

CA



THE INSTITUTE OF  
**CHARTERED** ACCOUNTANTS  
OF SRI LANKA

# **SUGGESTED SOLUTIONS**

**KC2 – Corporate Finance & Risk  
Management**

**December 2015**

## Answer 01

| Relevant Learning Outcome/s: |   |
|------------------------------|---|
| 4.1.1                        | Analyse the capital budgeting process (including searching for investments, strategic prioritisation, identifying investment, investment appraisal, authorisation, capital budget, monitoring and review) |
| 6.2.1                        | Assess different tools/strategies to mitigate each of the risks identified above.   |

### Suggested detailed answer

(a)

| Option A   |  |
|--|--|
| Pros   | Cons   |
| Carries the lowest risk out of all the three options                         | No future cash inflows on usage of machine. Therefore, relatively low returns of the actual usage of X-ray machines increase in the future |
| Cash would be collected upfront at a 25% mark-up from the Ministry of Health |  |
| Cash inflows on the O&M agreement for 5 years                                |  |

| Option B   |   |
|--|---|
| Pros   | Cons  |
| Variable income streams correlate to the actual usage of the machine | Riskier than Option A as the O&M warranty would be the responsibility of Gamma  |
|  | No upfront cash - time value of money would decrease. The cost to be paid to the principal ownership would be with Gamma (risks & rewards of machine) |

| Option C   |   |
|--|---|
| Pros   | Cons  |
| Riskier than Option A, but less riskier than Option B  | Warranty/O&M to be done by Gamma during $Y_1 - Y_3$ . |
| Variable income stream depending on the actual charge of X-ray films, plus service from $Y_4 - Y_5$  | No upfront cash - time value of money would decrease. |
| The most important advantages of BOOT are: utilisation of private sector's investment instead of public sector's, transferring all the risk to the private sector. Transferring of technical knowledge is one of the |   |

most important benefits of this method for developing countries. Political resistance in using the private sector is less than other methods because the project will be owned by the government eventually.

(6 marks)

(b) X-ray machine USD 35,000 → Rs. 4,900,000

|                    |                  |
|--------------------|------------------|
| Freight (0.5%)     | 24,500           |
| Insurance (USD750) | <u>105,000</u>   |
| CIF                | 5,029,500        |
| Mark-up (25%)      | <u>1,257,375</u> |
| Value              | <u>6,286,875</u> |

∴ 200 machines → Rs. 1,257,375,000

| <b>Option A</b>  | <b>(Rs. million)</b> |       |       |       |       |       |
|------------------|----------------------|-------|-------|-------|-------|-------|
| Year             | 0                    | 1     | 2     | 3     | 4     | 5     |
| Cost of machines | (1,005.90)           |       |       |       |       |       |
| Sale proceeds    | 1,257.38             |       |       |       |       |       |
| O&M              |                      | 62.87 | 64.44 | 66.05 | 67.70 | 69.40 |
| Total cash flows | 251.48               | 62.87 | 64.44 | 66.05 | 67.70 | 69.40 |
| DF (15%)         | 1.000                | 0.869 | 0.756 | 0.658 | 0.572 | 0.497 |
| PV               | 251.48               | 54.63 | 48.72 | 43.46 | 38.73 | 34.49 |
| <b>NPV</b>       | <b>471.50</b>        |       |       |       |       |       |

| <b>Option B</b>          | <b>(Rs. million)</b> |        |        |        |        |        |
|--------------------------|----------------------|--------|--------|--------|--------|--------|
|                          | 0                    | 1      | 2      | 3      | 4      | 5      |
| Cost of machines         | (1,005.90)           |        |        |        |        |        |
| Spare parts              | (100.59)             |        |        |        |        |        |
| Service                  |                      |        |        | (4.20) | (4.20) | (4.20) |
| Scan income (Working 01) |                      | 262.8  | 331.13 | 405.63 | 486.76 | 638.87 |
| NCF                      | (1,106.49)           | 262.80 | 331.13 | 401.43 | 482.56 | 634.67 |
| DF (15%)                 | 1.000                | 0.869  | 0.756  | 0.658  | 0.572  | 0.497  |
| PV                       | (1,106.49)           | 228.37 | 250.33 | 264.14 | 276.02 | 315.43 |
| <b>NPV</b>               | <b>227.81</b>        |        |        |        |        |        |

