



# Examiner's report

## P4 Advanced Financial Management June 2015

### General Comments

In the June 2015 paper, similar to previous exams, there was one 50-mark compulsory question in section A, which also contained four professional marks. This was followed by three 25-mark questions in section B, out of which candidates had to choose two. All questions consisted of a mixture of computational and discursive elements.

The overall performance of the candidates was better than December 2014 and in line with previous P4 examinations. The main reasons for candidates performing less well were:

- i) Not reading the requirements of the question and therefore answering the question incorrectly. This was particularly relevant to question 1(a) and question 3(a);
- ii) With reference to question 1(b)(i), converting cash flows to dollars instead of working through them in the local currency;
- iii) Not studying the articles in Student Accountant in sufficient detail. This was particularly relevant to question 4(b);
- iv) Poor time management. Spending too much time on familiar questions and then not having sufficient time to do other questions;
- v) Not structuring question 1(b) into a report format and not gaining all the professional marks;
- vi) Lack of detailed knowledge of parts of the syllabus areas, answering only parts of some questions focussing either on the numerical parts or the discursive parts instead of a balanced approach;
- vii) Not using the reading time effectively to plan a strategic approach to tackling the paper, and to select the optional questions wisely;
- viii) Presenting the discursive answers in brief bullet-point format, often in incomplete sentences, as statements and not as discussion-based narrative. This was particularly relevant to question 1(b)(ii)

In the P4 examination, candidates should focus on the eight factors in order to maximise their chances of gaining a good pass.

1. **Having a sound knowledge and understanding of the entire P4 syllabus, through sustained study and question practice.** Although P4 has a large syllabus, evidence from previous exams, including December 2014, clearly highlights that candidates who are well-prepared, as a result of sustained study over a long period of time, are more likely to be successful. Such a strategy results in a deep understanding of the subject and also of the current issues in financial management. On the other hand, last minute intensive study, attempting to spot questions or topics and relying on hints is a strategy that is unlikely to yield success. Like in previous P4 papers, the June 2015 paper required candidates to have a thorough knowledge of a range of syllabus areas.
2. Excellent answers were obtained from candidates who **applied their knowledge and understanding** to the scenario given in each question. This follows from point 1 above; candidates need to know the syllabus well, in order to apply their knowledge to the question scenario. Unsatisfactory answers tended to give more general answers rather than answers specific to the scenario.
3. Good answers **provided a balanced answer for all the parts of each question**, whether the part



required discussion or calculations or both. Markers consistently commented that candidates, who answered all the questions reasonably, even with small errors, were more likely to pass compared to scripts which left parts of questions or whole questions unanswered, even where the answers to other questions were good. Make sure that you can answer all the requirements of the question before selecting it.

4. **Good time management is vitally important.** The overall opinion of the marking team was that some candidates spent too long on a part of a question, and therefore did not devote enough time to the other questions. On the other hand, candidates who devoted enough time to answering each question and each part of each question were significantly more likely to succeed.
5. **Answer the question set.** This will help with time management. Good answers and good scripts did this effectively. Areas where this was done less well are highlighted in the comments for each question below. It is important that in questions, both the requirements and the narrative of the scenario are read carefully. Irrelevant answers, not related to the requirements (and the scenario), will score few, if any, marks.
6. **Legible, well presented and well-structured answers often get high marks (and these will also help you manage your time better).** Well-presented answers, with clear labelling, structure and workings, achieved high marks. It is very important to plan and structure answers properly.

Adopting these good practices will also enable candidates to get the majority of the professional marks available. It was disappointing that many candidates did not pay enough attention to the presentation and structure of their answers, and as a result, they failed to gain many professional marks.

Many candidates' scripts had marks of between 40% and 49%. If these candidates had structured their answers well and thereby gained all the professional marks, as well as adopting a good time management approach, and giving a balanced answer to all parts, of all questions, then they could have easily gained a pass mark.

7. **Use the Examiner's report, articles in the Student Accountant and other resources wisely.** There was a recent article in Student Accountant which related directly to question 4(b). It was evident that many candidates had not studied this in sufficient depth and could not answer question 4(b) well. It is important that many resources available to supplement your study are not only read but understood in detail.
8. **Do a quick check; does your numerical answer make sense?**

## Specific Comments

### Question One

This was the 50-mark compulsory question. The question's scenario was complex and required candidates to undertake a number of detailed calculations and discuss the issues thereon. Therefore, it

was essential that the candidates managed the volume of information provided effectively, in order to provide coherent and detailed answers.

Question one asked candidates to consider whether or not a company should invest in a project in another country. They were first asked to consider whether or not the company consider its own plant or to licence the assembly. The question then asked candidates to report on the financial feasibility of the project if it set-up its own plant through an international investment decision, to discuss the assumptions made and other issues that should be considered and to reach a reasoned conclusion.

