



Examiner's report

Advanced Financial Management (AFM)

June 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.

Overarching Comments

In this Advanced Financial Management (AFM) paper, as part of the Strategic Professional exams, all three questions are compulsory. It was pleasing to see that only a few candidates did not attempt all the questions. This 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 in line with 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 single 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 of the scenario set out in the question.

This is an advanced level optional exam which builds on the knowledge and skills examined in the Financial Management exam. 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 paper, tested a candidate's ability to provide sound advice, supported by relevant computations where applicable, in a coherent report, on an investment decision using conventional investment appraisal techniques, as well as applying real options methodologies to the scenario. It also included a discursive exploration of wider objectives such ethical and sustainability issues.

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 establish 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 (b) 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. Such answers will not earn many marks;
- 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) Presenting answers in brief bullet points, without adequate discussion or evaluation;
- ix) 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 assessing a new project that a company wants to undertake, using conventional net present value method and real options. Further, the discussion progresses into looking at the possibility of production shifting to another country, the issues arising from that and their resolution.

In part (a) candidates were asked to discuss how incorporating real options into computations can help in making investment decisions. Surprisingly this part was not done very well. Only a minority of candidates considered the full range of discursive points. Many answers simply stated the different kinds of real options, such as the option to expand, delay a decision or discontinue, and then went on to mention that real options were helpful in situations where there was flexibility in making the decisions. Very few responses then progressed to discuss how this could be incorporated into investment decisions, and whether or not real options were helpful. Some responses just mentioned the variables input into the BSOP model. This area is examined often and therefore the lack of demonstration of understanding of the underpinning rationale of real options was surprising.

In part (b) i) candidates were asked to undertake a conventional net present value computation of a project. This part was done well, with the majority of candidates achieving high marks. In most answers, inflation was applied correctly to the revenues and costs. Errors mainly occurred in doing tax calculations because the question scenario was sometimes not read properly and some candidates undertook tax allowable depreciation calculations using reducing balance instead of straight-line, and sometimes a negative tax was not applied to year one, although it was stated in the question that this should be done. Errors also occurred where some candidates did not apply the working capital from year 0.

Part (b) ii) asked candidates to apply real option valuations to the question. Very few candidates were able to demonstrate how the asset value of the follow-on project was estimated. However, the majority of candidates were able to determine all the initial variables of the option to abandon a project, except for the asset value in some cases. Many candidates recognised that because it was an abandon option, they needed to determine the put value. A minority of candidates tried to calculate the $N(d_1)$ and $N(d_2)$, although these were provided.

Responses to part (b) iii) were variable. Many candidates provided a good discussion of the assumptions made and achieved high marks. Fewer candidates were able to discuss the

comprehensive list of assumptions across both the conventional NPV and real options, and so achieved fewer marks. Some candidates did little in the way of an assessment and/or just listed the assumptions but didn't discuss them.

Part (b) required the answer in a report format to which the professional marks were attached. While many candidates did present their answers in a report format, and thereby gained the majority or all the professional marks; a substantive minority of students did not address this requirement fully or at all.

Part (c) asked candidates to discuss the impact on the company arising from ethical and sustainability issues, and then discuss how they may be resolved. This part was not done well by many candidates. Few responses went much beyond the ethical issue highlighted in the question, where young teenage children were being employed. Few responses considered the full range of strategic commercial interests which a company would consider. Instead some suggestions like paying for the education without employing the teenagers or setting up (building) a school did not make sense and were not feasible in the context of the scenario. Many responses contained lots of repetition for which few marks could be awarded.

Question Two

This was a 25-mark compulsory question on the management of interest rate risk with calculations required for options on futures and swaps. The question also asked candidates to discuss the advantages and disadvantages of using swaps to undertake risk management, and the quality of staff needed in a treasury department vis-à-vis its contribution to the strategic success of the business.

Part (a) asked candidates to calculate the impact of an option on futures and a swap, which were used to manage the interest rate risk of a future borrowing. The results of a FRA and of the exchange traded futures were already provided. All four results were to be commented upon in the answer. Many candidates did well in this question part and achieved good marks. However, a significant minority of candidates did not do this part well, mainly because of a lack of knowledge. This is surprising since it is clearly specified that this syllabus area will be tested. Therefore, candidates who studied this area well, achieved high marks.