| <b>Option C</b>          | <b>(Rs. million)</b> |        |        |        |       |       |
|--------------------------|----------------------|--------|--------|--------|-------|-------|
|                          | 0                    | 1      | 2      | 3      | 4     | 5     |
| Cost of machines         | (1,005.90)           |        |        |        |       |       |
| Spare parts              | (50.30)              |        |        |        |       |       |
| Service                  |                      |        |        |        | 4.90  | 4.90  |
| Scan income (Working 02) |                      | 438    | 578.16 | 741.97 | -     | -     |
| NCF                      | (1,056.20)           | 438.00 | 578.16 | 741.97 | 4.90  | 4.90  |
| DF (15%)                 | 1.000                | 0.869  | 0.756  | 0.658  | 0.572 | 0.497 |
| PV                       | (1,056.20)           | 380.62 | 437.09 | 488.22 | 2.80  | 2.44  |
| NPV                      | <b>254.97</b>        |        |        |        |       |       |

| <b>Working 01 - Scan income</b>   |              |               |               |               |               |
|-----------------------------------|--------------|---------------|---------------|---------------|---------------|
| Year                              | 1            | 2             | 3             | 4             | 5             |
| No. of scans per hour per machine | 5            | 6             | 7             | 8             | 10            |
| No. of scans per day per machine  | 120          | 144           | 168           | 192           | 240           |
| No. of scans per year per machine | 43,800       | 52,560        | 61,320        | 70,080        | 87,600        |
| Total no. of scans                | 8,760,000    | 10,512,000    | 12,264,000    | 14,016,000    | 17,520,000    |
| Charge per scan (Rs.)             | 30.00        | 31.50         | 33.08         | 34.73         | 36.47         |
| Income (Rs. million)              | <b>262.8</b> | <b>331.13</b> | <b>405.63</b> | <b>486.76</b> | <b>638.87</b> |
|                                   |              |               |               |               |               |
| <b>Working 02</b>                 |              |               |               |               |               |
| Year                              | 1            | 2             | 3             |               |               |
| Charge per scan (Rs.)             | 50           | 55            | 60.5          |               |               |
|                                   |              |               |               |               |               |
| Income (Rs. million)              | <b>438</b>   | <b>578.16</b> | <b>741.97</b> |               |               |

Option A should be selected as it has the highest NPV.

(15 marks)

- (c) Securitization is the transformation of illiquid assets into a security. It involves taking a relatively illiquid asset, or a group of assets, and transforming it into a more identifiable, secure and liquid security through financial engineering. This improves economic efficiency and enhances liquidity. Conceptually, asset securitisation converts regular and classifiable cash flows from a diversified portfolio of illiquid present or future receivables. Thus, securitisation serves, as a refinancing mechanism to diversify external sources of asset funding and to transfer specific risk exposures asset securitisation would offer an interesting funding alternative to traditional channels of external finance captive to a pernicious bank-based financial system.

Securitization transactions often issue pass-through securities whose repayment obligations effectively match the repayment characteristics of the underlying assets (promotes managing and matching asset/liability profiles). Asset securitisation is one operational means of risk management, which allows issuers to reallocate, commodities and transfer different types of risks (e.g. credit risk, interest rate risk, liquidity risk or pricing risk) to capital market investors in return for some fair market price. While banks and other financial institutions view securitisation as an expedient means to evade inconsistent regulatory capital charges for credit exposures of similar risk (“optimisation of regulatory capital”), non-financial entities would employ securitisation primarily for the liquidity management of existing trade receivables. Securitization arises from the flexibility available in transforming cash flows and risks of the collateral pool into those of the securities issued on the pool. For example, creative use of credit enhancements allows relatively poor-quality receivables to be transformed into some tranches of high credit quality and other tranches of low credit quality. Similarly, it is possible to carve out long-term, non-revolving securities from short-term, revolving credit card receivables. Accordingly, securitization of assets can lower risk, enhance liquidity, and reduce cost of funds.

