THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN EXAMINERS' COMMENTS	
SUBJECT Business Finance Decisions	**SESSION** Certified Finance and Accounting Professional (CFAP) Examination - Winter 2017

General:

The performance in this attempt with a passing percentage was much below the performance in the previous five attempts. One of the main reasons was the candidates' inability to perform well in even the easier questions like question 3 and 4. A review of the question wise comments would indicate that most of the mistakes made by the candidates were those which are not expected at this level. Usually, these types of mistakes are committed when the candidates do not read the information available in the question carefully or start answering the question and making calculations without planning their answers.

Question-wise comments

Question 1

The overall response to this question was quite poor and most of the students were unable to secure passing marks. The commonly observed errors were as follows:

- Free cash flows were reduced by the amount of tax whereas the term free tax flows means that all expenses/outflows including tax have already been taken into consideration.
- While computing opportunity cost on account of rent foregone on disposal of property most of the students ignored to net it off with income tax. Further, many students ignored the rent foregone altogether.
- Terminal value was computed on the basis of free cash flows related to increased production capacity whereas terminal value of opportunity cost of disposal of investment property was mostly ignored.
- Following steps were required to be followed to arrive at the weighted average cost of capital of the company after disposal of 50% of the investment property division:

    (i) Computation of steel industry asset beta. This was correctly computed by most of the students.
    (ii) Ungearing of current company beta and then computing the asset beta of investment property division. These steps were mostly ignored.
    (iii) On the basis of asset beta of investment property division and steel industry asset beta, new asset beta after 50% disposal was to be computed but was ignored by a vast majority of the students.

(iv) The new asset beta of CT as a whole was then to be adjusted for gearing to compute the equity beta. Instead, most of the students used only the steel industry asset beta (computed as mentioned in point (i) above) with revised gearing to compute the equity beta.

(v) The next two steps included computation of cost of equity and computation of WACC. Many students treated cost of equity as the WACC.

Question 2(a)

This part of the question was well responded by most of the students. However, some students could not mention the required number of four factors whereas many students repeated the same points to reach the tally of four.

Question 2(b)

The requirement in this part of the question was to estimate the effect on a company's WACC due to a 35% decline in KSE-100 index and decline in yield to maturity of debentures from 9% to 7%. The performance remained average as majority of the students carried out some of the steps correctly but very few could get the entire answer correct. The main errors were as follows:

- Existing cost of equity (pertaining to 2017) was calculated based on profit growth of 13% instead of dividend growth of 4.8%.
- The same cost of equity was assumed for the year ending 30 June 2018 also.
- Market value of equity (existing as well as revised) was computed by applying the price to book value ratio on share capital instead of total equity.
- Growth rate of dividend was computed based on five years between 2014 and 2018, instead of four years.
- Revised market value of debentures was calculated assuming 5 years to maturity instead of 4 years.

Question 3

This question required evaluation of a company's plan to establish a power plant in a foreign country. The overall performance remained below average. Most of the students made mistakes which could easily have been avoided. The common errors were as follows:

- Inflation and growth rates were applied on billing from year 1 instead of year 2.
- Interest on cash balance was ignored.
- Most of the students ignored the increase in working capital requirement and recovery thereof at the end of the project.
- Gain on disposal of plant and terminal value of the plant was ignored.
- It was mentioned in the question that treasury bonds issued by Government of Filansia (GOF) are considered risk free. Hence, difference between these treasury bonds and US treasury bonds should have been used to compute sovereign yield spread whereas most of the students used the difference between rate on Eurobonds issued by GOF and rate on US treasury bonds' rate, for onward computation of country risk premium.
- Many students treated the sovereign yield spread as the country risk premium.
- The country risk premium was ignored in computing the cost of equity.

Question 4

The requirement in this question was to determine the most feasible option available for managing receivables. Though it was a simple question yet the overall response was not very encouraging as only 23% candidates secured passing marks. The most common issue was that the candidates were unable to carry out a like to like comparison of the various options. For example, when under the existing option the cost of bad debts was taken as Rs. 12 million, under option 1 (without recourse), the cost was taken as minus Rs. 12 million instead of zero and hence the savings were assumed to be Rs. 24 million instead of Rs. 12 million. Other common errors were as follows:

- While computing agency commission and interest on advance payment under factoring option, most of the students computed them as a percentage of existing sale of Rs. 1,200 million rather than the increased sale of Rs. 1,250 million.
- In the with recourse alternative of Option 1, bad debts were taken as zero which was incorrect as in with recourse option, the bad debts have ultimately to be borne by the company.
- In Option 1, cost of investment in receivables was totally ignored despite the fact that only 80%/85% of the debtors were to be financed by the factor.
- In option 3, margin lost on cash sales was either ignored or computed incorrectly.

Question 5(a)

This part of the question required determination of most feasible currency hedging option for a company (CPL). The overall performance was satisfactory. Some of the common mistakes observed were as follows:

- In money market option of Chinese contract, selling rate of 6.77 was used instead of the buying rate of 6.67 for calculation of CNY's spot rate.
- In calculating the forward rate, premium was added to the spot rate instead of being deducted and discount was deducted instead of being added.
- Most of the students combined both the transactions for making the final decision whereas each transaction should have been evaluated separately.

Question 5(b)

The requirement in this part of the question was to devise a strategy and making investment using share future contracts and calculation of net outcome and the hedging strategy. The overall response was quite poor and most of the candidates appeared unable to form a co-ordinated approach. Most of the students performed in a totally confused manner as they carried out many calculations without really specifying as to what they were doing. Some of the more common errors are described below:

- Very few students were able to correctly compute the closing predicted future price of the securities. It could have been determined by taking the difference between future rate and current spot rate and prorating the same on the basis of number of months remaining and adding the amount so computed to the expected spot rate.

- Most of the students were unable to appreciate that buying as well as selling would take place on the future counter and hence transaction cost related to future market should be used in determining the actual cost. Many candidates took into consideration only once instead of considering double the amount i.e. once for purchase and once for sale.
- The number of shares to be purchased was determined using the future market price instead of the ready market price.
- Cost of borrowing was ignored.

(THE END)