THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

EXAMINERS' COMMENTS

SUBJECT	**SESSION**
Business Finance Decisions	Final Examination - Summer 2008

Overall Feedback

It was an easy paper and most of the questions were set from the core topics of the subject and similar type of questions have been asked many times in the previous examinations. However, overall performance of students was not satisfactory. One of the main reason of this unsatisfactory performance is selective study. It has now become a regular feature of the student's performance that they perform quiet well in two or three questions while their performance in the remaining questions remains far below the required standard.

Question-wise comments:

Q.1 This question examined the students understanding on portfolio theory. A large number of candidates were able to calculate the portfolio beta and required rate of return on each security by using the CAPM but failed to perform well in part (b) of this question.

Following common mistakes were noted:

<u>Part (a)</u>

While calculating the portfolio beta, many candidates used market standard deviation as the denominator instead of using market variance.

<u>Part (b)</u>

- A large number of candidates were totally ignorant of the method of calculation of estimated price at the end of the year i.e. December 31, 2008. They simply used the following incorrect formula:

  Price on December 31 = Price on Ist January x (1+ dividend yield percentage).

- A large number of candidates worked out portfolio beta on the investment value as at January 1, 2008 instead of calculating it on the basis of estimated value at December 31, 2008.

- Some students incorrectly calculated the portfolio beta by simply adding the betas of each security instead of taking the weighted average of the various betas based on the estimated values as at December 31, 2008.

- Total return on the portfolio is equal to the total of the return on each security. While calculating the estimated total return on the security, many candidates applied the respective dividend yields on the value of security and ignored the capital gain which is also an important part of the total return.

Q.2 An average performance was witnessed in this question which required computation of market value of shares and TFCs, and weighted average cost of capital of the company. Many candidates were able to calculate the market price of shares and WACC but most of them failed to compute the market price of TFCs.

Common mistakes observed were as follows:

- The current expected dividend of Rs. 1.375 (1.25 x 110%) was ignored while calculating the value of shares.

- For computing market value of TFCs, the coupon rate i.e. 6% was used for discounting instead of prevailing commercial rate for similar risk bonds i.e. 11%.

- Some candidates deducted tax of 35% while computing the coupon payment. They failed to realize that the tax rate of 35% is applicable to the company whereas the price of TFC's in the market is related to the return which the TFC holder receives. On the other hand, while computing the WACC, the tax shield available to the company on interest payment was ignored.

- Many candidates ignored the short term loan while calculating the WACC.

- A large number of candidates assumed Rs. 100 as the redemption value of the TFCs. In fact, it was clearly mentioned in the question that the company's IRR on this project is 10% and it is the policy of the company that TFCs are carried at amortized cost. The redemption price of TFCs should have been worked out on the basis of the above information.

Q.3 It was a straight question based on Modigiliani and Miller theory. A basic assumption in the theory is that the value of a levered firm is equal to the value of unlevered firm plus the tax savings on debt. Most of the candidates ignored the effect of tax savings while computing the minimum amount of equity to be raised. It was evident that they had not studied this important theory.

Other mistakes which were commonly witnessed in many answer scripts were as follows:

1. While determining the total market value of the company after the investment, the NPV of the new project was ignored.

2. In part (b) of the question a vast majority of the students arbitrarily declared that the right share should be issued at the market price prevailing in the market i.e. Rs. 16.80 per share. They failed to realize that this price would fail to meet the other conditions i.e. the price after issue of right shares would be different from the current market price.

In order to determine the issue price at which the market price would remain the same, they should have followed the steps mentioned hereunder:

(i) Compute the total value of Company's equity after issuance of right shares by adding the following

- Current equity of Rs. 672 million.
- Equity to be issued as determined in reply to part (a) of the question.
- NPV of the new project (un-geared).
- Benefit of tax shield on debt funding.

(ii) Divide the value determined in (i) above with the current market value i.e. Rs. 16.80, to arrive at the total number of shares of the company after the right issue.

(iii) Deduct the existing shares from the total number of shares determined in (ii) above to arrive at the number of right shares to be issued to the existing shareholders.

