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| THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN | |
| EXAMINERS' COMMENTS | |
| SUBJECT Business Finance Decisions | SESSION Certified Finance and Accounting Professional (CFAP) Examination - Winter 2018 |

General:

The overall passing percentage in this attempt declined to 27% as compared to 41% in the previous attempt. The primary reason for the decline was poor performance in question no. 4 and 5. Historically, transfer pricing has been a difficult topic for the students and this time it was no exception. Expertise in transfer pricing is only possible through practice as every situation is different and requires a rethink of the existing strategy. However, it seemed the desired amount of practice was lacking and this trend was visible in almost all the questions, though the maximum impact was on the question on transfer pricing i.e. question no. 4.

Question-wise comments:

Question 1

This question was based on the topic of demerger. The overall performance was satisfactory as 53% candidates secured passing marks in this question and a significant number of students secured full marks as well. Almost all the students who passed this paper secured high marks in this question.

Question 1(a)

The candidates were required to evaluate the financial viability of the demerger scheme under the given scenario. This required comparison of new values of divisions after demerger with the existing value of the equity of the company before demerger. Those who could not perform well made the following types of mistakes:

- While calculating present values of the divisions after the demerger, instead of taking the free cash flows as given in the question, the amount was taken after deducting tax @ 30%.
- The steps involving ungearing of industry beta and re-gearing the asset beta was ignored. Consequently, industry equity beta was used to work out the cost of equity.
- Instead of calculating IRR for cost of TFCs, the coupon rate was used for calculating WACC.
- Instead of WACC, cost of equity was used for determining the annuity factor to be used for computing present value of projected cash flows.
- While calculating WACC of a particular division, industry debt equity ratio was used instead of that division's debt equity ratio.
- Incorrect annuity factors were used for computing cumulative present value of projected cash flows from year 6 to year 10.

Question 1(b)

The candidates were required to list down additional information to assist directors in evaluating the decision of demerger. This was attempted in an average manner. Many students wrote the advantages and disadvantages of demerger which was not required at all.

Question 2

This question consisted of two independent parts. The overall performance was below average as 42% candidates secured passing marks. Part-wise performance is discussed below:

Question 2(a)

In the given scenario, the candidates were required to determine the amount of savings that could be achieved by using multilateral netting. Most of the students did not seem to have a complete idea of the concept of multilateral netting. They converted the inter-company receivables and payables from different subsidiaries into Pak Rupees accurately but could not determine the amount of savings by applying the cost of transaction percentage to the difference of gross and net receipts/payments.

Question 2(b)

In this part, the candidates were required to advise the best interest rate hedging strategy by comparing SWAP option with futures option.

The net gain to be derived from SWAP option and the company's share of potential gain were correctly calculated by majority of the students. However, many candidates ignored the bank's fee.

In futures option, the 'Basis' at 01 December 2018 was correctly calculated by many students but the 'Basis' remaining at 01 March 2019 was not prorated and consequently, the March future price was calculated incorrectly. Moreover, only few students took their workings further to calculate the future outcome and the effective interest rate.

Question 3

In this question, the candidates were required to evaluate a proposed contract by using adjusted present value method. Very good performance was witnessed in this question and 71% of the candidates secured passing marks whereas few candidates secured full marks also.

The mistakes observed were as follows:

- Revenue for tax purposes was taken net of mobilization advance and retention money. In some cases, the initial cash flows pertaining to mobilization advance and purchase of plant were also considered for tax computations.
- Tax was charged on residual value whereas there was no tax profit or loss on sale of the asset (since residual value was equal to tax WDV).
- The brought forward losses were ignored for tax calculation.

- The cash inflows pertaining to residual value of plant after 4 years and release of retention money in the 5th year were either ignored or taken incorrectly.
- The opening and closing balances of cash were ignored in arriving at the figure of running finance required and the yearly cash flow working were considered as the net running finance requirement for that particular year.
- The loan amount was not grossed up by the issue cost of loan resulting in incorrect calculation of interest expense on loan.

Question 4

This proved to be the most poorly attempted question of this paper as only 1.8% of the candidates secured passing marks. The basic reason was the inability of the students to pick up the gist of this question. Only bits and pieces of some correct calculations resulted in few marks in this question.

The question depicted a situation where Division managers' individual policies are affecting the overall profitability of the company. The clue to this question lied in figuring out that Division A sells its output to external market because it can earn higher contribution margin per unit as compared to internal transfer to Division B. Whereas Division B can earn higher CM by selecting the most appropriate mix of Division A's product Alpha and alternate imported product Ceta. Considering the different price and import duty bands of ceta based on the ordered quantity, the options available to the company were to be worked out and then compared with the existing condition to reach to a conclusion.

Question 5

This question required determination of the optimum investment mix under two discrete scenarios i.e. when the individual investments were divisible and could be scaled upward by 50% and when these were indivisible. Further, two of the three investment projects were mutually dependent. The overall performance was very poor as only 7.6% candidates secured passing marks.

An important point to understand was that project A and C were mutually dependent and therefore should have been considered as a single project. In the first case (part a) the combination of A and C was to be evaluated against the third project using linear programming and considering the constraints. Only few candidates were able to develop all the constraints correctly. Many students did not treat the projects A and C as one project despite that it was clearly mentioned in the question. Some such students stated that this question can only be solved using simplex method which is not a part of syllabus. Mostly, candidates were only successful in gaining marks for the calculation of NPV of the three projects.

In the second case (part b) also where the projects were to be considered indivisible, the performance was quite poor. The return on investment of excess funds was to be calculated year wise considering the outflow of investment amount at Year 0 and Year 1 and its return (inflow) at Year 2 and then discounted for present values. This was then to be added to the NPV calculated in part (a) to get a final picture. The initial outflow of excess amount was missing in most of the answers. Correct compounding of return for the two years was also not carried out by majority of the students.

(THE END)