(4 marks)

**(Total: 25 marks)**

## Answer 02

| Relevant Learning Outcome/s: |  |
|------------------------------|--|
| 5.2.1                        | Evaluate business valuation techniques (asset based, earnings based, proxy PE base, cash flow based) for a specific merger or acquisition or divestment.   |
| 1.1.1                        | Discuss appropriate strategic objectives, both financial and non-financial, for different types of organisations (profit maximisation, wealth miximisation, value for money, balanced scorecard) and how these objectives can assist in meeting the corporate goals of such organisations. |
| 2.2.1                        | Evaluate working capital requirements and investment decisions using working capital cycle and permanent and temporary working capital estimations.  |
| 2.2.2                        | Evaluate the appropriateness of different working capital financing policies.  |

### Suggested detailed answer

$$\begin{aligned} \text{(a) (i) Economic Value Added (EVA)} &= \text{NOPAT} - (\text{Invested capital} * \text{WACC}) \\ &= 26,640 - (63,000 * 0.133) \\ &= 26,640 - 8,379 \\ &= \mathbf{18,261} \end{aligned}$$

$$\begin{aligned} \text{WACC} &= \frac{30,000}{63,000} * 0.2 + \frac{33,000}{63,000} * 0.1 * (1-0.28) \\ &= 0.48 * 0.2 + 0.52 * 0.072 \\ &= 0.096 + 0.037 \\ &= 0.133 \\ &= 13.30\% \end{aligned}$$

Note: Answers, which considered the book value of debts as Rs. 70,000, also gained two marks.

$$\begin{aligned} \text{Market Value Added (MVA)} &= 63,000 - 53,000 \\ &= 10,000 \end{aligned}$$

### Alternatively

$$\text{MVA} = 30,000 - 20,000 = 10,000$$

(6 marks)

### (ii) Destroyers of shareholder value

Creating shareholder value is a fundamental requirement for all companies. Therefore, most of the leading companies adopt a mantra of shareholder value to meet the increasing expectations of shareholders.

Fundamentals and valuation metrics are used in traditional and value-based approaches to equity securities analysis. In the traditional realm, growth rates, margins, return on equity, multiples, and the fundamental stock return are at the core. However, the traditional approach has a number of limitations. Focus is now moving away from classic attempts to model earnings based returns and assessments based on growth expectations, cash flow return on invested capital, and risk. In response to the changing concerns of institutional investors, equity analysts at securities firms are also revising their approaches to value analysis, such as EVA and MVA.

Economic Value Added (EVA) is the difference between the company's net operating profits after taxes and the cost of capital employed in generating those profits in a financial year. If EVA is positive, the company creates shareholder wealth and if EVA is negative then the shareholders' wealth is destroyed. EVA is a better measure of performance as it includes various aspects in calculating value than other performance measures such as ROI, ROE, EPS, etc.

Another performance measure that can be used in conjunction with EVA is MVA. MVA is defined as the difference between the total market value of debt and equity of a company and its invested capital. MVA is also equal to the market's estimate of the NPV of all future EVA. MVA indicates how much a company has created or destroyed in terms of shareholder capital. Successful companies will generate a positive MVA.

