The Institute of Chartered Accountants of Pakistan

Business Finance Decisions

Final Examination	4 December 2013
Winter 2013	100 marks - 3 hours
Module F	Additional reading time - 15 minutes

Q.1 Premier Airline Company Limited (PACL) has incurred losses during the past several years. Recently, a new management team has taken over the operations of PACL. The new management has observed that there is substantial over-staffing in the non-core functions. The excess staff is also being paid overtime under the union's pressure. The preliminary findings have revealed the following information about employees engaged in non-core functions:

Non-core functions	No. of staff	Average annual staff cost per head (including 25% overtime allowance) *1	Departmental overheads (variable)
		(Rs.)	(Rs.)
Flight kitchen staff	100	390,000	30,356,097
Janitorial staff	120	240,000	-
Van drivers	80	360,000	12,000,000
Other support staff	150*2	270,000	-

*1 *basic salary constitutes 75% of gross salary excluding overtime*
*2 *number of other support staff is 3 times of the actual requirements*

In order to resolve the problem, a committee consisting of HR and finance professionals has proposed the following scheme of restructuring :

- Flight kitchen may be outsourced to a leading hotel chain which would provide in-flight meals at an average cost of Rs 350 per meal. About 150,000 meal servings are required annually.
- The required support staff may be provided by an independent human resource management company at a rate equivalent to existing gross salaries plus 15%.
- Janitorial services may be outsourced to a firm at an annual contract price of Rs. 12,000,000.
- A transport service provider may be engaged to provide the required number of vehicles with drivers at monthly rental of Rs. 45,000 per vehicle. The present fleet which comprises of 40 vehicles, would be disposed of.
- Golden Handshake Plan (GHP) in the form of 36 basic salaries would be offered to the redundant staff.

The committee has indicated that the labour union may agitate strongly against the restructuring proposal which may create difficulties in the implementation of the scheme. Therefore, only 20% of the staff is expected to avail the GHP facility when the scheme becomes effective. The remaining 80% staff is expected to opt for GHP at the end of first year (40% probability) or at the end of 2nd year (60% probability). On the commencement of the scheme, such staff would be transferred to a surplus pool.

Company's cost of capital is 15%.

Required:
Evaluate the financial feasibility of the above restructuring scheme in terms of net present value. **(23)**

Q.2 After the increase in tax rates for salaried individuals in the Finance Act, 2013, the executives of Supreme Group of Companies (SGC) has requested the management to provide them with company maintained cars in lieu of car allowances to reduce the tax burden.

The relevant information regarding the staff in management cadre is as follows:

Management cadre	Head count	Car allowance (Rs.)
Senior Manager	80	40,000
DGM	16	65,000
GM	8	90,000

A survey of similar companies has revealed that on average, their car policies involve the following:

Management cadre	Car entitlement	Maximum value of car (Rs.)	Monthly estimated fuel reimbursement (Rs.)	Monthly maintenance allowance (Rs.)
Senior Manager	1000cc	1,000,000	15,000	5000
DGM	1300cc	1,500,000	20,000	7000
GM	1800cc	2,000,000	25,000	10000

The finance department has informed that the cars can be obtained from a leasing company under the following terms and conditions:

IRR	12%
Lease period	5 years, rent payable on monthly basis
Insurance	3% annually on cost of vehicle payable in equal monthly installments
Down payment	10% of cost
Residual value	20% of cost at which employee would be able to purchase the car at the end of the lease period

SGC can obtain financing from the bank at the rate of 13% per annum.

Required:
Advise whether it would be worthwhile for the company to adopt the proposed vehicle policy. Substantiate your answer with all necessary calculations. **(15)**

Q.3 Finest Holding Company Limited (FHCL) carries out a number of inter-group transactions with its three foreign subsidiaries FAL, FBL and FCL which are located in Saudi Arabia, UAE and UK respectively. Details of receipts and payments which are due after approximately three months are as follows.

