

# Advanced Financial Management

## Specimen Exam – September 2022

### Get to know your exam

*These graphical representations are intended to give an indication of exam requirements and associated question content.*

*Please note that you will not be able to complete answers within these documents and in isolation they will not sufficiently prepare you for your exam.*





*We encourage you to visit the ACCA Practice Platform in order to attempt up to date practice exams within the computer-based exam environment.*

## Instruction screens

Advanced Financial Management (AFM) Specimen - from September 2022 onwards

### Instructions (1 of 4)

#### The Workspace

- Your exam consists of a number of questions. Each question is presented in a workspace. Each workspace will include:
  - Introductory information for the question.
  - Exhibits – these contain the question scenario content broken down into sections or sources of information you will need to answer the question requirement(s).
  - Requirements – these list the requirement(s) you are expected to answer in the workspace.
  - Response Options – you may be presented with one or more word processor and/or spreadsheet response options within which to construct your answer.
- When selected, the exhibits, requirements and response options will display in windows, which can be moved and resized as required.
- You can close each window individually or close all windows at once by selecting  **Close All** on the top toolbar. Note that any answers you have entered into the response options will be saved and you can re-open them and change your answers at any time.
- There is a splitter bar which can be used for you to see more or less of the left or right hand side of the screen, as required.
- When using PDF exhibits in the exam, and you want to select text to highlight, strikethrough or copy, you need to select the 'text tool' button  at the top of the exhibit.
- You can highlight or strikethrough text in the introductory information, PDF exhibits or requirements by selecting  **Highlight** or  **Strikethrough**
- You can copy and paste between exhibits, requirements and response options by using the Ctrl-C (Copy) and Ctrl-V (Paste) shortcuts. **Note:** When pasting into a spreadsheet response from elsewhere in the workspace you must double-click the cell or select the formula bar.

**Note:** In a number of countries ACCA works in partnership with the national professional accountancy organisation in the delivery of examinations.


Next →

## Instruction screens (continued)


Advanced Financial Management (AFM) Specimen - from September 2022 onwards

### Instructions (2 of 4)


#### Navigation

- The question number you are viewing is displayed in the top display bar. You can hide or restore this display by selecting 
- You can navigate between screens by selecting **Next →** or **← Previous**, or by clicking on a question number from the Navigator or Item Review screens.
- You can revisit questions and change your answers at any time during the exam.




#### Time Remaining

- The time remaining for your exam continually updates and is displayed in the top display bar. You can hide or restore this display by clicking 
- You will be presented with a message confirming when you have 15 minutes remaining.


#### Flag for Review

- If you wish to revisit/review a question later in the exam, click  **Flag for Review**
- Click the button again to remove the flag.

#### Help

- Click the **Help** button provided to access:
  - A copy of these exam instructions.
  - Help and guidance on workspaces.
  - Formulae sheets/tax tables if your exam requires these. Note that the name of the Help button will indicate if formulae sheets/tax tables are available i.e.  **Help**,  **Help/Formulae Sheet** or  **Help/Tax Tables**

#### Calculator

- You have the option to use the on-screen standard or scientific calculators by selecting  **Calculator**
- Note that you are also permitted to use your own calculator providing it does not have the facility to store or display text.


← Previous   Next →

## Instruction screens (continued)


Advanced Financial Management (AFM) Specimen - from September 2022 onwards

### Instructions (3 of 4)


#### Workings/Scratch Pad

- You may use an on-screen Scratch Pad to make notes/workings by selecting  **Scratch Pad**
- You can cut and copy text from the Scratch Pad and paste into your response options using the Ctrl-C (Copy), Ctrl-X (Cut) and Ctrl-V (Paste) shortcuts, or the on-screen buttons. **Note:** When pasting into a spreadsheet response you must double-click the cell or select the formula bar.
- The Scratch Pad retains all notes/workings entered for all workspaces. These are available for the duration of the exam but will not be submitted for marking.
- You will also be provided with paper for notes/workings should you prefer to use it. This will be collected at the end of the exam and must not be removed from the exam room.
- **Important:**
  - The notes/workings entered onto the Scratch Pad or your workings paper will not be marked.
  - If you want the marker to see any notes/workings for question requirements you must show them within the relevant response options.