(4 marks)

(iii)

|                           | <b>Rs. '000</b> |
|---------------------------|-----------------|
| Profit after tax for 2016 | <u>24,840</u>   |
| Retain (60%)              | 14,904          |
| Dividend (40%)            | 9,936           |
| 10% to employees          | 993.6           |

**Alternatively**

|  | <b>Rs. '000</b> |
|--|-----------------|
| Profit after tax for 2016                      | <u>24,840</u>   |
| Retain (60%)                                   | 14,904          |
| Dividend (40%)                                 | 9,936           |
| Dividend to employees<br>( <u>9,936 * 10</u> ) | <b>903.2</b>    |
| 110  |                 |

(3 marks)

(b) (i) **Summary**

|                                | <b>Working capital investment policy</b> |                 |                   |
|--------------------------------|--|-----------------|-------------------|
|                                | <b>Conservative</b>                      | <b>Moderate</b> | <b>Aggressive</b> |
| Current assets                 | 34,000                                   | 29,000          | 19,800            |
| Fixed assets                   | 25,000                                   | 25,000          | 25,000            |
| Total assets                   | 59,000                                   | 54,000          | 44,800            |
| Current liabilities            | 18,000                                   | 18,000          | 18,000            |
| Estimated sales                | 94,500                                   | 87,900          | 76,500            |
| EBIT                           | 9,400                                    | 8,700           | 7,700             |
| Current ratio                  | 1.889                                    | 1.611           | 1.1               |
| Rate of return on total assets | 0.1593                                   | 0.1611          | 0.1719            |
| Net working capital position   | 16,000                                   | 11,000          | 1,800             |
| Current assets to fixed assets | 1.36                                     | 1.16            | 0.79              |

The net working capital or current ratio indicates the risk element while the rate of return shows the return (measure of return).

At the conservative level, risk is low but so is the return. Similarly, at the aggressive level risk is high but so is the return. The company should decide on the suitable level to operate by looking at the risk appetite of the owners and the market return.

(7 marks)

(ii) **Importance of Supply Chain Finance**

Many companies lag when it comes to their forecast and demand management capabilities. As a result, they have excess inventory leading to excessive costs and their service levels are lower than desired. They also suffer from an inability to adapt quickly enough to changes in supply chain demand, and poorly defined and inconsistent processes.

The key concept behind supply chain finance (SCF) is to provide suppliers with access to advantageous financing facilities by leveraging the buyer's stronger credit rating.

Forward-thinking companies are increasingly turning to outsourcing to improve the performance and cost management of their supply chains. This approach can help companies prepare for new economic realities by enabling them to respond to near-term cost pressures, while adopting intelligent long-term approaches that support the entire business far into the future. It forces many companies to better manage liquidity and strengthen their balance sheet. SCF can often be an attractive way for companies to improve their working capital position. Thus, the buyer can benefit from longer supplier payment terms and a reliable, financially robust supply chain.

(5 marks)

**(Total: 25 marks)**



## Answer 03

| Relevant Learning Outcome/s: |  |
|------------------------------|--|
| 2.4.1                        | Discuss debt financing methods available (including bank loans, bonds, debentures, securitizations, commercial papers, debt sweeteners (convertibles and warrants), senior vs junior debt and international bonds. |
| 2.4.2                        | Assess the value (interest yields) of undated bond/irredeemable debt and the value (yield to maturity) of dated bond/redeemable debt.  |
| 6.2.2                        | Assess various types of financial derivatives (including forward contracts future swaps and options)   |
| 2.3                          | Equity financing   |
| 5.2.3                        | Recommend appropriate valuation and terms, taking into account financial and strategic implications for a specific merger or acquisition or divestment.  |
| 3.1.1                        | Discuss different dividend policies, taking into account factors such as cliental effect, leverage and capital requirements, solvency ratios, tax considerations and Company Act pre-requirements.                 |

### Suggested detailed answer

- (a) (i) When a loan is obtained in foreign currency, a company should calculate the reporting currency equivalent cost of the debt. There are a few elements that would impact the real cost of debt in rupees in the given scenario.
- USD interest rate
  - Repayment period and pattern
  - Exchange rates

Therefore application of the local currency denominated loan cost would not be appropriate when calculating the real cost of debt.

