Examiner’s report

Advanced Financial Management (AFM)
March 2019

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.

Introduction

All three questions are compulsory for this Advanced Financial Management (AFM) exam. Since compulsory questions were introduced last September, it is pleasing to note most candidates attempted all the questions.

The exam was in two sections. Section A consisted of a compulsory question for 50 marks. Section B consisted of two questions of 25 marks each. All of the questions in the exam consisted of a mixture of computational and discursive elements to varying degrees.

General Comments

This is an optional Strategic Professional exam, which builds upon the knowledge and skills examined in the Financial Management exam. At this advanced stage, candidates will be required to digest data quickly, and apply relevant knowledge and skills, using a relevant methodical approach. Candidates are expected to use the professional judgement expected of a senior manager in recommending financial management decisions that will have a significant impact upon the whole organisation. Section A particularly will include a complex business scenario, where candidates are expected to understand, deal with and communicate strategic issues that a senior financial manager may encounter.

This exam also includes a significant number of technical computations to test candidates’ ability to perform them. Generally, candidates need to assess the findings of technical computations in the context of the question scenario.

Senior managers work under tight deadlines. To reflect this, prioritising and managing time is crucial to performing well in examination conditions.

Professional skills are relevant across all Strategic Professional exams. This exam specifically rewards professional skills in Question One, but candidates should realise that they underpin good performance throughout the exam. Core skills include appreciating why information in scenarios will impact upon the decisions being taken, understanding the viewpoints of those interested in the decisions, and communicating recommendations concisely and clearly.

The main reasons for candidates performing less well were as follows:

(i) Lack of detailed knowledge of parts of the syllabus areas and consequently 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. There are often instances of question parts being missed out and others appearing to be answered in a rush. An essential part of preparation is question practice, both of individual questions and full practice exams, under the time limits that apply in this exam;

(iii) When answering written parts, some candidates did little more than restating the information provided in the question. For example, if the question narrative states that "*a company is all equity financed*". Candidates who wrote that "*the company is solely financed by equity. This means it has no debt currently in the company*" will receive no mark for restating that statement. Marks are awarded for responding to the information. Failing to add anything meant that sometimes candidates wrote a lot down but did not score well;

(iv) Candidates sometimes limit their marks by 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 question requirements. Again these are skills that question practice will help develop;

(v) Computational answers that are poorly structured. A sequential approach with clear and easy to follow workings is particularly important for computational elements. Candidates whose approach are disorganised often missed out stages that would have gained marks;

(vi) Not taking account of the marks available allocated to written question parts, resulting in providing detailed answers for relatively minor parts, but very brief answers for those parts where more marks are available;

(vii) Focussing more on either the discursive or computational parts of the exam paper. Candidates need to be aware that a balanced approach is required to achieve a pass.

Specific Comments

Section A

Question One

This was the 50-mark compulsory question, in which the case study scenario focused on the impact of financing on investment decisions, discussing about the superiority of adjusted present value (APV) method over the net present value (NPV) method and the feasibility of raising finance through securitisation.

Part (a) required a discussion of the factors to consider when raising debt finance instead of equity finance. The majority of candidates answered this part well with quite a few scoring full marks. Some candidates wasted time when they wrote too much for the marks available. Quite a few candidates however received limited marks when they described the theoretical capital structure models such as "Modigliani and Millers with and without taxes", not recognising the fact that the company in the scenario 1) pays tax and 2) it is currently all equity financed and the amount it expects to borrow is not high. Some candidates explained that raising debt finance for an investment would reduce shareholders dividends, without realising that the objective of the investment is to increase the company's annual cashflows, thereby potentially increasing future dividends.

Part (b) asked for a report that estimates a new project's specific cost of capital when the company diversifies into a different business activity, and to discuss why the APV method might be a better technique compared to the NPV method in appraising investment decisions.

This question has financial data for three companies. Careful scrutiny and planning would have avoided producing answers where the financial data from one company is incorrectly mixed up with data from another. On the whole, candidates who did not do well demonstrated a lack of understanding of the rationale for estimating the cost of capital which is that the expected return for debt and equity should reflect their risks; the need to consider the effect of risks on asset and equity betas; and thereafter applying the CAPM formula to estimate the project's cost of capital.

Part (b) (i) required candidates to calculate an estimated asset beta attributable when undertaking a new project in a different business activity.

A significant number of candidates scored high marks on this question part with quite a few achieving maximum marks.

The common mistakes made by candidates who scored limited marks were miscalculating the number of shares issued, using book instead of market values to weight the asset betas, and applying their own weighted average method instead of the equal weighting method as required in the question to determine the new project's asset beta.

Part (b) (ii) asked candidates to calculate the risk-adjusted cost of equity, the cost of debt and the new project's cost of capital. A significant number of candidates scored either high or very limited marks. Well-prepared candidates scored high marks when they demonstrated their knowledge and sequentially structured their answers to determine the various costs and their weightings that make up the new project's cost of capital. Less well-prepared candidates struggled to estimate the bond spot yield that is added to the credit spread which then provides the discount rate for estimating the value of the proposed bond. Common mistakes were not recognising that the proposed bond is in $100 denominations, incorrectly re-gearing the project's asset beta, and omitting to estimate the bond's yield to maturity.