The type of option needed, the number of contracts, the basis remaining and the decision to exercise or not were all determined correctly by many candidates, as was the premium calculation and the net result of the option. Common errors included making mistakes in determining the number of contracts, the remaining basis and the premium calculation. Candidates who worked in percentages instead of \$ amounts generally tended to make more errors. Calculating the impact of the swap created a few issues, but many candidates did this correctly as well. Common errors included not knowing whether the company should borrow at a fixed rate or at a floating rate initially and getting the interest rate advantage wrong. A significant minority of candidates also spent time calculating the impact of the futures and FRA, even though these were given. This resulted in poor time management and was due to not reading the question properly. Most candidates made relevant comments, but quite often these were brief and did not gain full marks.

Part (b) asked for the advantages and disadvantages of using swaps as a tool for managing risk. This part was done well by the majority of candidates who attempted it. Candidates who

contextualised the discussion achieved the highest marks. For example, even though counterparty risk exists, this is mitigated somewhat as the swap is arranged through a bank, and therefore the bank acts as the counterparty to both the company and the third party.

Part (c) asked candidates to criticise the views of the company's chief executive on the quality of staff needed in a treasury department in terms of its contribution to the strategic success of the business. Responses to this part were varied. Many candidates defended the need for qualified and experienced staff in a treasury department, as well as less qualified and less experienced staff, well. However, fewer candidates contextualised this in relation to the contribution a treasury department makes to the strategic success of the business. This may be because the question was not read fully and properly by the candidates who did not discuss the context.

Question Three

This was a 25-mark compulsory question on demergers and factors which determine communication policies.

In part (a), candidates were asked to discuss the advantages and disadvantages of demerging a business unit part of a company into a new, independent company. This part of the question was done well by most candidates, with high marks being achieved by many candidates. Responses which related directly to the scenario achieved the highest marks.

Part (b) asked candidates to initially calculate the change in the cost of capital of the original company due to the demerger, and then compute the value of the new company using the free cash flows method. In order to do this, candidates needed to calculate the cost of capital of the demerged company as well. Many candidates found this part difficult and few candidates were able to achieve high marks. The main reason for this was that, because the answer does not lend itself to a proforma structure, many candidates did not know which cost of capital information was relevant to which bit of the computation and therefore the responses were often presented in a confused manner, with calculations made but not using the correct or relevant information.

Part (b) also asked candidates to produce a company valuation. Many candidates did the initial three years correctly. However, often tax was not applied correctly and this could be because candidates had learnt techniques to answers to past exam questions which did not involve tax, and then could not apply the same method for this question. The perpetuity calculations after the first three years were often not done correctly. Although many candidates attempted the perpetuity calculations, few were able to deal with future tax and additional investment correctly.

Finally, part (b) asked candidates to discuss their results, but this was also limited because many candidates were not sure of what they had done and why. Only a small minority of candidates compared the original value of the company with the combined value of the two companies post-demerger, and critiqued the method used.

Part (c) asked candidates to discuss factors which would determine the communication policies in relation to shareholders and stakeholders. This part was done well by only a small number of candidates, mainly because the requirement was not read correctly by many candidates. Often the communication policies were discussed instead of the factors which determine these policies.

Conclusion

To sum up, candidates need to spend enough time studying to acquire sufficient knowledge and understanding of all areas of the syllabus, and then be able to apply their knowledge and understanding to the exam question scenario.

Trying to spot topics which will be tested is risky and not at all advisable, as all the exam questions are now compulsory and several topic areas may be covered in a single question. All topic areas in the study guide and the syllabus can be considered as core and could be tested.

The consistent message is that candidates are strongly advised to attempt plenty of exam standard questions to practice and develop their knowledge and skills. This, in particular means that exam standard questions should be attempted to time and in exam conditions. Candidates' answers should then be compared with the answers provided to identify knowledge, understanding and application gaps. Candidates should then work on addressing the gaps identified. This should be done over a period of time, consistently and thoroughly.

Candidates must be able to identify what is important in scenarios, read and respond fully to question requirements and question narrative, appreciate what matters to businesses and financial stakeholders, and produce answers that are well-structured and presented appropriately in both numerical and discursive elements.