Examiner's report

Advanced Financial Management (AFM) September 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.

General Comments

All three questions are compulsory in this Advanced Financial Management (AFM) exam, which is part of the options choices available from the Strategic Professional exams.

The examination is in two sections. Section A consists of a compulsory question for 50 marks. Section B consists of two questions of 25 marks each. All three questions contain of a mixture of computational and discursive elements.
The marking scheme includes four professional marks for the structure and presentation in a report format written as part of the Question One requirements.

On the whole, the examination results were similar to previous September sittings. A number of candidates received high marks on many of the question parts but other candidates did not perform well in both numerical and discursive parts, as will be covered later.

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. Applying knowledge with reference to the scenario described in the question is key to passing AFM. It follows that any discussion or evaluation must relate to the context of the scenario set out in the question.

AFM is an optional exam which builds on the skills and knowledge examined in the Financial Management exam. Candidates are required to demonstrate their ability to read quickly and analyse comprehensive and detailed questions and apply relevant knowledge and skills, using a methodical approach. Candidates are expected to use the professional judgement expected of a senior financial adviser, in recommending financial management decisions that are likely to affect the entire organisation. For example, Section A normally sets out a complex business scenario in the form of a case study where candidates are expected to demonstrate their ability to understand, deal with and communicate strategic issues that a senior financial adviser or manager may encounter in his or her career.

The Section A question in this exam tested a candidate's ability to provide sound advice, supported by relevant computations where applicable, in a coherent report, on the choice between two potential investment decisions using the adjusted present value technique and duration based on the scenario set out in the question. Additionally, it included a discussion of how risk is identified and managed.

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 aims. Senior management work under tight deadlines, and hence prioritising and effective time management is essential to performing well under examination conditions.

Business reports and proposals are expected to be professionally written, succinct, and easy to read with clear headings and conclusions. A candidate, who demonstrates this approach, will earn the full professional marks that are available in Question One.

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. Requisite core skills include being able to grasp why information in given scenarios , will impact upon the decisions being taken, understanding the viewpoints of those interested in the subsequent decisions, and communicating recommendations succinctly.

The main reasons for candidates performing less well were:

(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, which was less evident in this exam. Some candidates spent too much time discussing the same issue differently, without considering a range of other relevant issues or take too long to carry out relatively straight forward calculation tasks;

(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 question requirements. These are the kind of skills that question practice will help develop;

(iv) Computational answers that are poorly structured. A sequential and logical 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;

(v) 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;

(vi) Not reading the requirements of the question properly and therefore answering the question incorrectly. It is also important that answers should be relevant to the question asked. General answers which do not directly relate to the scenario are unlikely to be awarded many marks;

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

Specific Comments

Question One

This was a 50-mark compulsory question, in which the case study scenario focussed on evaluating and justifying the choice between two potential investment projects that a company wants to undertake, using the adjusted present value method and duration.

In part (a), candidates were required to discuss why a company may prefer to use the adjusted present value (APV) method, rather than the net present value (NPV) method. This question part was not done as well as expected. A number of candidates described how the APV method is carried out, not why it is preferred to the NPV method. There is also the misconception by some candidates that the cost of debt is not accounted for under the NPV method. Candidates did well when they discussed that the APV method separates out investment from financing cash flows and applies a specific discount rate to the appropriate cash flow to determine the value added or destroyed, whereas the NPV method uses a single rate (the weighted average cost of capital) to discount all the cash flows arising from the potential investment project.

In part (b) (i), candidates were required to estimate the minimum amount of debt borrowing after allowing for the proceeds from a sale of a factory located abroad. This part was done well, with the majority of candidates scoring high marks. However, errors include borrowing the full amount instead of an amount sufficient to allow for the expected sale receipt, and using the wrong exchange rate in converting. Candidates should understand that financial institutions invariably offer a customer an exchange rate which ensures the customer is worse off when converting a foreign currency receivable or payable.

Part (b) (ii) required candidates to estimate two potential investment projects' APV and their duration. Many candidates did well on calculating the projects' APV and scored high marks. In determining the base case NPV, a surprising number of candidates did not compound the inflation rates of the sales revenues and production costs correctly. Many candidates did not read carefully the question which allowed tax relief on operating losses to be claimed in the same year against other profits. Instead their answers mistakenly carried forward the operating loss to be claimed in future years.