(3 marks)

- (ii) The suggested rupee equivalent cost of debt would be as follows:

Annual installment formula to use

$$P = \frac{r(PV)}{1 - (1 + r)^{-n}}$$

*P = Payment*

*PV = Present Value*

*r = rate per period*

*n = number of periods*

Base value: USD 600,000  
 Interest rate: 5.75%  
 Period: 6 years (equal installment)

Therefore the fixed installment = USD 121,065

Approximate NPV of loan schedule (Rs.)

| Year                         | 2008          | 2009     | 2010      | 2011      | 2012      | 2013      | 2014      | 2015      |
|------------------------------|---------------|----------|-----------|-----------|-----------|-----------|-----------|-----------|
| Loan value (USD)             | 600,000       |          |           |           |           |           |           |           |
| Interest during grace period |               | (34,500) |           |           |           |           |           |           |
| Installment                  |               |          | (121,065) | (121,065) | (121,065) | (121,065) | (121,065) | (121,065) |
|                              | 600,000       | (34,500) | (121,065) | (121,065) | (121,065) | (121,065) | (121,065) | (121,065) |
| Exchange rate                | 109           | 115      | 122       | 129       | 137       | 145       | 153       | 162       |
| Loan value (Rs. million)     | 65.40         | (3.97)   | (14.77)   | (15.62)   | (16.59)   | (17.55)   | (18.52)   | (19.61)   |
| DF (10%)                     | 1.000         | 0.909    | 0.826     | 0.751     | 0.683     | 0.621     | 0.564     | 0.513     |
| PV                           | 65.40         | (3.61)   | (12.20)   | (11.73)   | (11.33)   | (10.90)   | (10.45)   | (10.06)   |
| <b>NPV at 10%</b>            | <b>(4.87)</b> |          |           |           |           |           |           |           |
|                              |               |          |           |           |           |           |           |           |
|                              |               |          |           |           |           |           |           |           |
| Loan value (Rs. million)     | 65.40         | (3.97)   | (14.77)   | (15.62)   | (16.59)   | (17.55)   | (18.52)   | (19.61)   |
| DF (15%)                     | 1.000         | 0.869    | 0.756     | 0.658     | 0.572     | 0.497     | 0.432     | 0.376     |
| PV                           | 65.40         | (3.45)   | (11.17)   | (10.28)   | (9.49)    | (8.72)    | (8.00)    | (7.37)    |
| <b>NPV at 15%</b>            | <b>6.92</b>   |          |           |           |           |           |           |           |

$$\text{IRR} = 0.1 + \frac{(4.87)}{(11.79)} * (0.15 - 0.10)$$

$$= 12.06\%$$

Therefore the suggested cost of the USD loan, which they should have applied in the initial phase of the WACC calculation, is 12% (rupees equivalent).

Alternatively,

$$\begin{aligned}\text{Interest} &= \text{LIBOR} + 1.5\% \\ &= 4.25 + 1.5 \\ &= 5.75\%\end{aligned}$$

Effect of exchange rate

$$\begin{aligned}162 &= 109 \times (1 + r)^7 \\ r &= 5.8\%\end{aligned}$$

Average exchange rate increase of 5.8%

∴ LKR depreciated rate of 5.8% annually.

$$\begin{aligned}\therefore \text{effective rate } k_d &= 1.0575 \times 1.058 - 1 \\ &= 1.1189 - 1 \\ &= 11.89\%\end{aligned}$$

(8 marks)

(b)

(i) Currency SWAP agreement

TSEL should have opted to go for a currency SWAP as detailed due to the reason that most of the settlements take place in Euros.

They could get into a currency agreement whereby the payment will be in Euros. In return, USD inflows would be built up, which can be used to serve the loan to a certain level and minimise any exchange losses.

