

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

EXAMINERS' COMMENTS – FINAL EXAMINATIONS

SUBJECT	SESSION
Business Finance Decisions	Summer 2007

General:

The overall performance of the students in this paper remained disappointing. Overwhelming majority of the students was unable to grasp the requirements of most of the questions and provided only partly correct answers. A significant lot, wasted valuable examination time in writing long descriptive answers that were mostly irrelevant. The success rate therefore remained dismally low.

The question wise comments are as follows:

Q.1 This was a fairly straightforward question of investment decision making. The students were asked to determine the most beneficial mix of investments out of five projects. The right approach was to determine the appropriate annuity factor for each project keeping in view their varying cash inflow starting periods, determining present values of inflows and recognizing mutual dependency of projects D&E by considering them jointly. The most common errors were as follows:

- Annuity factors were not calculated correctly.
- The cash inflows were to start after a gap of few years. The proper approach was to get the annuity factor based on the life of the project and to deduct therefrom the annuity factor related to the period during which there were no cash flows. Most of the students ignored the annuity factor relating to the period in which the inflows were zero and used the annuity factor based on the life of the project. Many others while deducting the annuity factor of the period in which cash flows were zero also included the year in which the cash flows had started. For example, according to the question the cash flow of project “D” **had started** in the third year. Therefore, it was only in the first two years that the inflows were zero. Many students took the first three years inflows as zero.
- Mutual dependency of projects D&E was not recognized.

Q.2 This question checked the concepts of Arbitrage in Spot & Futures transactions.

Part (a) required the computation of arbitrage gain. The correct approach was to determine the gain as difference of spot and future price and then deducting transaction costs and borrowing costs on purchase price and margin to arrive at net arbitrage profit. This part was generally attempted well by the students. Common errors in this part were as follows:

- The transaction costs were deducted from the purchase price instead of being added.

- There were two types of borrowing costs i.e. those related to spot purchases and those related to deposit on future sales. Some students ignored them altogether whereas many others ignored one of the two types of borrowing costs.

Part (b) proved very difficult for most of the students as they failed to approach the question correctly. This part required the determination of increase in future price at the end of first month after which the company will incur loss. The correct approach was to understand that the company will incur loss if the borrowing costs on the amount paid as the difference exceeds the arbitrage gain. There were three types of borrowing costs involved in the transaction as given below:

- Borrowing cost of purchase price for two months
- Borrowing cost of 10% margin for two months.
- Borrowing cost of the difference in the futures sale price at which the transaction was booked and the sales price prevailing at the end of the first month.

The students were generally ignorant about the fact that the company will have to pay a difference if the sales price at the end of the first month exceeded the sales price at which the company has carried out the transaction. The price differential increases with the increase in price. If the differential becomes so large that the total borrowing costs exceed the amount earned on the arbitrage transaction, the company starts incurring losses.

- Q.3 The question was very clear. It required the examinees to compute the change in share price if the company disclosed a change in its dividend policy according to which the company had decided to skip dividend payment in the forthcoming year to allow the shareholders to avail benefit of exemptions on capital gain.

Most of the students could not do the question correctly till the end. Some of the students wrote long descriptions of Tax preference theory which were irrelevant.

Other common errors were as follows:

- Failure to grasp the requirement of the question.
- Incorrectly assuming that the increase in price is linked to the distribution of dividend only.
- Failure to understand the method of determining the discount rate which was to be used for calculating the present value.

- Q.4 It was an average question and tested the concepts of Portfolio Investments. The examinees were required to select one out of the two proposed projects. The data about returns and standard deviations were provided. Overwhelming majority of the students was only able to give half correct answers as they either ignored the analysis part altogether or did it incorrectly. The correct approach was to first compute the combined portfolio returns and risks of two types of combinations i.e. the existing project with each of the two projects separately. The next step was to analyse the same combinations from the Risk/Return perspective to evaluate as to which of them was more efficient i.e. where the “Excess Return per unit of risk” was higher. Whereas many of the students were able to compute the combined portfolio returns and risks in either case, very few could do the next step correctly. Many of the errors were made because the examinees were not conceptually clear about the method of calculation. Some of them failed to compute the combined standard deviation correctly. Although the formula was given yet many examinees were even unaware as to how it was to be applied.
- Q.5 It was an easy question and tested the concepts of relevant costing. The concept of learning curve was also tested. The response was average and very few of the students were able to do the whole question correctly.