It was surprising to see many candidates unable to calculate the balancing allowance. The balancing allowance should take into account any disposal value at the end of the investment period. Equally surprising was how often candidates' timings and amount of incremental working capital cash flows were incorrect. Unless stated otherwise, all cash flows are assumed to occur at the end of the respective time periods. Therefore, the working capital required at the start of the first year, should be shown under Year 0 column (i.e the end of Year 0 is effectively the start of Year 1), not under Year 1 column (which is the end of Year 1). The amount of incremental working capital for each year is the increase or decrease in working capital, not the difference between the increase or decrease in working capital.

Other common errors include using the same spot exchange rate every year to convert the foreign component cost into the home currency; not compounding inflation rates for each successive year (for example, a 10% yearly inflation rate would be 10% in year 1 and 21% in year 2); or incorrectly applying the interest rate differentials when forecasting exchange rates. Some candidates showed figures on their cash flow statements without supporting workings, making it difficult to award marks if markers cannot determine where the figures came from.

In determining the project's APV, many candidates correctly calculated the financing side effects or were given OFR marks based on the method applied. Some candidates mistakenly discounted the financing cash flows using the all equity cost of capital, instead of using the company's normal borrowing rate.

Determining the project's duration was done well by most candidates. However, a number of candidates erroneously used the project's cost instead of its total present value as the denominator in calculating the project's duration.

In part (b) (iii), candidates were required to evaluate and justify the choice between the two potential investment projects with a discussion of the assumptions made.
This part of the question was done well by candidates who articulated their arguments with reference to their calculations. However, very few marks were earned when evaluations did not go beyond merely restatements of the calculation results. Some candidates however, did not choose one of the two potential projects, which was required in their discussion. The duration concept was mistakenly discussed as the payback technique by some candidates. A significant number of candidates did not provide an evaluation as well as a discussion of the set of assumptions made, resulting in scoring low marks. Candidates who write a list of assumptions without discussing whether they are reasonable or valid, earn very few marks as they did not address this question requirement.

Professional marks in part (b) were awarded for the format, structure and presentation of the report. While many candidates presented their answers in a report format as required thereby gaining the majority or all the professional marks, a significant minority of candidates did not address this requirement fully or not at all. These relatively easy marks to obtain could make the difference between a pass or a fail for some candidates.

Part (c) required candidates to discuss why a company may be exposed to economic risk and how it may be managed. This part of the question was poorly attempted by most candidates. Often, candidates did not seem to understand what economic risk (economic exposure) is and were unable to provide a clear definition. Many candidates misunderstood economic risk to be caused only by interest rate changes when it is the impact on a company's cash flows caused by a set of long-term macroeconomic factors that can produce a permanent shift in parity conditions (including interest rates). Most candidates did not recognise this long-term dimension and the problems of managing it appropriately. Instead they incorrectly focussed on managing it using short-term hedging techniques.

In part (d), candidates were required to discuss how the risks categorised may be managed.
This part of the question was generally not done well. Candidates often did not discuss beyond the TARA definitions and few candidates suggested practical measures other than insurance. Some candidates mixed up the TARA model, others made vague suggestions on how to manage each risk. A significant number of candidates suggested risks that were not severe and not frequent should be ignored, but this is not the same as accepting these risks. Some candidates misinterpreted the question requirement and mistakenly described different types of risks such as transaction, foreign exchange or interest rate risks.

Question Two

This was a 25-mark compulsory question on assessing a company's dividend policy and the governance and ethical issues associated with dividend and remuneration policies.

Part (a) required candidates to forecast a company's dividend capacity. Many candidates did well in this question part. However, a significant minority did not do this part well, mainly because they did not deduct the tax from interest payable; added depreciation when it was already accounted for; or calculated the additional investment required incorrectly.

Part (b) required candidates to discuss with supporting calculations, the viability and financial impact of a company seeking to maintain its current dividend policy. Many candidates found this question part difficult and few candidates achieved high marks. A significant number of candidates limited their marks by not doing any calculations. Others produced one or two calculations which will not earn all of the 6 marks available for calculations as stated in the question part. In addition, some candidates did not show the formulae used to produce the ratios calculated, making it difficult for markers to award marks. It was disappointing that many candidates at this advanced level were not able to calculate ratios and trends that are associated with a company's dividend policy. Few candidates recognised that a rival company's financial figures shown in the question were meant to be used as a benchmark.

Generally, candidates who did well, identified the rise in gearing to help finance the increase in dividends paid, and the conflict between paying dividends and retaining funds for investment opportunities. Few candidates discussed that the significant increase in recent investments could be attributed to the company making up for the lack of investments in the past. Also, few candidates identified the slowdown in the company's share price growth which when taken together with the comments in the analyst's report, suggest the market is aware as to what the company's directors were doing.