#### Symbol

- You can add a selection of currency symbols to your answers by selecting  **Symbol** on the top toolbar.

#### Navigator Screen

- Navigator can be accessed at any time during the exam by selecting  **Navigator**
- This screen allows you to jump to any question number in the exam.

← Previous Next →

## Instruction screens (continued)

Advanced Financial Management (AFM) Specimen - from September 2022 onwards

### Instructions (4 of 4)

#### Exiting the Exam

- The exam will automatically end when the allocated time has been reached.
- If, however, you wish to end the exam before this time you must:
  - Navigate to the **last question** in the exam.
  - Click **Next →**
- This takes you to the Item Review screen:

#### Item Review Screen

- This screen gives you an opportunity to see the flag and completion status of all questions before you finally exit the exam.
- You can select individual questions you wish to revisit, or quickly access groups of questions from this screen.
- During the item review period Navigator is not available however you can navigate to questions by selecting **Next →**, **← Previous** or **→ Review Screen**
- Once you have completed your item review and wish to finally end the exam click **↪ End Exam**

Select **Next** to move to the Exam Summary screen.

← Previous Next →

## Exam summary screen

Advanced Financial Management (AFM) Specimen - from September 2022 onwards

### Exam Summary

**Time allowed:** 3 hours 15 minutes.

This exam is divided into two sections:

#### Section A

- One question worth 50 marks.
- 50 marks in total.

#### Section B

- Two questions, each worth 25 marks.
- 50 marks in total.

All questions are compulsory.


Select **Next** to start your exam.

← Previous Next →

## Exam questions

### Section A – summary screen

Advanced Financial Management (AFM) Specimen - from September 2022 onwards

 Flag for Review

#### Section A

This section of the exam contains **one question**.

This question is worth **50 marks** and is compulsory.


This exam section is worth **50 marks** in total.

#### Important:

You must:

- Indicate which requirement each of your responses relate to so that this is clear for markers.
- Show all notes/workings that you want the marker to see within your responses. Remember, any notes/workings made on the Scratch Pad or on your workings paper will not be marked.

Select **Next** to continue.

 Navigator **Next** →

## Section A – question 1

Advanced Financial Management (AFM) Specimen - from September 2022 onwards 1 of 3

\$ Symbol  ▼ Highlight ✖ Strikethrough 🧮 Calculator 📝 Scratch Pad Close All 🚩 Flag for Review

### Exhibits

- 📄 1. Kingtim Co
- 📄 2. Takeover defences
- 📄 3. Financial details
- 📄 4. Employee remuneration

### Requirements

- 🎯 Requirements (50 marks)

### Response Options

- 📄 Word Processor
- 📊 Spreadsheet

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:


1. Kingtim Co
2. Takeover defences - to be used by Kingtim Co
3. Financial details - relating to cost of capital and bond information
4. Employee remuneration

This information should be used to answer the question **requirements** within your chosen **response option(s)**.

? Help/Formulae Sheet ← Previous 🧭 Navigator Next →



## Requirements

Requirements (50 marks) 

**(a) Discuss the feasibility and effectiveness of the defence strategies of selling off individual garden centres and enhancing directors' remuneration.**

(7 marks)

**(b) Prepare a report for the board of directors of Kingtim Co which:**

**(i) estimates the company's cost of capital before the new bonds are issued;**

(4 marks)

**(ii) estimates the market value and post-tax cost of debt of the new bonds;**

(7 marks)

**(iii) estimates the revised cost of equity and revised cost of capital if the new bonds are issued;**

(7 marks)

**(iv) discusses the impact on Kingtim Co's cost of capital and the reaction of equity and bond holders to the chief executive's proposal. The discussion should include an explanation of any assumptions made in the estimates in (b) (i) – (iii) above.**

(9 marks)