(iv) Divide the minimum amount of equity to be raised, by the right shares worked out in (iii) above, to determine the required price of right issue i.e. which will maintain the current market price of the company's shares.

3. Most of the candidates were unable to determine the market price of the company if the right issue is made at Rs.14 per share. In this part, the candidates should have taken the following steps:

(i) Divide the minimum equity determined in part (a) of the question by Rs. 14, to determine the number of right shares to be issued to the existing shareholders.

(ii) Divide the new equity as determined in para 2(i) above by the total number of shares after the right issue, to determine the market price after right issue.

Q.4 This was the easiest question of the paper requiring a comparison between two options i.e. financing through bank loan or lease. Many students were able to secure good marks. The salient features of the candidates' performance are described hereunder:

(i) Most of the candidates were able to compute the net present value if the company opts to get the machine on lease. However, the following mistakes were also witnessed:

- It was clearly mentioned in the question that insurance costs would be borne by the lessor. Still many candidates included it in the total outflows.

- Surprisingly, some candidates charged tax depreciation on leased assets. Obviously such errors are not expected at the final level.

(ii) While computing the NPV in case of bank loan, many students committed one or more of the following mistakes:

- Many candidates could not work out the amount of installments. They omitted the repayment of principal from the outflows and computed NPV on the basis of other inflows/outflows.

- Few candidates provided the tax shield on the whole installment instead of providing it only on interest.

- Tax benefit/loss on sale of machine, at the end of useful life, was ignored.

- The full amount of tax loss on sale of machine was considered as a tax shield instead of applying the tax rate on the amount of loss.

- Many candidates used the bank interest rate of 11% for the purpose of discounting instead of using the WACC i.e. 14%.

- Many candidates did not give their final recommendation.

Q.5 (a) In this question the candidates were required to prepare a brief report discussing the feasibility of a de-merger scheme. Overall performance of the candidates was not satisfactory. Following common mistakes were observed in the answer scripts:

- The depreciation deducted for computing profit before tax and the tax shield, should have been added back to arrive at the projected cash flows. Many students failed to do so and took the profit before tax as the outflow.

- One time de-merger costs were ignored while calculating the net cash flows.

- The knowledge regarding incorporation of inflation adjustment in the discount rate was generally lacking. Consequently, the impact of inflation was quite often ignored.

- The values of both the companies were worked out by discounting their net cash flows but no comparison was made with the existing market value of HL Limited and consequently the final recommendations and the impact of the de-merger scheme on the company's shareholders was generally missing.

(b) In this part most candidates were unable to give the additional information which could have been useful in making a final decision in the situation discussed in Part (a) of the question. Some of the information that could have been useful in the analysis, includes the following:

- Risk profiles of the company (ies).
- The uncertainties involved and their expected impact.
- Impact on the companies' ability to negotiate with suppliers and financial institutions.
- Further details of items included in the projected Profit and Loss Accounts.

Q.6 It was a straight forward question on the application of correct exchange rates. A large number of students secured good marks in part (a) of this question. However, the performance in part (b) and (c) was below par.

It was commonly noted in all parts of this question that students erred a lot in applying the exchange rate. For example, in the case of purchase, they used the buying rate applicable to Thai Bhat instead of the Selling rate and in the case of sale, they used selling rate of US $ instead of its buying rate.

The other common mistakes were as follows:

- Many candidates were totally ignorant of the method of solving the question. Some of them tried to compute the gain by taking the difference between spot rates and forward rates and applying the difference in rates on the amount of currencies purchased and sold. Obviously, they could not get anywhere near the correct answer.

- In part (b), the candidates were required to cancel the forward purchase contract maturing in July and the forward sale contract which was maturing in August and cover the September purchases and October sales through new contracts. Very few of the students performed these steps.

- The above type of error was also made in response to Part (c) of the question.

- Many candidates who otherwise performed well, ignored the commission costs. Some students worked out the purchases and sales but did not bother to calculate the profit.

(THE END)