The initial agreement will be signed in the notional principal in both currencies as below.

|                       |                                       |
|-----------------------|---------------------------------------|
| Initial loan value    | USD 600,000                           |
| 50% exposure          | USD 300,000 - Notional USD principal  |
| Equivalent Euro value | EUR 214,286 - Notional Euro principal |

The cash flows will be in the following manner:

|   | Year 0  | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6           |
|---|---------|--------|--------|--------|--------|--------|------------------|
| Notional principal in Euros                 | 214,286 |        |        |        |        |        |                  |
| TSEL will pay in Euros at 4% per annum      |         | 8,571  | 8,571  | 8,571  | 8,571  | 8,571  | 8,571 + 214,286  |
| Notional principal in USD                   | 300,000 |        |        |        |        |        |                  |
| TSEL will receive in USD at 5.75% per annum |         | 17,250 | 17,250 | 17,250 | 17,250 | 17,250 | 17,250 + 300,000 |

(5 marks)

- (ii) It is important for TSEL to monitor the mark-to-market value due to a several reasons.

If the exchange rates deviate significantly between the USD and Euro (from the base rate), it would have a material impact on the income statement on either side due to the exchange gain or loss when the cash flows are revalued at the spot rate for each payment. Also, at the maturity of the agreement, the settlement process would be subject to exchange rate exposure. Therefore, it is important to keep a track on the mark- to-market value and take prompt action.

In the event TSEL is not in a position to meet obligations due to certain reasons, they may go for an “unwinding swap”. It requires the settling party to factor future payments into their present value and settle them using an appropriate exchange rate (net payment). Generally, unwinding a SWAP is an expensive affair under normal circumstances.

(5 marks)

- (c) The nature of equity capital is such that they are the real owners of the company who take risks and rewards equally. When the business is making a loss, they are also responsible for the loss and should equally participate in the loss absorption.

Therefore Joe cannot agree on the following:

- Requesting for the same amount invested, as there is an impairment of the investment
- Interest for the holding period as equity holders do not deserve interest but dividends

(4 marks)

(d) **Valuation methods**

Asset based valuation methods

| <b>Net Assets Basis Valuation</b> |             |
|-----------------------------------|-------------|
|                                   | <b>2016</b> |
| On going concern basis            |             |
|                                   |             |
|                                   |             |
| Total Assets                      | 949,940     |
| Liabilities                       | 430,737     |
| Net assets (Rs,000)               | 519,203     |
| Number of shares                  | 5,500,000   |
|                                   |             |
| Value per share (Rs.)             | 94.40       |

**Discounted cash flow (DCF) method** (first 4-year cash flows)

|         | <b>(Rs. '000)</b> |                  |                       |                 |                |
|---------|-------------------|------------------|-----------------------|-----------------|----------------|
|         | <b>NOCF</b>       | <b>Tax (28%)</b> | <b>NOCF after tax</b> | <b>DF (12%)</b> | <b>PV</b>      |
| 2016/17 | 40,219            | (11,261)         | 28,958                | 0.893           | 25,859         |
| 2017/18 | 50,273            | (14,077)         | 36,197                | 0.797           | 28,849         |
| 2018/19 | 62,842            | (17,596)         | 45,246                | 0.712           | 32,215         |
| 2019/20 | 67,241            | (18,827)         | 48,413                | 0.636           | 30,791         |
|         |                   |                  |                       |                 | <b>117,714</b> |

Year 2020/21 onwards cash flows

2020/21      71,948      (20,145)      51,802

PV in perpetuity

2020/21      71,948      (20,145)      51,802

Applying the growth model

$51,802 / (0.12 - 0.07)$

= 1,036,045

1,036,045 \* 0.636

658,925

**Total**

**776,638.70**

|  |                |
|--|----------------|
| PV of loan payment (Rs. '000) (Working 01) | (206,067.54)   |
| PV of tax benefit (Rs. '000)( Working 02)  | 12,605.19      |
| Total                                      | 583,176,353.33 |
| No of shares                               | 5,500,000.00   |
| <b>Value per share</b>                     | <b>106.03</b>  |