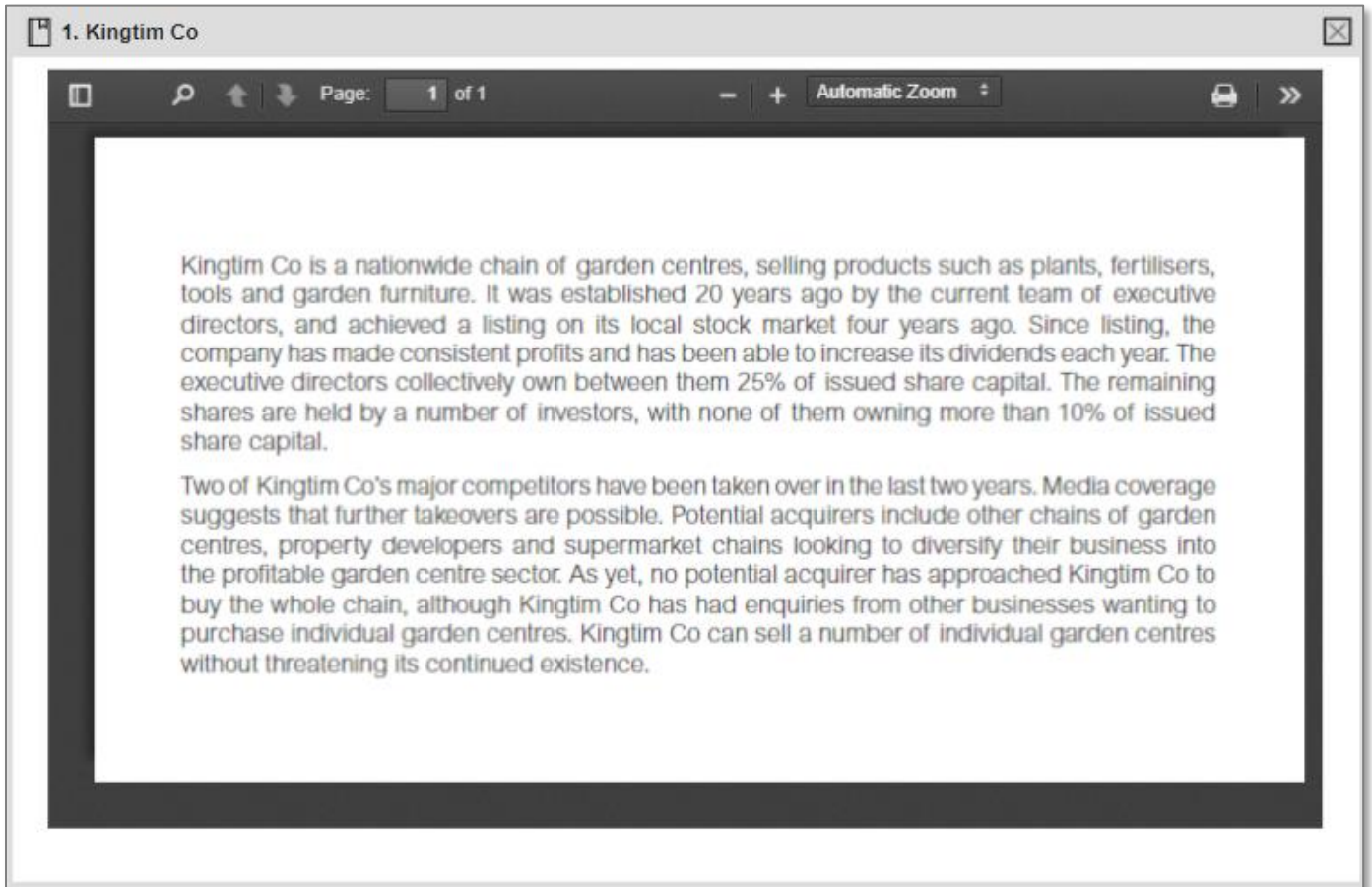
**(c) Discuss the approach taken to employee remuneration by Kingtim Co's Northern region and the issues associated with it.**

(6 marks)

Professional marks will be awarded for the demonstration of skill in communication, commercial acumen, analysis, scepticism and evaluation in your answer.

(10 marks)

## Exhibit 1



## Exhibit 2

2. Takeover defences

Page: 1 of 1 110%

Kingtim Co's executive directors remain committed to the business. They are fearful of a takeover, believing that the new owners will want some, or all of them, to leave the company. They have therefore been considering possible defences against a takeover bid. Kingtim Co's chief executive has received two proposals from directors:

- Sell individual garden centres which would be particularly attractive to purchasers. Disposal of these centres would make Kingtim Co, overall, a less attractive purchase.
- Pay the executive directors higher remuneration and change their contracts so that they would receive much higher compensation for loss of office if their contracts were terminated early.