In part (c) of this question, candidates were required to discuss the governance and ethical issues associated with a company's dividend and remuneration policies. The discussion about the governance issues relating to remuneration policies was generally done well with many candidates discussing about the long-term view and that having no share option scheme could turn out to be a governance issue. However, few candidates discussed about balancing the interests of different stakeholders in the company.

Discussion about ethical issues was generally unsatisfactory. Many candidates did not refer to the scenario that suggested low pay to workers in the company could be an ethical issue in the light of the government's enquiry into low pay. Few candidates discussed the questionable ethics behind the statement made by the directors that they were confident the dividend increase could be maintained despite knowing about an increase in gearing and uncertainty surrounding future income prospects.

Question Three

This was a 25-mark compulsory question on synergies, mergers and acquisitions and the likely reaction of shareholders to cash and share-for-share offers.

Part (a) required candidates to discuss possible sources of financial synergy, why synergies may be overestimated and steps that a company may take to prevent it happening. For the first part, candidates often discussed non-financial synergies such as revenue and cost synergies which were not asked for. These candidates did not read the question carefully and thus wasted their time as no marks were given for such a discussion. Whilst the majority of candidates agreed that synergies were often overestimated, they did not discuss the reasons why synergies may be overestimated. Candidates must read the question requirements carefully to ensure they are addressing the question which has been set. The element of the requirement on preventative measures that a company may take to avoid overestimating synergies was generally well answered.

Part (b) required candidates to determine a suitable share-for-share exchange offer and to calculate the impact of cash and the share-for-share exchange offer on the acquirer and target shareholders' wealth. The answers to this part of the question were generally poor, with many candidates not following the process of applying the Price Earnings (PE) ratio valuation model to determine the pre-acquisition valuations, followed by post-acquisition valuations that included synergies and finally a suitable share-for-share exchange offer. Doing so would enable candidates to determine the impact of the cash offer and share-for-share offer on shareholder wealth.

Common errors include not using the correct earnings figure, and not using earnings after tax to calculate the PE ratio; an incorrect number of shares issued by a company; not adding synergies to combined earnings or adding synergies without deducting tax first. Determining a company's PE ratio is knowledge expected to be brought forward from the Financial Management exam and it is disappointing that a large number of candidates were unable to calculate this ratio correctly.

A significant problem encountered was that many candidates' workings lacked a clear structure which meant their calculations were hard to follow, especially when their figures were presented without explanations. Candidates should aim to be neater and clearer in their calculations so that a marker can follow their workings when their answer is incorrect and award OFR marks where appropriate.

Part (c) required candidates to discuss the likely reaction of the acquirer and target shareholders to the cash and share-for-share offers. This question part was on the whole, satisfactorily answered by candidates who despite poor attempts at part (b) were able to discuss general but valid points that would have an impact on the shareholders reaction. Such valid points were given due credit even though they were not covered in the suggested solution.

In answering this question part, some candidates did not clearly identify which group of shareholders they were considering in their discussion, making it difficult for markers to award marks.

Many candidates did not consider the founders shareholders viewpoint, or differentiate the viewpoint of the venture capitalist from other shareholders. The problems with the calculations in part (b) meant that candidates were not prompted to specifically discuss the differing premiums on the alternative offers. Few candidates questioned whether the synergies would be realised, which is surprising as they should have been prompted by the requirement in part (a).

Conclusion

Candidates need to spend enough time studying to equip themselves with sufficient knowledge and understanding of all areas of the syllabus, and then be able to apply them to the scenario in the question. Candidates should bear in mind that the knowledge learnt from the Financial Management syllabus is expected to be demonstrated and developed in this Advanced Level paper.

Attempting to spot topic areas examined is fraught with risks as all exam questions are now compulsory and several topic areas may be included in a single question. All topic areas within the syllabus and study guide are examinable and could be tested.

Candidates must read the questions and their requirements carefully and respond appropriately, otherwise time and effort may be wasted. Candidates must also explain or show their workings clearly to support the figures produced. Markers may not be able to award marks when it is hard to determine where the figures came from.

The clear message therefore, is that candidates are strongly advised to practice answering plenty of exam standard questions to the time allowed and under exam conditions in order to develop their knowledge and skills. Candidates should compare their answers with the published solutions provided to identify any deficiencies in their knowledge, understanding and application. Candidates should then work on addressing the deficiencies identified. This work should be done consistently and thoroughly over a period of time.

To sum up, candidates must be able to identify what is important within the scenarios set out, respond fully to question requirements, raise pertinent questions and issues, appreciate what matters in practice to businesses and financial stakeholders, and produce answers that are logical and well presented in both computational and discursive elements.