| <b>Working 01 - PV of loan payment (Rs. million)</b> |       |                 |           |
|--|-------|-----------------|-----------|
|  |       | <b>DF (12%)</b> | <b>PV</b> |
| 2016/17  | 67.83 | 0.893           | (61)      |
| 2017/18  | 67.83 | 0.797           | (54)      |
| 2018/19  | 67.83 | 0.712           | (48)      |
| 2019/20  | 67.83 | 0.636           | (43)      |
|  |       |                 | (206.07)  |

| <b>Working 02 - PV of tax benefit (Rs. million)</b> |                 |                  |                 |           |
|---|-----------------|------------------|-----------------|-----------|
|   | <b>Interest</b> | <b>Tax (28%)</b> | <b>DF (12%)</b> | <b>PV</b> |
| 2016/17   | 20.83           | 5.8324           | 0.893           | 5.21      |
| 2017/18   | 17.83           | 4.9924           | 0.797           | 3.98      |
| 2018/19   | 12.83           | 3.5924           | 0.712           | 2.56      |
| 2019/20   | 4.83            | 1.3524           | 0.636           | 0.86      |
|   |                 |                  |                 | 12.61     |

### Summary of values

|                      | <b>Value per share (Rs.)</b> |
|----------------------|------------------------------|
| Net book value basis | 94.40                        |
| DCF method           | 106.03                       |

The above summary shows that Joe should negotiate within a price range of Rs. 94.40 to Rs. 106.03.

(10 marks)

(e) **The following synergies can be expected by BOBR once acquired**

Additional operational cash flows

|                             | <b>Year 1</b>   |
|-----------------------------|-----------------|
| <b>Operating cash flows</b> | <b>Rs. '000</b> |
| Additional sales income     | 12,000          |
| Cost savings                | 5,000           |
| Staff lay-off savings       | <u>1,400</u>    |
|                             | 18,400          |
| Tax (28%)                   | (5,152)         |
| Annual post tax cash flow   | 13,248          |

Additional non-recurring cash flows

|                                 | <b>Rs. '000</b> |               |               |               |
|---------------------------------|-----------------|---------------|---------------|---------------|
|                                 | <b>Year 0</b>   | <b>Year 1</b> | <b>Year 2</b> | <b>Year 3</b> |
| Director fees                   |                 | (1,728)       | (1,728)       | (1,728)       |
| Data processing termination fee |                 |               |               |               |
| Termination cost                | (2,000)         |               |               |               |
| Net cash flows                  | (2,000)         | (1,728)       | (1,728)       | (1,728)       |
| DF (12%)                        | 1.000           | 0.893         | 0.797         | 0.712         |
| PV                              | (2,000)         | (1,543)       | (1,377)       | (1,230)       |

Total cost benefit analysis

|                                       | <b>Rs. '000</b> |
|---------------------------------------|-----------------|
| NPV of non-recurring cash flows       | (6,151)         |
| Present value of recurring cash flows | 110,400         |
| NPV before merger plan                | <u>583,176</u>  |
| Total NPV                             | 687,425         |
| Number of shares in issue             | 5,500,000       |
| Value per share (Rs.)                 | 124.99          |

The best price that BOBR would come up with would be Rs. 124.99 per share. Therefore, anything more quoted by Joe would not be materialised from a rational perspective.

(10 marks)

(f) There are two main types of returns a shareholder can expect:

- Dividends
- Capital gain

A profitable and growing company may postpone dividends due to several reasons. The most common and widely visible reason is to fund business expansion into more profitable business lines.

How that would benefit shareholders is answered by the increasing stock price resulting from positive NPV projects. This will allow shareholders to sell shares in the market place and materialise the profit.

Therefore, zero dividend stocks should not be a cause for concern to shareholders unless such money is mismanaged by the top management of the company.

(5 marks)

**(Total: 50 marks)**



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