THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

EXAMINERS' COMMENTS

SUBJECT	SESSION
Business Finance Decisions	Final Examination - Winter 2007

Overall Feedback

The questions were generally easy and mostly pertained to the topics which have been tested many times in the recent past. Inspite of that, the candidates did not perform well in this paper. Many seemed to lack knowledge of even the basic concepts of financial management.

The concepts of discounting cash flows is extremely important in the study of this subject and in most questions this concept is involved in some way or the other. However, it was commonly observed that in most of the scripts, the layout and presentation of answers related to discounted cash flow left much to be desired. Besides frequent errors, duplication and unnecessary calculations were witnessed in a number of scripts.

Question-wise Comments:

Q.1   This was an easy question about valuation of ordinary shares based on the Free Cash Flow (FCF) growth model and many students were able to attempt it well. However, a large number failed to do this simple question also. The students who performed badly could be categorized as follows:

(i)   Those who did not know anything about the concept of free cash flows.

(ii)   Those who knew the concept but perhaps due to lack of practice or lack of adequate preparation, made numerous mistakes.

Students in the first category, made basic types of mistakes such as:

- Deducted interest for arriving at FCF.
- Ignored the increase/decrease in working capital and capital expenditures, in the calculation of FCF.

In the second category, the following types of mistakes were generally witnessed:

- Cost of equity was used for discounting purposes instead of using the weighted average cost of capital.
- In arriving at the value of equity, the market value of the debt (TFC's) should have been deducted from the total value of the company. In many cases this was ignored altogether whereas many students deducted the par value of debt instead of deducting the market value.

- Some students made the assumption that it was not possible to compute market value of TFC's from the given data. In fact, it could easily have been computed by first determining the par value (Interest paid/Coupon rate) and then taking 118.35% thereof.

Q.2 According to the question, the management of a company was considering whether to offer discount to the customers and also, whether to accept discount offered by the suppliers. In case of suppliers, two different types of credit terms were being offered i.e. credit terms for raw material were different from those offered by suppliers of finished goods. The question at this level, was very easy. However, for the benefit of those who could not perform well, it is specified that the methodology in each case was the same i.e.

- determine the amount of discount to be offered/availed.
- determine the additional financing cost or the savings in financial cost, due to change in the payment dates.
- for determining the discount, it was necessary to compute the amount of sales/purchases from the given data.

The errors which were mostly observed, were of the following types:

- Some students didn't understand the requirement of the question and analyzed the combined effect of all the three types of discounts, instead of assessing each of the three situations independently.
- Credit sales of Rs. 240 million was mostly computed correctly using the formula (Debtors/Debtor days x 360). Similarly, the purchases of finished goods were also computed correctly but many students failed to compute the raw material purchases of Rs. 120 million (Rs. 5.0 million x 24).
- While computing the cost of financing the examinees applied the rate of 13% on the gross amount of sale and purchases instead of applying it on the gross amount less the amount of discount given/availed.

Q.3 This question was based on the topic of foreign currency transactions. An importer of chemical was required to decide whether to take forward cover or not and in either case, whether to avail bulk discount or not (A total of four options). The payment was to be made in Hong Kong $ which was not quoted against Pak Rupees on the forward counter, however, forward rate of both currencies was quoted against US$. The examinees were required to evaluate each of the four options as described above.

The following types of mistakes were generally observed.

- It was mentioned in the question that minimum value of each order shall be HK $ 3,800,000. Hence the minimum quantity to be ordered should have been 50,000 kgs. Since the total annual demand was 100,000 kgs., there were only two options available with the Company i.e. place two orders during the year, each of 50,000 kgs or order the full quantity of 100,000 kgs in one order. Some students ignored this conditions and placed the first order for HK $ 7,000,000 (while considering the two options in which the bulk discount was to be availed) and the second order for the remaining quantity i.e. for HK $ 600,000.