Kingtim Co's chief executive believes, however, that any defence Kingtim Co adopts should also strengthen the company's future. She is therefore proposing to expand the company's current limited sales of camping products in its garden centres by establishing a chain of Kingtim outdoor shops, selling camping, walking and other outdoor equipment. The outdoor retail sector is competitive, but the chief executive believes that Kingtim Co will be successful. The establishment of the chain of outdoor shops would be funded solely by debt, the idea being that changing Kingtim Co's finance structure by having significantly more debt would make it less attractive to acquirers.

## Exhibit 3

3. Financial details

Page: 1 of 1 Automatic Zoom

Kingtim Co currently has 25 million \$1 shares in issue, with a current share price of \$5.56 per share. It also has 0.45 million 6.5% bonds in issue. Each 6.5% bond has a nominal value of \$100, and is currently trading at \$104 per \$100. The premium on redemption of the bonds in three years' time is 2%. Based on a yield to maturity approach, the after-tax cost of the bonds is 4.1%.

Kingtim Co's quoted equity beta for its existing garden centre business is 0.9.

Kingtim Co plans to issue 0.6 million, 7.5%, new bonds, each with a nominal value of \$100. These bonds will be redeemable in four years' time at a premium of 8%. The coupon on these bonds will be payable on an annual basis. These bonds are anticipated to have a credit rating of BBB-. The issue of the new 7.5% bonds will not affect the market value of Kingtim Co's shares or the existing 6.5% bonds.

The market value of the new bonds will be determined by using information relating to Kingtim Co's credit rating and the four bonds which the government has issued to estimate Kingtim Co's yield curve. All the bonds are of the same risk class. Details of the bonds are as follows:

Bond	Annual yield (based on spot rate)	Redeemable in
Ga	4%	1 year
Th	4.3%	2 years
De	4.7%	3 years
Ro	5.2%	4 years

Credit spreads, shown in basis points, are as follows:

Rating	1 year	2 years	3 years	4 years
BBB-	56	78	106	135

Kingtim Co plans to invest \$60m in non-current assets for the outdoor shops (working capital requirements can be ignored). Currently, Kingtim Co's non-current assets have a net book value of \$150m. It is assumed that the proportion of the book value of non-current assets which will be invested in the outdoor shops and the garden centres will give a fair representation of the size of each business within Kingtim Co. The asset beta of similar companies in the outdoor retail sector is assumed to be 0.88.

Before taking into consideration the impact of this new investment, Kingtim Co's forecast pre-tax earnings for the coming year is \$24m. It is estimated that the new investment will make a 10% pre-tax return and after-tax earnings will increase by \$1.125m.

The corporation tax rate applicable to all companies is 25% per year. The current risk-free rate of return is estimated to be 4% and the market risk premium is estimated to be 9%.

## Exhibit 4

4. Employee remuneration

Page: 1 of 1 Automatic Zoom

Kingtim Co's annual report contains a general commitment to act with social responsibility, in line with society's expectations. It also commits to paying its staff fairly in accordance with their responsibilities and states that its staff are vital to its success.

To try to improve the situation of low-paid employees, the government has recommended a basic hourly wage as the minimum level employees should be paid, although this minimum is not legally enforceable. A newspaper investigation has revealed that some staff in Kingtim Co's garden centres in the northern region of the country are paid up to 15% less per hour than the recommended minimum wage. Most of these staff are part-time staff, working limited hours each week.

The manager of Kingtim Co's northern region centres, when asked to comment, stated that Kingtim Co had obligations to its shareholders to control staff costs. Lower pay levels were necessary to differentiate between staff, ensuring that managers and staff with experience and expertise were appropriately rewarded. The manager commented that pay levels also reflected the lower commitment to Kingtim Co which part-time staff made compared with full-time staff.

## Section B – summary screen

### Section B

This section of the exam contains **two questions**.

Each question is worth **25 marks** and is compulsory.

This exam section is worth **50 marks** in total.

#### Important:

You must:

- Indicate which requirement each of your responses relate to so that this is clear for markers.
- Show all notes/workings that you want the marker to see within your responses. Remember, any notes/workings made on the Scratch Pad or on your workings paper will not be marked.

Select **Next** to continue.

