullet point format, with no adequate explanation and often as incomplete sentences;
- vi) Not structuring Question one, part b) in a report format and consequently, not gaining all the professional marks available;
- vii) Focussing more on either the numerical or discursive parts of the examination. Candidates need to be aware that a balanced approach is required to achieve a pass;

- viii) Not carefully reading the requirements of a question and therefore not answering the question that was asked;
- ix) Too much effort often being put into answering question parts worth only a few marks whilst less effort made in answering question parts worth more marks.

Article I.

Article II.

Specific Comments

Question One

This was a compulsory 50-mark question. The question's case scenario was complex and required candidates to undertake various 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 assess whether the corporate restructuring programme suggested is the appropriate strategy to ease the company's financial difficulties.

Part a) of the question required candidates to explain what a reverse takeover means and whether it is better method for the company to be listed rather than going through an initial public offering (IPO). It is important to read a question carefully otherwise the time and effort made to answer it is not rewarded. For example, candidates received no marks when they discussed about the advantages and disadvantages of an IPO listing instead of the advantages and disadvantages of a reverse takeover as a listing method when compared with an IPO. Candidates who had read a recently published technical article on reverse takeovers were able to earn very good marks.

Part b) asked candidates to write a report that includes an assessment of the financial position of the company and an estimated value to the equity shareholders, after having carried out the restructuring programme. Candidates were then asked to explain the valuation method that they have used and the assumptions made in estimating the company's equity value. Candidates were finally required to discuss the impact of the restructuring programme on the company and on one of its key shareholder groups.

Few candidates were able to reasonably construct the company's post reconstruction statement of financial position. Candidates also found difficulty in using the free cash flow model to estimate the equity value of the business. For example, candidates omitted to deduct depreciation when forecasting the taxable profit and then applied an incorrect discounting rate. It was quite disappointing that candidates did not explain the valuation method employed as required in part b) ii). Quite a few candidates earned full marks for explaining about the assumptions used, and indeed some wrote far too much for the marks available here.

Discussion of the impact of the restructuring programme on the company and a key shareholder group was unsatisfactory. Few marks could be given for answers that were too general and incomplete.

Four professional marks were available for presenting part b) in a report format. As in previous exams, it was disappointing that more candidates could have earned all four marks available. Some candidates omitted to produce their part b) in a report format, other reports lack structure and presentation and therefore earned few professional marks.

Part c) required candidates to discuss why the company's attention to its stakeholders represented on the supervisory board may change once the company is listed. This part of the question was not well answered. Very

few candidates discussed about the pressure to keep the company's share price buoyant as well as trying to fulfil shareholders' objectives means the interests of the other stakeholder groups are likely to be superseded.

Question Two

This wholly discursive question tested candidates on their ability to describe the factors that determine the optimal financing mix and structure within a specified business context; identify the investment risks and describe the controls to manage them; discuss the issues when communicating information to external finance providers; and finally, to evaluate the impact of behavioural finance on the company's share price. Candidates should note that for discursive questions of this nature, due credit is given to relevant and valid points discussed that may not be included in the model answers.

A significant number of candidates answered parts a) and b) i) of this question well. Candidates who achieved high marks raised and discussed a number of relevant factors when evaluating the company's potential sources of finance. However, some candidates remarked that financing via a rights issue will dilute the ownership of existing shareholders which is only true to the extent that they sell their rights.

Many candidates demonstrated their understanding of the various investment risks and the type of controls established to manage such risks. However, a significant number of candidates suggested general risks and controls thus earning less marks than if they had specifically addressed the scenario in the question.

The answers to part b) ii) were unsatisfactory because many candidates did not read this part of the question carefully. It asked them to discuss issues such as confidentiality and transparency that could determine the kind of information the company communicates; not what kind of information needs to be communicated.

Part c) of the question tests candidates on a new subsection of the syllabus about behavioural finance. Most candidates revealed a lack of knowledge and understanding of how and why behavioural finance affects share prices, even though a published technical article covered this topic area.

Question Three

This 25-mark optional question required candidates to demonstrate their knowledge of how to use currency swap and over-the-counter currency options as tools to hedge an organisation's financial risks.

Part a) required candidates to discuss the advantages and drawbacks of using the currency swap as a hedging instrument. Candidates who discussed the relevant reasons with reference to the company's financial circumstances, scored high marks.

Candidates were required in part b) to calculate the annual interest savings from using a currency swap and then evaluate the financial viability of accepting the rail franchise. Many candidates correctly determined the interest saved but some had difficulty in demonstrating the swap mechanism process even though a technical article on this subject was recently published. Very few candidates demonstrated an ability to perform a net present value evaluation which involves a currency swap arrangement and forecast exchange rates. Quite a few candidates struggled to estimate future exchange rates based on predicted inflation rates, a topic area covered in the F9 syllabus. Candidates are expected to apply their F9 knowledge when attempting questions in this advanced exam.

Part c) required candidates to hedge a receivable using an over-the-counter currency option. A large number of candidates showed a lack of understanding when they chose call instead of put options. Many attempted to treat

the currency options as if they were exchange traded when they were not. Finally, few candidates discussed whether the currency option is a preferred hedging method to a currency swap, hence many missed out on the marks allocated for this part of the question.

Question Four

This question required candidates to apply the adjusted present value technique to appraise an investment decision that includes a significant change in the organisation's financial structure. It also required candidates to assess the impact of financing and capital structure upon the organisation's value.

Part a) required candidates to recommend whether the project should be accepted after applying the adjusted present value technique. Many candidates scored good marks in determining the base case net present value. However, the answers to the financing side effects were mixed, with the weaker answers not correctly calculating the tax shield on loans and subsidy benefits. Some candidates wasted time discussing many assumptions when there was little credit available.

Candidates were required in part c) to discuss their knowledge of Modigliani-Miller's (MM) capital structure theories with reference to the non-executive director's comment in the question. Surprisingly, many candidates revealed a lack of knowledge about MM theories, a topic area that is examinable in F9. In particular, they confused MM theories with the traditional/static trade off theory.