- For determining the date of paymenty, two conditions were relevant i.e. delivery after 30 days of order and payment after 60 days from the date of delivery i.e. a total of 90 days after the order. Some students ignored the first condition and calculated incorrect dates of payment. Consequently, they resorted to interpolation, for determining the exchange rates.

- While using the forward rates, a number of students used the selling rate instead of the buying rate and vice versa.

- After determining the amount payable under each option, the students were required to compute the present value (or future value) at a certain date, for each of the two options and then to select the option with the lowest present/future value. A large number of the examinees were able to compute the amount payable under different options but failed to compute the present (or future) value for comparison purposes.

Q.4   (a)   According to the given situation, a company had purchased bonds carrying an option to convert these into five ordinary shares. The option was exercisable after three years. This part of the question required computation of minimum growth rate in market price of the shares at which the company may decide to exercise the conversion option. Most candidates were able to develop their answers correctly by computing the future value of the cash flows associated with the bond and then determining the rate of increase in share price, at which the price of 5 shares will equal the future value calculated above.

(b)   The answer to this part of the question was very simple but most students got confused and made all sort of lengthy calculations which were not required. The present value of the inflows from the bonds in the last two options was Rs. 127 i.e. equal to the market value of the bonds. The calculation of cash flows associated with the first option i.e. holding bonds till redemption, required computation of net present value of cash flows from interest payments (net of tax) and redemption. Common mistakes were as follows:

- Tax implications on cash flows were not considered.
- Some students applied tax on the gain arising from the redemption of bonds although capital gains were exempt.
- Most of the candidates did not conclude which option was feasible.
- The students generally failed to give reasons in support of their conclusion.

Q.5   This was a comprehensive question which examined the decision making ability of the students with regard to the concept of relevant costs. It seemed that the students after seeing the length of the question attempted it half heartedly. Although the question was slightly lengthy as compared to the other questions of the paper but it was not difficult and the students could have gained good marks had they been able to apply their knowledge logically and planned the presentation of the answer properly.

Common mistakes observed were as follows:

- This question may have been solved either by considering the incremental cash flows under each option or working out the total cash flows in accordance with the conditions applicable to each option. Many students got mixed up and ended up using both methods simultaneously.

- The concept of relevant costs was generally lacking and most students excluded the costs allocated to Cee without allocating them to the other products. On the other hand directly attributable fixed costs were included in costs inspite of the discontinuance of the production of Cee.

- Many candidates computed the contribution margin of product Cee and Dee and considered it as the minimum rent. They ignored the other cash flows and their tax effects.

- As regards both the options, it was clearly mentioned that the premises will be rented for one year only. Still, many students included insurance costs of Rs. 650 thousand in each of the following five years.

- In option no. 2, many candidates ignored the cash flows from the sale of existing plant and assets related to product Cee.

- In many cases, the net cash flows were also used for calculating tax effect without considering the impact of depreciation. In some cases, the reverse situation was also witnessed i.e. profit/loss inclusive of depreciation was treated as cash flows.

- Many students calculated the cash flows for year 1 only and applied the same on year 2 to 5 also.

Q.6   This was a straight forward question requiring valuation of shares through dividend growth model. The knowledge of the examinees as regards market efficiency was also tested. This question was generally well attempted and lot of students developed the correct approach to its solution. However, following common errors were observed in many scripts:

- Many candidates incorrectly used the company's overall beta in the CAPM computation instead of equity beta.
- Many candidates were unaware as to how they should estimate the present value of dividends till perpetuity. Some of them used incorrect formulas whereas many others computed present values of dividends for the next few years (mostly 6 to 10 years) and ignored the rest.
- Most students did not know the difference between Semi-Strong Form Efficient Market and Strong Form Efficient Market. In the given scenario, if the market was Strong Form Efficient the investors would be in a position to know that the company would be earning high profit (20%) in the next two years. On the other hand, if the market was Semi Strong Form Efficient this knowledge would not be available with general investors and consequently the market price would be lower.

THE END