

Question Paper

Financial Management – II (MSF1B4): October 2007

- Answer all questions.
- Marks are indicated against each question.

1. A firm may need long term capital for various purposes while setting up a new project. But which of the following is **not** a long term use of fund? [< Answer >](#)

- (a) Buying miscellaneous fixed assets
- (b) Paying fee to the consultant
- (c) Buying raw-materials
- (d) Providing margin money for working capital
- (e) Providing for contingencies.

(1 mark)

2. Which of the following is/are **true** if a firm uses its short term funds for financing fixed assets? [< Answer >](#)

- I. This will result in serious asset-liability mismatch.
 - II. This will improve the liquidity position of the firm.
 - III. Since interest on long term borrowing is higher than short term borrowings, it will help reduce the financing cost and thereby increase profitability.
 - IV. This will lead to interest rate and liquidity risks.
- (a) Only (I) above
 - (b) Only (II) above
 - (c) Both (I) and (III) above
 - (d) Both (I) and (IV) above
 - (e) Both (II) and (III) above.

(1 mark)

3. Identify the statement which is **not true** regarding the right issue of shares? [< Answer >](#)

- (a) When a firm issues additional equity capital it has to first offer to the existing shareholders on a pro-rata basis
- (b) This right offer should be kept open for a period of 60 days
- (c) The shareholders can surrender the offer but cannot transfer it in favor of any other person
- (d) The cost of floating the right issue is comparatively less than that of public issue
- (e) The right issue is priced lower than public issue.

(1 mark)

4. Which of the following is **not** an advantage of private placement method of financing? [< Answer >](#)

- (a) Faster access to fund
- (b) Lower issue cost
- (c) Fewer procedural formalities
- (d) Widen the investor base
- (e) Easy access to any company.

(1 mark)

5. A debenture is a marketable contract whereby the company promises to repay the principal and interest at specified rate for a definite period to the owner on the specified date of maturity. Which of the following is **not true** regarding the issue of debenture? [< Answer >](#)

- (a) Debentures are usually secured by a charge on the immovable properties of the company
- (b) A trustee is usually appointed to ensure that the company fulfils its contractual obligations to the debenture holders
- (c) For debentures with maturity of more than 18 months, the company has to create a debenture redemption reserve
- (d) The debenture redemption reserve should atleast be half of the issue amount before the redemption commences
- (e) The company can attach a put option but not a call option to the debenture.

(1 mark)

6. Saroja Mills Ltd. has issued 10 percent preference shares with face value of Rs.100 redeemable at a premium of 5 percent after 10 years. The amount realized per share is Rs.95. The applicable tax rate is 40 percent. The cost of preference share to [< Answer >](#)

the company is

- (a) 10.00%
- (b) 10.50%
- (c) 11.00%
- (d) 11.05%
- (e) 19.05%.

(2 marks)

7. The following information is relating to Madhuri Coats Ltd.

[< Answer >](#)

Particulars	Year 1	Year 2	Year 3
DPS (Dividend Per Share)	Re.1.00	Re.1.50	Rs.2.00
Price per share at the beginning of the year	Rs. 10	Rs. 12	Rs. 15

If the price per share at the beginning of the fourth year is Rs.17, what would be the wealth ratio of the company in the third year? (Round off your answer to the nearest integer)

- (a) 13%
- (b) 27%
- (c) 33%
- (d) 45%
- (e) 70%.

(2 marks)

8. The Kerala Ayurvedic Pharmaceuticals is going in for fresh issue of equity capital. Their cost of raising fresh equity

[< Answer >](#)

- (a) Is equal to the existing retained earnings
- (b) Is equal to the floatation cost
- (c) Will be more than the existing cost of retained earnings on account of floatation costs
- (d) