



Examiner's report

Advanced Financial Management (AFM)

December 2018

The examining team share their observations from the marking process to highlight strengths and weaknesses in candidates' performance, and to offer constructive advice for future candidates.

General Comments

In this Advanced Financial Management (AFM) exam, all three questions are compulsory. It was pleasing to see that only a few candidates did not attempt all the questions. It suggests that the change to a compulsory questions format enabled candidates to maximise their time more efficiently in answering the examination questions.

On the whole, the examination results were better compared to previous sittings. Some candidates scored high marks for a number of requirements, but other candidates struggled to perform well in some numerical and discursive parts, as explained below.

This exam is in two sections. Section A consisted of a 50-mark compulsory question. Section B consisted of two compulsory questions of 25 marks each. All three questions in this examination contained a mixture of computational and discursive elements.

AFM exams test a range of syllabus areas and often more than one topic area of the syllabus in a question. Candidates need to be able to apply knowledge and skills learnt, to the requirements of each question part. Application of knowledge to the scenario laid out in the question, is essential to pass this paper. It follows that any discussion or evaluation must relate to the context within the scenario set out in the question.

This is an optional exam which builds upon the knowledge and skills examined in, 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 exam, tested a candidate's ability to provide sound advice, supported by relevant computations where applicable, in a coherent report, on management buy-outs and management buy-ins, corporate restructuring, acquisition values, methods of payment for the acquisition, and IPOs and reverse takeovers. It required candidates to discuss and make judgements on a variety of choices.

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, candidates will be expected to assess the findings of the technical computations within the context of the question's scenario.

Professional skills are relevant across all Strategic Professional exams. This exam specifically rewards professional skills in Question One, but candidates should realise that they also underpin good performance throughout the exam. Requisite core skills include why information in scenarios will impact upon the discussion and evaluation asked for, understanding the viewpoints of those interested in the subsequent decisions and communicating recommendations clearly and concisely.

The main reasons for candidates performing less well were:

- i) Lack of detailed knowledge of parts of the syllabus areas and thereby not answering all parts of questions fully. Many candidates were not able to answer some questions comprehensively because they had not studied that area of the syllabus and study guide in sufficient depth;
- ii) Poor time management, which was less evident here compared with previous exams. Sometimes candidates spent too much time in carrying out relatively simple calculation tasks, and sometimes discussing one area repeatedly without considering a range of relevant areas;
- iii) Failing to respond fully to question requirements or take account of details in question scenarios that established the parameters of the answer. Candidates must read question scenarios carefully and pay particular attention to the wording in the question requirements. These are skills that question practice will help develop;
- iv) Poor structure to the numerical and written answers. Not structuring question one, part (c) in a report format and thereby not gaining all the professional marks;
- v) Presenting the discursive answers in brief bullet-point format, often in incomplete sentences, as statements and not as discussion-based, analytical, or evaluative, narrative;
- vi) Focussing more on either the numerical parts or the discursive parts of a question, instead of a balanced approach. In order to pass, a balance between undertaking calculations and providing discursive narrative is necessary;
- vii) 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;
- viii) Failing to take account of the marks available when answering written questions, thereby providing detailed answers for relatively minor part, but very brief answers for a question where more marks are available.

Specific Comments

Question One

This was the 50-mark compulsory question in which the case study scenario focused on restructuring through a management buy-in (MBIs), covered through discussion, and an acquisition. The computations, report and evaluation areas in the question involved estimating the additional value created by synergy benefits of the acquisition and how these synergies were shared out between the acquiring company's shareholders and the target company's shareholders. The final part of the question asked candidates to discuss the differences between an IPO and reverse takeovers when undertaking a listing.

Part (a) asked candidates to distinguish between a management buy-out (MBO) and a MBI and discuss why a company may be sold through a MBI. The majority of candidates did this part well, with many candidates scoring full marks. A small number of candidates could not distinguish between MBOs and MBIs.

Part (b) initially asked candidates to explain what portfolio restructuring and organisational restructuring involve. This was done less well by a significant number of candidates. Many confused portfolio restructuring with individual portfolio construction and sometimes referred to it as a financial reconstruction. It seems that this confusion occurred due to lack of knowledge. It is important to remember that all areas of the syllabus need to be studied in depth.

Part (b) then asked candidates to discuss possible reasons why a change in the type of shareholders may have made a company change its business focus. This was well-answered by many candidates, but a few did not realise that a company does not need to undertake diversification for shareholders who hold well-diversified portfolios themselves.

