

CORPORATE FINANCIAL MANAGEMENT – PAPER 12

1.0 General Performance

- Overall performance was poor. The pass rate dropped from 44.17% in the December 2010 examinations diet to 35.12%.
- Candidates' preparation for the examination was not adequate.
- There was a big problem with computational questions; many candidates left such questions unanswered.
- The theory part was fairly answered by an average number of candidates.

2.0 PERFORMANCE IN INDIVIDUAL QUESTIONS

2.1 Question 1:

- Required candidates to: (a) explain the difficulties that are faced in determining the cost of capital for a private limited company, (b) explain the concept of an efficient market, differentiating clearly between technical and fundamental analysis, (c) compute the current cost of capital and use it to evaluate the viability of the investment., (d) explain and compute the concept 'yield to maturity' of the proposed bond issue, (e) comment on the effect of the new issue on: (i) interest cover,(ii) gearing and (iii) share price.
- In part (a) some candidates scored good marks. However, a good number of candidates gave reasons that were not related to cost of capital as well, for example political instability and inflation, which showed that they were not at all ready as far as this part of the syllabus was concerned.
- In part (b) most candidates explained the concept but only a handful differentiated the fundamental and technical analysis as required. So they could not score good marks.
- In part (c) most candidates calculated correctly variable cost and fixed cost in order to find the before-tax cash flows over the four-year appraisal period required by the directors of the company. Some candidates calculated correctly the tax benefit arising from capital allowances (tax-allowable depreciation), but provided a balancing allowance in the final year, yet it was clearly stated it would not arise.
- The treatment of working capital was a problem for many candidates. The three elements of working capital can be relevant in investment appraisal, namely initial investment, incremental investment and recovery at the end of the investment project. The first element was needed here.
- Only a few candidates computed the current cost of capital using the dividend model for equity and the interest with market value of debt for the redeemable debenture. A very good number of candidates did not attempt this part of the question.
- In part (d) some candidates explained the concept but could not compute. Others explained the yield curve instead of yield to maturity. Although the yield curve is related to bonds as well, it is not the same as yield to maturity. More than half of the candidates did not attempt this question.

- In part (e), though ratio analysis has been consistently examined since the inception of the new syllabus, many candidates still could not write down a formula for key financial ratios. Many candidates were able to compute the ratios before the bond issue but were unable to incorporate the effect of the bond issue on the financial statements. Issuing a bond at 12% meant that interest expense was supposed to go up and the level of debt would also increase by one billion. Candidates generally lacked the analytical skills required for this part of the question.

2.2 Question 2:

- Generally, the candidates were provided with a scenario of two companies PCL and RCL who were looking at possible merger. Share capital information, earnings, as well as price earning (P/E) ratios before and after the merger /takeover.
- The question required candidates to: (a) distinguish between a divestment and a demerger, (b) give advantages and disadvantages of a demerger, (c) give advice a shareholder holding 5000 shares before the merger, on the impact of the merger on his wealth.
- In part (a) many could define demerger, but very few knew what divestment meant.
- Part (b) was fairly well answered
- Over 80% of the candidates who attempted this question left it part (c) unanswered.

2.3 Question 3:

- Required candidates to: (a) explain the relevance and principles of corporate financial management to a charity organization which also operated retail shops to raise money, (b) explain how the net present value (NPV) is related to the major corporate objective of the firm.
- In part (a) a only a few candidates identified the key corporate financial management principles and methods and scored high marks. Others only wrote about the objectives of a firm. Some candidates totally misfired by writing about ethical issues. What was required here were the principles and methods of corporate financial management, investment, financing, working capital and dividend (but remember this was a charity so dividend payment was quite irrelevant)
- Part (b) it was relatively well answered. However, some candidates identified the major corporate objective as profit instead of wealth maximization.

2.4 Question .4:

- Candidates were given data related to past dividend of a company as related to profits and number of shares. This company intended to get listed and the management had conflicting views about dividend decision
- It required candidates to: (a) comment on the policy over the past years, (b) comment on the conflicting views of the managers and the determinant factors for dividend policy, (c) differentiate between private placement and offer for sale as methods of issuing shares.
- Though part (a) required candidates to compute at least a dividend per share or payout ratio, then comment on it, some candidates just commented without computation thus limiting their marks.
- In part (b) many candidates identified the conflicting views of the two managers as based on Modigliani and Miller and traditional views and scored relatively well.
- Part (c) was fairly well attempted. This was the overall best answered question, though some candidates still left it unanswered.

2.5 Question 5:

- Required candidates to: (a) give advice on how the money market hedge could be used to manage the exchange risk in the given transactions, (b) explain common challenges of currency hedging to corporate finance managers in developing countries, (c) explain securitization as a source of funds, and (d) give two advantages of securitization as a means of raising funds.
- These requirements were based on a scenario of a businessman who had obligations in Hong Kong as well as some expected receipts from Hong Kong.
- very few candidates attempted part (a) and even those who attempted it could not realize the fact that if one expects to receive and pay the same currency at the same time, then one has to net off and hedge the net difference of 20 million Hong Kong dollars. Other candidates computed forward contracts, yet the question was so clear about the money market hedge only. Other candidates did not realize that interest rates given were per quarter. They simply interpreted them as per annum and divided by 4 thus getting it wrong. On the receipt in six months time, the interest needed to be multiplied by 2 since it was for a quarter.
- In part (b) many candidates gave types of exchange risks (transaction, translation). Only a few candidates answered this part well.
- In part (c) some candidates did a good job but many others had no idea what securitization is.
- Part (d) was well answered for those who had answered part (c) well.
- Generally, this was the worst attempted and answered question.