

Examiner's report

P4 Advanced Financial Management
December 2017

The ACCA logo consists of the letters 'ACCA' in a white, bold, sans-serif font, centered within a solid black square.

General Comments

This exam paper consisted of two sections. Section A contained a compulsory 50-mark question. Section B contained three 25-mark questions, 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 with and communicate 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 examination tested a candidate's ability to provide sound advice supported by relevant computations, in a coherent report, on the impact of a change in the company's capital structure by increasing the proportion of debt. It asked candidates to perform calculations of the debt instruments, estimate the impact on earnings and financial position of the company, and discuss the impact on the company and the key stakeholders.

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 candidates 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) Not structuring question one, part (b) in a report format and thereby not gaining all the professional marks;

- iv) Presenting the discursive answers in brief bullet-point format, often in incomplete sentences, as statements and not as discussion-based, analytical, or evaluative narrative;
- v) Focussing more on either the numerical parts or the discursive parts of a question, instead of a balanced approach;
- vi) 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;
- vii) 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 a restructure of the capital structure of a company, resulting in increased debt finance. Candidates were asked to calculate the change in debt value, the coupon rate for a new debt instrument, and the duration. The impact on earnings, financial position and key ratios was required as well. Candidates were also asked to discuss how the company may benefit from changes in the capital structure and the impact on specified stakeholder groups.

Part (a) of the question asked candidates to discuss the benefits of higher levels of debt on risk, on protection against acquisition bids and on taxation benefits. This part was answered quite well by most candidates, with the majority of candidates achieving a pass mark. Whilst most candidates provided good answers to the taxation benefits and reasonable answers to protection against acquisition bids, few candidates addressed the risk issue. In particular, few candidates recognised the fact that companies often face a trade-off between business and financial risk, and where companies have stable cash flows and therefore lower business risk, they can afford to take-on higher financial risk.

Part (b) of question one asked candidates to estimate and discuss the impact of additional gearing and the resulting change in the bond yield curve on existing and new debt.

Part b) i) asked candidates to estimate the value of the existing bonds due to changes in the yield curve, and to estimate the coupon rate at which the new bonds would be issued. Few candidates were able to do this part successfully and the main reason was that they found it difficult to apply the yield curve to the bond to estimate the coupon rate. A significant number of candidates attempted to undertake an internal rate of return calculation because they confused bond value with bond cost.

In part b) ii) candidates were asked to estimate the duration of the new bond based on conventional repayments of annual coupons and payment of the capital face value at the end of the period, and the duration of the bond if the repayment of the bond is made in equal annual repayments of interest coupons and capital face value. Many candidates were able to perform the duration computation for the conventional bond well, but few candidates were able to calculate the duration of the equal annual repayment bond.

Part b) iii) asked candidates to estimate the impact of the new bond on the income statement, financial position, earnings per share and gearing under two proposals. The first where the

proceeds from the bond are used to repurchase equity shares and the second where the proceeds from the new bond are used for investment purposes. Many candidates were able to estimate the impact of the investment from the second proposal on the financial position and on the income of the company, but few candidates were able to estimate the impact of the changes in interest payable due to the new bond and the change in the coupon interest of the existing bond. The impact of the change in earnings per share and on gearing were calculated correctly in most cases, where candidates attempted this part of the question.

In part b) iv) candidates were asked to discuss the impact of the restructure on the capital structure of the company and the impact of the two proposals on given stakeholder groups and on the company itself. Many candidates only provided a brief discussion here. It is important that candidates consider the number of marks assigned to each part of a question as an indication to the significance of that part and how much time and effort they should put on that part. Better answers to this part made reference to the numerical answers from parts b)i), b)ii) and b)iii), as asked for in the requirements.

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 in the examination.

Question Two

This was a 25-mark optional question and it was a popular choice. The question asked candidates to consider the acceptability of a project using a number of investment criteria and a discussion of how risk is involved in the evaluation of the project.

In part (a) candidates were asked to evaluate a project using net present value, internal rate of return, modified internal rate of return and value at risk. Candidates were also asked to discuss how risk was incorporated into these methods. The calculation and discussion as part of evaluation were done well by most candidates. The main difficulties encountered by candidates were incorrectly ungearing and re-gearing beta factors when estimating a project specific, risk-adjusted cost of capital for the project, and incorrectly estimating tax and working capital. Some candidates made errors in the internal rate of return and value-at-risk calculations. And some candidates used two new discount rates for the internal rate of return, instead of using the cost of capital as one of the rates.

The discussion on how risk was incorporated into the methods was done less well. In many cases, answers tended to be general and not address each method specifically, with value-at-risk having the least detailed discussion.

Part (b) asked candidates to discuss benefits of using a Monte Carlo simulation method and assumptions involved when using this method. Many candidates could not answer this part of the question in depth and few answers made more than a point or two of relevance. It seems that many candidates had not studied this syllabus area, as the requirement should not have posed any difficulty for a well-prepared candidate.

Question Three

This was a 25-mark optional question and it was the less popular choice of the three questions. However, the performance of candidates who attempted this question was good. Perhaps the length of the question discouraged some candidates from choosing it.

In part (a) candidates were asked to evaluate the financial performance of the company by calculating ratios and trends, and using these to frame their analytical discussion. Overall, the answers to this part of the question were good and the majority of answers achieved a comfortable pass mark. The question stated that 10 marks were available for calculations and credit was given for the range of ratios and trends provided. The analyses in many cases identified the issues and relationships between the ratios well, but sometimes candidates merely stated that a ratio/trend was increasing or decreasing, without attempting to address why this may be happening.

Part (b) asked candidates to consider how the company may finance future investments. Overall, answers provided a sound discussion of general sources of finance, although few addressed the revolving credit facilities mentioned in the question, nor addressed the difficulty in raising finance through equity issues when the share price is declining. Therefore, relating the discussion to the specifics of the question was more limited. Some candidates confused reserves to mean cash, and it is surprising that this confusion occurs at the Professional level.

Question Four

This was a 25-mark optional question and it was a popular choice. The question asked candidates to consider the impact of a currency hedge using futures contracts, and to consider forward contracts and option contracts.

In part (a) candidates were asked to calculate the gain or loss resulting from a futures market hedge that had been undertaken and gain or loss if basis had declined at a constant rate. Candidates were also asked to discuss the significance of basis risk. Overall candidates found this part challenging. Excellent answers, which required few computations, were received from a minority of candidates, who clearly understood the topic area well and had probably studied the Student Accountant articles on this topic

Many candidates had difficulty in calculating the profit/loss on the futures market, and some did not convert the hedge result into the domestic currency. Many candidates also found it difficult to calculate the futures price based on the basis declining at a constant rate. Many candidates attempted to fit the answer to this question into a pre-learned proforma and unfortunately this question did not fit readily into a proforma. The discussion of basis risk in many cases lacked sufficient depth and there continues to be confusion between basis and basis risk.

Part (b) asked candidates to calculate the result of the hedge if forward contracts and option contracts had been used as alternatives to futures contracts, and to advise on the best alternative. This part was generally done well. Most candidates who attempted this question, correctly calculated the amount using forward contracts. Many candidates correctly calculated the impact of the options hedge, including dealing with over/under hedge properly. Some candidates found it difficult to calculate the premium, the impact of the under/over hedge using forward contracts, and a minority of candidates did not identify that it was a put option which was needed. The advice on the best alternative, when provided, was, on the whole, detailed and correct.

Conclusion

To sum up, candidates need to be able to apply their understanding and knowledge of advanced financial skills to pass P4. Sustained study, over a long period of time, is an essential pre-requisite for success. In this examination, 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 time to read the question and plan for it appropriately, are essential requirements for success.