Many candidates found the calculations required in this question difficult and appeared to spend a significant amount of time on them. This created pressure on them to complete the rest of the requirements of the question in less time and also the structure of the report was often unsatisfactory. This meant that candidates failed to gain many of the easier marks available for discussing the assumptions and the majority of the professional marks. Many candidates' scripts which had marks of between 40% and 49% could have passed if these marks had been gained.

Part (a) of the question asked candidates to discuss the possible benefits and drawbacks of a company setting up its own plant in another country or licensing the assembly to a local company in that country. Generally this part of question one was done well with many candidates getting between three and five marks out of five. Where marks were lower, the candidates did not compare between the two options but merely talked about the benefits and drawbacks of setting up a plant in another country. Sometimes candidates made too many points on this part and spent too long on it. Good time management within questions, as well as between questions, is essential.

Part (b) (i) of question one required candidates to undertake a net present value computation of an international investment decision to assess whether or not the investment was worthwhile. The calculations were complex because there were three currencies involved and because of changing inflation rates. Complexity was also increased because a tax holiday was available in the first two years of operation, because of other complications such as royalty fees and parts coming from the parent company, both of which could have the amounts changed, depending on the assumptions that the candidates made. Finally, there was the added complication of the impact on the current situation in terms of redundancies and lost contribution, although this was not significant.

On the whole, this part was done quite well by many candidates. Varying inflation rates were applied correctly and the impact of the working capital required was determined correctly. In many answers, tax was correctly calculated and the tax holiday was taken into account. Some answers assumed that tax, if not paid in Yilandwe, would be paid in the USA. This was a valid assumption for which credit was given. The better answers also considered the royalties, contribution and opportunity costs correctly, as well as any tax implications. But many candidates simply ignored these more difficult aspects. Many satisfactory answers then converted the Yilandwe currency into dollars at the end.

The following errors were made in a number of responses:

1. Unsatisfactory answers tried to convert all cash flows into dollars from the outset, instead of keeping them in Yilandwe currency. This was not a good approach, as it made the subsequent inflationary impact very difficult to calculate and often the answers were incorrect. Therefore, such answers received few marks.

2. Sometimes inflation was not taken into account at all or not cumulated correctly. Some responses used average inflation rates instead of year-specific rates
3. In terms of taxation calculations, sometimes candidates did not carry forward losses or apply the tax holiday properly. In a minority of cases, a tax rate of 25% was used or reducing balance was applied to allowable depreciation or an additional tax was also paid in the USA.
4. Some candidates did not increase the royalties or contribution, and did not make that assumption. Other responses made the assumption but still used the higher figures. A significant number of answers simply ignored these figures completely.
5. On occasion the full amount of working capital was used every year instead of the incremental amount.
6. A minority of candidates estimated future expected exchange rates, even though they were given in the question.

These points suggest that sometimes candidates either do not read the question properly or do not understand fundamental aspects such as how to inflate future cash flows. It is also concerning when some candidates convert currency into dollars at the outset because this makes the question much more complex. These are serious shortcomings and candidates need to ensure that they take account of these when undertaking discounted cash flow techniques in international capital investment type questions. Sometimes candidates are quite tactical and avoided the more difficult and time-consuming calculations. This may be a valid time management strategy, but it is risky. It assumes that the calculations that are done are correct.

Part (b) (ii) asked candidates to discuss the assumptions made and the risks and issues which should be considered by the company before a final decision is made. On the whole, this part was done well with the majority of responses gaining at least half of the total marks. The satisfactory answers discussed a variety of points, and used commercial sense to contextualise them. Unsatisfactory responses stated the points without much discussion, repeated the same point in different forms and/or did not discuss how the issue, risk or assumption would impact the company commercially.

Part (b) (iii) asked candidates to give a reasoned recommendation. Most answers stated whether or not the project should be accepted or not but then did not take the points from (b) (ii) to give a more detailed and considered justification.

Four professional marks were available for the report for part (b). It was disappointing that many answers could not frame a report adequately and gained few professional marks. Given that a number of scripts were awarded marks in the higher 40s, gaining all the professional marks would have enabled these scripts to achieve a pass mark.

It is important that answers to all the questions focus on good layout, structure, presentation and neatness (including legibility). Such an approach shows the markers that the candidate understands the topic area(s) and makes awarding marks a straightforward process.

### **Question Two**

This was a 25-mark optional question which asked candidates to assess and discuss whether or not to dispose of an equity stake in a company.



In part (a), candidates were asked whether or not it may be beneficial to dispose of the shares through a dark-pool network instead of through a stock exchange. Those candidates who knew about dark pool networks were able to gain marks when they explained the reasons for their existence and use. Better answers then discussed why it may be beneficial for the company in the scenario, when it disposed shares using a dark pool network. This part of the question was generally done well.

Part (b) asked candidates to discuss whether or not the company should dispose of its stake or not. Although not specified in the requirements of the questions, pointers in the question narrative such as the financial statements and industrial ratios and trends indicated that this was a performance measurement type question. Some credit was also given to answers which attempted to value the company, although this probably would not have yielded many relevant answers unless numerous assumptions were made.