## Section B – question 1

Advanced Financial Management (AFM) Specimen - from September 2022 onwards 2 of 3

\$ Symbol  Highlight ✖ Strikethrough 🧮 Calculator 📝 Scratch Pad Close All Flag for Review

### Exhibits

- 📄 1. Colvin Co
- 📄 2. Project information
- 📄 3. Discount rate

### Requirements

- 🎯 Requirements (25 marks)

### Response Options

- 📝 Word Processor
- 📊 Spreadsheet

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:


1. Colvin Co
2. Project information
3. Discount rate

This information should be used to answer the question **requirements** within your chosen **response option(s)**.

? Help/Formulae Sheet ← Previous 🧭 Navigator Next →



## Requirements

Requirements (25 marks) 

**(a) Evaluate the suitability of the investment proposal in Canvia, including the impact of the country risk premium on the net present value of the project.**

(14 marks)


**(b) Discuss the validity of the chief executive's reasons for adjusting the discount rate used in appraising the project in Canvia.**


(6 marks)

Professional marks will be awarded for the demonstration of skill in commercial acumen, analysis, scepticism and evaluation in your answer.

(5 marks)

## Exhibit 1

1. Colvin Co 

Page: 1 of 1    -    +    110%        >>

Colvin Co is based in the eurozone region and was established ten years ago to manufacture competition standard bicycles for professional road racers. When the company obtained a listing five years ago, the founder retained a small minority shareholding. The remaining shares are held by a number of institutional investors.

The board recently decided to expand the range of models and to look for new growth opportunities abroad. Whilst manufacturing is currently restricted to the eurozone, the board of directors has identified Canvia as a key growth market and is considering a potential investment project to manufacture and sell a new model there. This would involve establishing a subsidiary in Canvia.



## Exhibit 2

### 2. Project information

Page: 1 of 1 110%

The currency in Carvia is the Carvian lira (CL) and the current exchange rate is CL9·91 per euro (€). The annual rate of inflation in Carvia is expected to remain at 10% throughout the four-year duration of the project.

The finance director estimates the project's sales volumes, inflation-adjusted, pre-tax contribution and fixed costs as follows:

Year	1	2	3	4
Sales volume (units)	109,725	121,795	148,590	197,624
Pre-tax contribution (CLm)	419·4	500·2	671·3	961·2
Fixed costs (CLm)	270·0	291·6	314·9	340·1

The project will require an immediate investment of CL75m in land and buildings and CL700m in plant and machinery. Tax allowable depreciation is available on plant and machinery on a straight-line basis at an annual rate of 25% on cost. Colvin Co's finance director believes the plant and machinery will have a zero residual value at the end of the four years. The land and buildings will be disposed of at the end of the project and their tax exempt value is expected to increase at an annual rate of 30% throughout the four-year life of the investment.

The project will also require an immediate investment in working capital of CL25m. The annual incremental working capital requirements are expected to be as follows:

Year	0	1	2	3
CLm	(25·0)	(2·5)	(2·8)	(3·0)

Working capital will be released back in full at the end of the project. Colvin Co has a policy of extracting remittable cash flows as dividends at the earliest possible opportunity.

All components for the new bicycle will be produced or purchased in Carvia except for a gearing system component which will be manufactured by Colvin Co in the eurozone. The cost of acquiring this component from the eurozone is already included in the pre-tax contribution estimates, based on a transfer price of €10 per component. The finance director estimates a manufacturing cost of €2 per component. Both the transfer price and manufacturing cost are expected to increase in line with eurozone annual inflation of 4% in the first two years of the project and 2% in years three and four.

Corporation tax in Carvia is payable annually at 25% and companies are allowed to carry losses forward to be offset against future trading profits. Colvin Co pays corporation tax in its home country at an annual rate of 20%. Taxes are payable in both countries in the year the liability is incurred. A bi-lateral tax treaty exists between the two countries, which permits the offset of overseas tax against any domestic tax liability incurred on overseas earnings.

## Exhibit 3

3. Discount rate





Page: 1 of 1 110%

The board proposes financing the project with a mix of equity and debt in such a way that the existing capital structure remains unchanged. For the purposes of this project, the chief executive believes Colvin Co's weighted average cost of capital of 13% should be adjusted to include a country risk premium on the basis that Carvia is a developing economy and appears to be economically less stable than the eurozone countries. She made this decision after consulting a country risk index, which compares the standard deviation of market returns in various countries.



