



# Examiner's report

Advanced Financial Management (AFM)

September 2018

## General Comments

This is the first examination under the Strategic Professional Level, where all the questions on this Advanced Financial Management (AFM) paper are compulsory. There were relatively fewer candidates who did not attempt all three questions compared with previous exam sittings. 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 mixed. Some candidates scored high marks particularly in a number of the numerical parts. Others, however, struggled to perform well especially in some of the discursive elements.

## General Comments

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.

All AFM exams test a range of syllabus areas and often more than one topic area of the syllabus in a question, especially in the Section A question. For example, in this exam paper, Question One was an integrated case study covering related topic areas in overseas investment, foreign exchange risk hedging, international investment appraisal, and the treasury function. Secondly, a candidate needs to be able to apply knowledge and skills learnt to the requirements of each question. 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 advanced level exam which builds upon the knowledge and skills examined in Financial Management. At this advanced stage, candidates will be required to demonstrate their ability to read and digest quickly, comprehensive and detailed questions, apply relevant knowledge and skills and exercise the professional judgement expected of a senior financial person, in recommending or making financial management decisions that are likely to affect the entire business organisation.

Senior managers work under tight deadlines, and hence prioritising and managing your time is crucial to performing well under examination conditions.

This examination includes a significant amount of technical content 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 as for example 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 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.

Answers that score high marks show a reasoned structure, appropriate narrative discussions that are succinct, clear and relevant to the question asked and easy to follow numerical workings supported where

appropriate by brief notes. Achieving this in the AFM exam will ensure a candidate is on track to passing it.

The main reasons for candidates performing less well were:

- i) Poor time management. Far too many instances of question parts very briefly answered or 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;
- ii) Lack of detailed knowledge of parts of the syllabus areas. It was evident in this exam where candidates left parts of questions unanswered for example in Question Two (b) and moved on to attempt the remaining questions;
- iii) Written answers that are little more than copying out details given out in the question. Marks are awarded for providing insights about the information produced. Failure to add anything to the scenario detail meant that sometimes candidates wrote a lot but earned very few marks;
- iv) 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;
- v) Numerical answers that were poorly structured. It is difficult to award marks when a candidate's calculation does not indicate the relevant currency, for example in Question One (c) or no workings were shown where the ratios and trends were wrongly calculated as in Question Two (a);
- vi) Gaps in assumed knowledge for this examination. The AFM exam builds on the Applied Skills level exams in particular, Financial Management. Candidates are reminded that topics covered in these exams are assumed knowledge for this exam.

*Article I.*

Article II.

## **Specific Comments**

### **Question One**

This was a compulsory 50-mark question. It required candidates to discuss why organisations may benefit from investing overseas and contrasting between two kinds of option contracts. It also asks to evaluate a potential international investment project that includes a reasoned choice of a preferred foreign exchange risk hedge and the role of the treasury function.

The question's case scenario was complex and required candidates to undertake various calculations and discuss the issues therefrom. Thus, it was essential that candidates manage the volume of information provided effectively and structure their answers coherently and in sufficient depth.

Part (a) required a discussion of the competitive advantages gained when a company invests in overseas

projects compared with companies who only invest at home. Many candidates answered this part well, with a significant number of candidates achieving full marks. The competitive advantages were often well explained and referenced to the scenario. Some candidates however, received limited marks when they discussed about potential issues from investing overseas, instead of the competitive advantages.

Part (b) required a discussion of the comparative advantages and disadvantages between exchange traded and over-the-counter option (OTC) contracts. While some candidates did well for this part, others received no marks when they mixed up exchange traded with over-the counter options or compared options with futures/forwards. A number of candidates made the same point for example, tailor-made hedge for OTC options as an advantage, and not tailor-made hedge for exchange traded options as a disadvantage, therefore not gaining any extra marks for double the effort.