Paying Company	Receiving Company			
	FHCL (Pak)	FAL (SA)	FBL (UAE)	FCL (UK)
	-----------------------in million-----------------------			
FHCL (Pak)	-	SAR 4.21	AED 3.15	UK£ 0.98
FAL (SA)	Rs. 225.30	-	US$ 2.86	UK£ 1.64
FBL (UAE)	Rs. 105.80	US$ 1.85	-	-
FCL (UK)	UK£ 1.32	UK£ 2.10	-	-

The current spot exchange rates for each unit of foreign currency in equivalent Rupees are as follows:

Currency	Buy	Sell
US$	107.00	107.20
UK£	171.09	171.41
SAR	28.53	28.58
AED	29.13	29.19

Required:
Demonstrate how multilateral netting might be of benefit to FHCL. **(07)**

Q.4 The board of directors of Prime Automobile Limited (PAL) intends to raise Rs. 1,500 million for the company's expansion project which is expected to generate profit before interest and tax amounting to Rs. 325 million. Following options are under consideration of the Board:

Option I – 100% debt financing
Option II – debt and equity financing in the proportion of 50:50

Financial information from PAL's latest audited financial statements is presented below in a summarised form:

Summarized Statement of Financial Position

	Rs. in million
Non-current assets	2,358
Current assets	353
Total assets	**2,711**
Share capital (Rs. 10 each)	750
Reserves	913
14% term finance certificates (Rs. 100 each)	526
Current liabilities	522
Capital and liabilities	**2,711**

Summarized income statement

	Rs. in million
Sales	1,544
Cost of goods sold	(949)
Gross profit	595
Admin. & selling expense	(63)
Operating profit	532
Interest expense	(80)
Profit before tax	452
Tax	(155)
Profit after tax	297

Profit on TFCs are payable on half yearly basis. TFCs are currently being traded at Rs. 98 each and are to be redeemed at the end of 3rd year.

PAL has proposed a cash dividend of 30% and issuance of 10% bonus shares to its shareholders. PAL's shares are currently being traded at Rs. 30 (cum dividend).

The average ungeared beta of companies associated with similar business is 1.20. KSE 100 Index can be considered as a representative of market return which has moved from 15530 to 18325 points during the last year. 1-year treasury bills are currently being offered at 11% per annum.

Tax rate applicable to the company is 30%.

Required:

(a) Determine whether PAL has the borrowing capacity to raise the entire investment through debt sources as per the Prudential Regulations which requires a minimum debt equity ratio of 60:40. **(03)**

(b) Compute the existing weighted average cost of capital of PAL. **(05)**

(c) Compute the revised weighted average cost of capital of PAL under each of the two financing options, assuming that the effective cost of existing and new debt would increase as follows:
- Option I – by 200 basis points **(05)**
- Option II – by 100 basis points **(05)**

(d) Advise which of the above options would maximize the shareholders' value. **(04)**

Q.5 (a) Differentiate between conservative and aggressive strategies for financing the working capital requirements. What actions should a company take if it decides to follow aggressive working capital strategy? **(07)**

(b) Top Generators Pakistan Limited (TGPL) is a medium size company which imports and sells a leading brand of generators. Presently, TGPL's board of directors is considering to acquire a plant from China to manufacture a different brand of generators. The acquisition, installation and commissioning of the plant would result in estimated cash outflows of Rs. 600 million. The plant is expected to become operational in 6- 8 months.

TGPL's bankers have agreed to provide long-term financing for the acquisition of plant, to the extent of Rs. 300 million. The balance amount is proposed to be raised by revising its working capital strategy.

TGPL presently follows a conservative policy in the management of its working capital. Projected assets and liabilities at the end of the current year are as follows:

	Rs in 000
Property, plant and equipment	187,500
Trade debtors	375,000
Stock in trade	300,000
Cash and bank	75,000
Trade creditors	(210,000)
Short-term borrowings	(127,500)

The effect of adopting the proposed working capital strategy, would be as follows:

Decrease in trade debtors	20%
Decrease in stock in trade	30%
Decrease in cash and bank	75%
Increase in trade creditors	40%
Increase in short-term borrowings	30%

The short-term borrowings limit available to the company is Rs. 200 million. The bankers have informed that they would consider increasing this facility after the new plant would commence operations.

Required
Being the CFO of the company, prepare a report for the board of directors analyzing and discussing the proposed financing strategy and its consequences on the business prospects of the company. **(12)**
Marks for analytical clarity and logical presentation of the report **(02)**

Q.6 Paramount Industries Limited (PIL) has identified three projects for investment purposes. Due to shortage of funds, PIL can opt for only one of the identified projects. Details of returns and standard deviation of returns from existing operations and proposed investments are as follows:

Description	**Average annual returns**	**Standard deviation of returns**	**Co-relation of returns with existing operations**	**Ratio of existing operations with proposed investment**
Existing operations	17%	25%	-	-
Project A	11%	17%	0.20	85:15
Project B	20%	30%	0.10	80:20
Project C	14%	28%	0.30	90:10

Market returns are 12% with a standard deviation of 19%.

Required:
Determine the most beneficial project for investment. **(12)**

(THE END)