Part (c) (i) asked candidates to estimate the values of two companies individually and then estimate the value of the combined company. The majority of candidates did this part well, with many scoring full marks.

Part (c) (ii) asked candidates to estimate the percentage gain in value for the acquiring company shares and the target company shares under each of three methods: a cash payment, a share-for-share offer payment and a mixed offer payment. Many candidates did not do this part well. Common errors included an inability to share synergy benefits between the two companies' shares and not recognising that once a share of the synergy benefits go to the shares of one company, only the balance goes to the shares of the second company.

Part (c) (iii) asked candidates to evaluate the likely reaction of the two companies' shareholders to the acquisition offers. Again, many candidates did not do this part well. Answers from many candidates repeated the outcomes of calculations, which could have been presented very quickly in a tabular form, and commented on the assumptions made, which was not really what was required. Very few candidates looked at each offer in turn, and discussed and evaluated how the shareholders of each company would have reacted. Few candidates made use of the information provided in the question about premiums offered by other acquisitions in the industrial sector. At this level, it is expected that candidates are able to offer strategic level evaluation and advice. This

ability is gained through deep, sustained study and plenty of question practice. Candidates should follow the advice on effective study skills provided by tutors.

In terms of professional marks, some candidates did not provide a reasonable structure in their answer, nor put the answer to part (c) 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. Nevertheless, many candidates' answers were good, and they earned the majority of the professional marks.

Part (d) asked candidates to distinguish between an IPO and a reverse takeover, and to discuss whether either method was appropriate for a company to obtain a listing. This part was done well by the majority of candidates, with many scoring highly.

Question Two

This was a 25-mark question which, in part (a), asked candidates to evaluate whether futures contracts or options contracts would result in higher receipts and the scenarios when the options would and would not be exercised. Candidate performance for part (a) was variable in that the use of options was demonstrated well and the use of futures less well, nonetheless many candidates achieved a pass mark. Common errors included errors in calculating remaining basis, dividing by the exchange rates instead of multiplying and calculating the income received using forwards when the question scenario did not require this. Most of the candidates did not present the scenarios at which the options would be exercised and not exercised.

Part (b) asked candidates to compare over-the-counter options with forwards, and why the company may want to use exchange-traded derivatives. Most candidates provided a sufficient level of discussion to pass this part, but common errors included confusion between exchange traded and over-the-counter options and simply listing the benefits and drawbacks generally and not considering the relative benefits and drawbacks between the two products.

Part (c) asked candidates to explain the mark-to-market process using the initial and maintenance margins, and to illustrate the process, via calculations, using the information provided. This part was not done well by many candidates. The explanation tended to be general and very few candidates provided meaningful calculations for illustrative purposes.

Question Three

This was a 25-mark question which asked candidates to undertake an adjusted present value (APV) computation and conclude on whether to undertake the project in part (a) and then discuss the long-term finance policy and factors causing a change to this in part (b).

In part (a) the calculations required for the base case net present value (NPV) were largely done well, with many candidates calculating the working capital needs, the discount rate and the net present value of cash flows correctly. Errors included taxing the post-tax cash flows, not calculating the additional working capital requirements but calculating and using the full working capital needs, and trying to adjust the all-equity discount rate further. Candidates making these errors need to understand the rationale behind relevant cash flows and discount rates used in NPV calculations, in detail. In the many cases, candidates achieved full marks for the base case NPV calculations.

The calculations related to the financing side effects proved more challenging. The majority of candidates were not able to deal with a loan payable in equal instalments. A minority of responses either did not discount the financing side effect cash flows at all or used the normal cost of capital used for the base case. Again, this demonstrated a mis-understanding of the purpose and relevance of the adjusted present value method of assessing capital investment projects.

In part (b), most candidates were able to achieve a pass mark for the factors which determine the long-term financing policy and factors which cause the policy to change. Common errors included a focus just on debt financing, discussing long-term finance policy instead of factors which determine it, and putting much less discursive emphasis on factors which cause the policy to change.

Conclusion

To sum up, candidates need to spend enough time studying to acquire sufficient knowledge of all areas of the syllabus. Trying to spot topics which will be tested is risky as all the exam questions are now compulsory and may cover several topic areas in a question. Topic areas which are not considered core, but which are in the study guide and the syllabus could well be tested. Future candidates are advised to attempt plenty of exam standard questions to practice and develop their knowledge and skills. Candidates must be able to identify what is important in scenarios, respond fully to question requirements, appreciate what matters to businesses and financial stakeholders, and produce answers that are well-structured and presented appropriately in both numerical and discursive elements.