Part (c) asked for a report that evaluates after estimating the expected sale proceeds under each hedging choice available and the additional debt finance needed to fund the project's initial investment, whether it would be beneficial to undertake the overseas investment project,

Part (c) (i) examined technical knowledge and required candidates to estimate the JPY receivable under each hedge choice and the additional debt finance needed to fund the overseas investment project after deciding on the preferred hedge choice.

A number of candidates scored high marks by demonstrating that the proceeds from the sale of the European subsidiary was maximised when futures contracts were used, and together with investing the proceeds for six months, Washi Co will borrow the least amount of finance to fund the project's initial investment.

Of the three hedging methods to choose from, using forward contracts was done well by most candidates. On futures hedging, many candidates omitted to identify whether futures contracts were to be sold or bought at the start of the hedge. Quite a few candidates too incorrectly hedged using call options instead of put options.

A large majority of candidates made no attempt to calculate the proceeds from the six-month investment of the JPY receivable which would reduce the additional debt finance needed, thus receiving no marks for this part.

The main difficulty that many candidates encountered was calculating the ARD/JPY spot cross rates from the given JPY/EUR and ARD/EUR spot exchange rates and then forecasting ARD/JPY exchange rates using purchasing power parity. These spot cross rates and forecast exchange rates are then used to convert the initial investment amount in ARD currency to JPY currency to determine the debt finance required as well as for the investment appraisal in part c) ii). Common mistakes in the answers include not showing workings for the exchange rates produced, therefore no 'own figure rule' (OFR) marks could be awarded if the exchange rates were wrong; not labelling the currencies making it difficult for markers to identify the exchange rate referred to in the calculation; cross rates incorrectly calculated and purchasing power parity wrongly applied in forecasting the ARD/JPY exchange rates.

Part (c) (ii) required an estimate of the net present value (NPV) of the overseas investment project. The cash flow statement in ARD currency was given in the question and candidates were asked to incorporate further information and produce an NPV in JPY which is the organisation's home currency.

Many candidates scored reasonably well in this part of the question. However, quite a few candidates replicated the whole cashflow statement found in the question, wasting time and gaining no marks. Some candidates missed out the tax effects on lost contribution and component revenue sales. Others omitted to compound the inflation rate for the components revenue or misread and used a 5% inflation rather than 1.5%. Answers often left out the additional tax payable on the pre-tax profits due to the higher corporation tax in Japan, or wrongly calculated it on after-tax profits.

Part (c) (iii) asked candidates to evaluate the preferred hedge choice made, the debt finance needed and whether the overseas investment project should be undertaken.

This question part was generally not well answered. Given that this question required candidates to evaluate, most answers were too brief and lacked sufficient depth. Few answers went beyond pointing out the assumptions and whether or not to accept or reject the project. Many candidates also focussed only on the project's outcome and did not discuss about the important implications behind their hedging choice and extra funding required. Candidates at this strategic professional level, are expected to adopt a questioning approach when evaluating the results from competing choices, the consequences therefrom and the reliability as well as relevance of the assumptions used.

Professional marks in part (c) were awarded for use of a report format, and the structure and presentation of the report. Few candidates scored all four relatively easy professional marks. Some candidates failed to use a report format. Others did not clearly separate calculations and discussion. Most candidates missed out providing a conclusion, which is quite disappointing.

Part (d) required candidates to discuss the validity of decentralising the one treasury department for the whole group into individual treasury departments for the major subsidiary companies.

Most candidates demonstrated a good understanding in contrasting the benefits of both centralised and individual treasury departments and scored high marks. Answers which focussed only on the benefits of decentralisation or centralisation of the treasury function scored limited marks.

## **Question Two**

This was a compulsory 25-mark question covering the topic areas of assessing organisational performance using financial analysis and the impact of behavioural factors on share prices.

Part (a) required candidates to evaluate a listed company's performance and business prospects by calculating ratios and trends and evaluating them with reference to the comments made by its chief executive and the concerns raised by an institutional investor in the company.

While many candidates did reasonably well, in particular producing the ratios and trends, a significant number did not score high marks as was expected. The optimal way of answering this question would be to structure the analysis by calculating the relevant ratios and grouping them into their categories first, followed by interpreting and discussing the ratios in light of the comments made in the question.