Part (b) (iii) asked candidates to explain and justify the process followed in determining the estimates for the new project's cost of capital. This question part was not well answered. There is a clear distinction between 'state' and 'explain and justify'. Many candidates merely stated their calculations into words, instead of going further to explain that their calculations were based on the nature of risk, how risk impacts upon the returns required by various investors and hence justifying the financial models that were used. Some candidates spent time discussing about assumptions for which there was little credit as these were not asked in the question.

Part (b) (iv) asked for a discussion on why the APV method may provide a better estimate compared to the NPV method, when evaluating the new project. This question part was generally not well answered. Many candidates struggled to discuss the rationale behind using the different discount rates and cash flow streams for NPV and APV methods. They instead explained how the APV process can be carried out which earned limited marks. Quite a few candidates erroneously claimed that the NPV method did not take into account the benefits of debt financing. Others explained the merits of using the APV without comparing it against the NPV method.

Professional marks in part (b) were awarded for use of a report format, and the structure and presentation of the report. The number of candidates who scored full marks was not as high as expected. Some candidates failed to use a report format. Others produced their appendices inside the report itself, instead of attaching them to it. Few candidates produced a conclusion to their report. With a bit more planning, many candidates could earn all of the professional marks available.

Part (c) asked candidates to discuss whether securitising lease income generated from projects could provide an appropriate financing source for future projects. Answers here were generally disappointing. Few candidates understood and explained the concept of securitisation in terms of the scenario in the question. Candidates commonly mistook securitisation for security or collateral being offered when raising debt finance. There seemed to be a gap in their knowledge even though an article on it had been published in ACCA's online study resources. Candidates who demonstrated some understanding of securitisation, often failed to respond to the question verb 'Discuss' which generally requires some coverage of both merits and costs of securitising the lease income.

Section B

Question Two

This was a 25-mark question which asked candidates to evaluate the use of selected financial derivatives to hedge against interest rate risk. A question on managing financial risk is often asked in exams. Well-prepared candidates are able to work quickly and score high marks. Less well-prepared candidates earn limited marks if any, when they spend considerable time without making a meaningful attempt at answering the question.

Part (a) required candidates to recommend based on the specific hedging choices, the most appropriate strategy to hedge an expected future receipt against interest rate risk.

On the whole, this question part was reasonably done well and a significant number of candidates scored very high marks.

Of the three hedging choices, using forward contracts was done well by most candidates. In common with previous exam questions on futures hedge, candidates often fail to clearly state whether the hedge is initiated by taking a long or short position, and expecting the marker to determine this based on how the hedge was closed out. Some candidates omitted to carry out the collars hedge, instead choosing the options hedge which was not required in the question. Some candidates missed out on easy marks by not analysing their hedge results hence losing OFR marks available here.

Part (b) required candidates to discuss the view that interest rate risk should not be hedged or should be hedged using smoothing. Marks were disappointingly low for this part. Many candidates explained why companies should hedge but did not discuss the director's view why her company should not hedge interest rate risk. Very few candidates understood how hedging using smoothing might be carried out. The smoothing technique is covered in the Financial Management exam, and candidates are assumed to be able to apply this knowledge in Advanced Financial Management.

Part (c) asked for a definition of delta and gamma, and their importance in the context of delta hedging. Candidates generally were able to define delta and gamma but many were not able to explain how they relate to delta hedging.

Question Three

This was a 25-mark question about evaluating possible takeover target companies, calculating the value created from a takeover and the feasibility of selected defence strategies.

Part (a) required candidates to analyse the suitability of two possible takeover targets. This question part was quite well answered, and candidates covered a wide range of possible reasons. Some candidates questioned the takeover targets from a negative perspective seeing the weakness of target companies as a problem instead of an opportunity for the acquiring company to improve and strengthen its market share.

Also, very few candidates seemed to appreciate that when one company acquires another, the acquiring company will be in a strong position to dictate such matters as the dividend policy.

Part (b) required candidates to calculate the minimum price which the shareholders of the targeted company are expected to accept, and the gains accruing to the acquiring company, based on the free cash flow to equity valuation. Answers were generally disappointing. Some candidates did not provide any calculations for this part. Others struggled to derive the growth rate and the estimated equity value of the targeted company. The appropriate formulae were provided in the exam which some candidates appear not to be aware of.

Many candidates demonstrated a lack of understanding of how the value of the combined company could be calculated and the estimated accrued gains shared. Understanding why and how organisations are valued is crucial because it is the foundation upon which financial management decisions are made.

Part (c) required candidates to discuss how feasible and effective the suggested defence strategies are to fight a takeover bid. This question part was generally well answered. However, a significant number of candidates described the two defence strategies instead of discussing their feasibility and effectiveness from the targeted company's perspective. Additionally, others made no attempt to address the requirement in the question and instead spent time describing other potential defence strategies and thus gained no marks for their effort. A common misconception when defence strategies were discussed, was to give the target company's board far more power after being acquired than it would actually have. Post-acquisition, the acquiring company dictates business and financial strategies.

Part (d) required candidates to describe the due diligence review of particular operational areas that the company in question will undertake before acquiring a target company. This question part was either missed out or not well attempted. Often candidates who attempted, discussed generally about due diligence issues. Few candidates focussed on where the key areas of the due diligence review should be.

Conclusion

To sum up, candidates need to spend enough time studying to acquire sufficient knowledge of all areas of the syllabus and answer plenty of exam-standard questions to develop their application skills. Candidates must be able to identify what is important in scenarios, respond fully to requirements, appreciate what is important to businesses and financial stakeholders, and produce answers that are well-presented and well-structured in both written and computational elements.