The steps involved in the question were as follows:

- valuation of materials from the point of view of relevant costs taking into account the material already available in stock;
- estimating relevant labor hours and their costs;
- application of learning curve concept to compute unskilled labour hours;
- applying relevant yearly increments;
- putting all the above figures in an NPV model.

The common errors were as follows:

- Many students could not apply the correct relevant cost for materials.
- Learning curve technique was not applied correctly in most cases.
- Sunk costs such as cost of market research and cost of machine RR were also included in cash outflows by many students.
- Surprisingly, many students included depreciation in cash out flows.

Q.6 This question tested the concepts of Interest Rate Swap.

Part (a) required an advice regarding suitability of fixed or floating rate of interest in the context of two companies. The advice required appreciation of the specific circumstances of the two companies. Since the inflows of Matured Limited were uncertain, it was advisable for it to have a floating rate loan, to offset the adverse effects of economic depressions as such period is characterized by low rate of interest. On the other hand, fixed rate was advisable for Golden age because their inflows were almost certain and fixed and it was advisable for them to lock their borrowing costs at the fixed rate. Most of the students missed this point and based their decision on the basis of expectation of interest rate movements which were again based on hypothetical assumptions. Very few were able to advise the correct decision and the correct rationale.

Part (b) required a decision about whether the companies should go for swap arrangement. Most of the students were able to compute the savings of 0.25%. However, majority of them followed a very lengthy method i.e. they worked out the total interest without and with swap. They could have easily arrived at the net savings of 0.25% by just comparing the interest rates, with and without swap. More importantly, very few of them could assess the situation correctly i.e. that the savings of 0.25% didn't seem enough to cover the costs of arranging the swap.

In part (c) the examinees were required to determine the amount payable by one company to the other if a swap arrangement of Rs. 75.0 million was arranged and the ultimate rate of interest was 9%.

The correct approach was to determine the amount payable by each company with and without swap arrangements. In a swap arrangement, the loss to one company is compensated by the other company which has gained in the process, in such a way that the overall gain is distributed among both of them in a predetermined ratio.

Very few of the examinees had in-depth knowledge of how a swap arrangement works. All the others relied on guess work and could gain very few marks.

Q.7 (a) The relation of risk and return is a favorite topic of the examiner. However, it is disappointing to note that still, majority of the students have not even been able to grasp the basic techniques. Therefore the following comments are mostly relevant for those of the students who atleast have good knowledge of the basic techniques.

(i) Calculation of existing WACC was very simple and carried bonus marks for almost all the students.

- (ii) Computation of WACC at different debt equity ratio was also not much challenging as working of un-g geared beta and re-gearing at targeted debt equity ratio is an oft repeated area. However, since the formulas were somewhat complex, many students were unable to apply them correctly. Many students need to revise the rules of simplification which are usually studied at the school or high school level.
 - (iii) Many students rightly tried to find out growth percentage by using growth model formula. But somehow they applied the concept on equity return only and ignored the fact that growth percentage of total operating cash flows were required.
 - (iv) Similar growth model formula was required to be applied to arrive at revised market value of the company using new WACC as the discounting rate.
- (b) This part involved three simple steps as given below:
- Determination of cost of debt at the three interest rates given in the question.
 - Determining the interest cover in each case.
 - Ascertaining the applicable rate based on the credit rating (which again was based on interest cover) as given in the question.

However, very few students could reach this stage and do the above correctly.

(THE END)