Every candidate should have aimed for the 10 marks available on the calculations as they are relatively easily earned. As only a mark is typically awarded for a ratio calculation, candidates who calculated well in excess of 10 ratios have done extra work without gaining more calculation marks. Equally, some answers produced only a few ratios or did not examine the full trend. Doing so, meant they obtained fewer marks than

we available here. Some answers simply showed a percentage or figure without any workings at all. This meant that it is often difficult for markers to see how the ratio was arrived at. Therefore, OFR marks cannot be awarded when the same mistake is applied to calculating another related ratio. It is also disappointing to see answers which used the wrong formulae to calculate basic ratios particularly, the return on capital employed, asset turnover, current ratio, gearing and price/earnings. Or mixed up dividend yield with payout ratio. These ratios and their interpretation are considered as assumed knowledge from the applied skills level.

Answers which interpreted and discussed the ratios calculated with reference to the question scenario and provided insight scored high marks. However, all too often, answers earned very few or no marks for the evaluation aspect as they merely described the increases and/or decreases in ratios and trends over the three-year period without further analysis.

In part (b) candidates were asked to discuss how behavioural factors may have affected the company's higher than expected share price.

There were some excellent answers suggesting that these candidates may have read the AFM technical article published on this topic area. However, candidates on the whole, did not do well on this question part. Many candidates failed to focus on behavioural factors, but instead tried to offer rational reasons as to why the share price had increased, highlighting a gap in their knowledge of the syllabus.

### **Question Three**

This was a compulsory 25-mark question. The question asked candidates to evaluate the value created from an acquisition strategy and discuss how a cash bid for an acquisition might be financed.

In part (a) (i), candidates were required to estimate the combined company's equity value and expected additional value arising from the acquisition.

Most candidates performed satisfactorily, with a significant number scoring full marks. Common mistakes in the weaker attempts included getting the number of shares wrong for Selorne Co, mixing up free cash flow to equity with equity value and adding the two together, and miscalculating the additional value created.

Part (a) (ii) asked candidates to estimate the share of the gain from the acquisition to its shareholders.

The majority of candidates answered this question part quite poorly probably because there were no standard valuation models to apply. Answering this question part requires understanding that the share of the gain/additional value created is allocated first to Chawon Co, with the balance of it apportioned to Selorne Co. Some candidates attempted to calculate the % gain on each share which was not required. Very few candidates made comments on their results that were worthy of the marks available.

Part (b) required candidates to evaluate how reliable the estimated synergy benefits were, and the problems which may prevent them from being achieved.

Candidates who described the various types of synergies available and how they could be achieved, received limited or no marks as they did not answer the question asked. Answers which scored high marks made good use of the scenario in the question and provided suggestions to explain why the synergy estimates might not be reliable. Candidates generally, made a better attempt at evaluating problems

preventing the forecast synergies from being achieved.

In part (c), candidates were asked to discuss the factors to be considered when deciding on the sources of finance to select in financing a possible cash bid for the acquisition.

The majority of candidates did this part well as there were several sources of finance mentioned in the question that answers could draw upon to discuss about the factors. However, the layout of most answers was poor. Instead of directly discussing the factors, candidates described the potential sources of finance available to raise for the cash bid and in doing so, fortuitously brought up the relevant factors. Finally, two noteworthy observations. First, candidates received no marks when they compared the choice between a cash payment and a share-for-share exchange for the bid, as it is irrelevant to the question requirement. Secondly, it is disappointing to read in some answers which described that a rights issue would dilute the existing shareholders' control. Dilution of control would only happen if the said shareholders do not subscribe to their rights shares.

### **Conclusion**

To sum up, candidates need to spend enough time studying to acquire sufficient knowledge of all areas of the syllabus. Question spotting is highly risky as all the exam questions are now compulsory and may cover several topic areas in a question. Future candidates are advised to attempt plenty of exam standard questions to practice and develop your knowledge 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 in both numerical and discursive elements.