Additional factors taken into consideration include foreign exchange risk, the fact that there have been frequent changes of government, and hence economic policies, in Carvia. You have therefore been asked to use a discount rate of 16% to appraise this investment project.

## Section B – question 2


Advanced Financial Management (AFM) Specimen - from September 2022 onwards 3 of 3

**\$** Symbol   ▼ Highlight  Strikethrough  Calculator  Scratch Pad  Close All  Flag for Review



**Exhibits**

-  1. Boullain Co and its hedging policy
-  2. Hedging products

**Requirements**

-  Requirements (25 marks)


**Response Options**

-  Word Processor
-  Spreadsheet

The following **exhibits**, available on the left-hand side of the screen, provide information relevant to the question:

1. Boullain Co and its hedging policy
2. Hedging products

This information should be used to answer the question **requirements** within your chosen **response option(s)**.

Help/Formulae Sheet ← Previous  Navigator Next →

## Requirements

Requirements (25 marks)

**(a) Explain the rationale for the policy of hedging Boullain Co's foreign exchange risk and the potential benefits to shareholder value if that policy is effectively communicated to the company's key stakeholders.** (6 marks)

**(b) Recommend a hedging strategy for Boullain Co's foreign currency receipt in six months' time based on the hedging choices the finance director is considering. Support your recommendation with relevant calculations and appropriate discussion including the impact of the margin requirements.** (14 marks)

Professional marks will be awarded for the demonstration of skill in commercial acumen, analysis, scepticism and evaluation in your answer. (5 marks)

## Exhibit 1

1. Boullain Co and its hedging policy

Page: 1 of 1 110%

Boullain Co is based in the Eurozone and manufactures components for agricultural machinery. The company is financed by a combination of debt and equity, having obtained a listing five years ago. In addition to the founder's equity stake, the shareholders consist of pension funds and other institutional investors. Until recently, sales have been generated exclusively within the Eurozone area but the directors are keen to expand and have identified North America as a key export market. The company recently completed its first sale to a customer based in the United States, although payment will not be received for another six months.

At a recent board meeting, Boullain Co's finance director argued that the expansion into foreign markets creates the need for a formal hedging policy and that shareholder value would be enhanced if this policy was communicated to the company's other stakeholders. However, Boullain Co's chief executive officer disagreed with the finance director on the following grounds. First, existing shareholders are already well diversified and would therefore not benefit from additional risk reduction hedging strategies. Second, there is no obvious benefit to shareholder value by communicating the hedging policy to other stakeholders such as debt providers, employees, customers and suppliers. You have been asked to provide a rationale for the finance director's comments in advance of the next board meeting.

## Exhibit 2

2. Hedging products

Page: 1 of 1 110%

Assume today's date is 1 March 20X0. Boullain Co is due to receive \$18,600,000 from the American customer on 31 August 20X0. The finance director is keen to minimise the company's exposure to foreign exchange risk and has identified forward contracts, exchange traded futures and options as a way of achieving this objective.

The following quotations have been obtained.

**Exchange rates (quoted as €/US\$1)**

Spot	0.8707–0.8711
Six months forward	0.8729–0.8744

**Currency futures (contract size €200,000; price quoted as US\$ per €1)**

	Price
March	1.1476
June	1.1449
September	1.1422

**Currency options (contract size €200,000; exercise price quoted as US\$ per €1, premium: US cents per €1)**

Exercise price	Calls			Puts		
	March	June	September	March	June	September
1.1420	0.43	0.59	0.77	0.62	0.78	0.89

Assume futures and options contracts mature at the month end and that there is no basis risk. The number of contracts to be used should be rounded down to the nearest whole number in calculations. If the full amount cannot be hedged using an exact number of futures or options contracts, the balance is hedged using the forward market.

Once the position is open, the euro futures contract outlined above will be marked-to-market on a daily basis. The terms of the contract require Boullain Co to deposit an initial margin per contract with the clearing house. Assume the maintenance margin is equivalent to the initial margin.

Your manager is concerned about the impact of an open futures position on Boullain Co's cash flow and has asked you to explain the impact of the margin requirements and their significance for the hedging decision.