Good answers for this part, which provided calculations in a tabular format and then discussed the results in a holistic manner gained the majority of the marks. However, many responses tended to be unstructured, with few calculations to back up what was being said. Some responses also tended to be largely descriptive and piecemeal, where a ratio or trend was calculated and commented on, but the larger picture and discussion were missed. A similar question to this one was asked in a recent examination. Unfortunately, the same comment was made then and is repeated now.. It is important that question practice to prepare for the exam is done strategically to learn how to approach various types of P4 questions.

A surprising number of responses made errors in calculating the ratios and/or only gave ratios for one or two years. At this level, such an approach will not gain many marks. It is also difficult to discuss the key findings in any meaningful manner without examining a trend, but this cannot be done from examining one or two years' data.

### **Question Three**

This 25-mark optional question asked candidates to consider a management buyout (MBO) and look at the expected performance of the company in terms of whether it would be able to meet its restrictive covenants or not, and whether or not the MBO would be beneficial for the two groups of equity holders: the original managers and the venture capitalist.

In part (a), candidates were asked to distinguish between an MBO and a management buy-in (MBI). And then discuss the benefits and drawbacks of a disposal through an MBO instead of an MBI. Candidates who had studied and prepared this area gained high marks. However, many answers confused the two and some just explained what an MBO was only. The question asked for relative benefits and drawbacks, but only a few responses did this well enough to gain all the marks.

Part (b) asked candidates to calculate the gearing levels based on book values to assess when the gearing levels would be breached. Few candidates could apply the annuity factor to calculate the annual amount payable. Instead they opted to do it on a straight-line basis but this ignored the time value of money. However, a good number of responses then structured the profit or loss statement appropriately to take account of interest, tax and dividends, to get to the retained earnings figures. Nonetheless, some responses did not do this and therefore kept the book value of equity unchanged, casting doubt about whether or not they understand the relationship between the profit or loss



statement and the statement of financial position. In a small number of cases, candidates calculated tax after deducting both interest (correct) and dividends (incorrect).

In part (c), candidates were asked to assess whether or not the MBO was beneficial. Although not specified in the requirements, the appropriate way to assess benefit was to compare the value of the investment, the MBO in this case, with the cost of that investment, the price to be paid for the MBO. This part of the question was not done well and it seems that many candidates did not know which approach to take. It is to be stressed that at P4 level, it is expected that candidates will have a deep knowledge of the subject, obtained from sustained and effective study over a long period of time. This deep knowledge would enable them to identify how to approach answering the question. Unfortunately, not many candidates demonstrated that they had studied this area in detail.

#### **Question Four**

This was a 25-mark optional question which asked candidates to recommend a hedging strategy for borrowing using interest rate futures, options and option collars in part (a). And in part (b), the question moved on to examine how the derivatives markets operate and tested whether the candidates understood the difference between the time value and the intrinsic value of an option.

Part (a) was done reasonably well by most of the candidates who chose it as one of their two questions. Many candidates were able to identify that the correct futures hedge was to go short and to purchase put options, and how a collar should be constructed. Many candidates were also able to calculate the number of contracts and the remaining basis. The calculations involving futures and options were done a little bit better than the collar calculations.

Common errors included: not calculating the number of contracts and/or remaining basis correctly because of confusion with the months, not giving the amount reduction although the CEO requested this and constructing the collar to sell the put and buy the call.

The discussion element was done well and most candidates got 2 to 3 marks for it.

Part (b) was done unsatisfactorily by most candidates. Very few candidates got the calculations of the marked-to-market correct. These were relatively simple calculations as the number of contracts and tick value remained mostly unchanged. What was required was to identify the change in ticks or basis points and multiply the three numbers together. Many candidates explained mark-to-market but fewer candidates identified the impact on the company's cash flows. Many candidates knew about the margin account and could explain this well. Only a small minority of candidates were able to explain why options are not normally exercised but sold with reference to the intrinsic and time value of an option.

It is surprising that part (b) was not done well given that there was an article written on this area in the Student Accountant a few months ago. The following could be possible explanations: that the candidates did not read the article or that candidates read the article but did not understand it in depth. It is unlikely that an article will relate completely to an exam question, but the examining team write the technical articles because they feel that it is an important area for candidates. However, it is then necessary for the candidates to take the content and subject matter of the article, and ensure that they understand the content fully.

## Conclusion

Overall, a good understanding and knowledge are essential requirements for passing the P4 exam paper. Sustained study, over a long period of time, is an essential pre-requisite for success. In this paper, successful candidates demonstrated this clearly, whilst candidates who did not achieve a pass, did not demonstrate sufficient knowledge and understanding of all the topics which constitute the Advanced Financial Management syllabus. In addition to this, well-presented and well-structured answers, answering the requirements of the question, and using the reading time appropriately, are critical requirements for success.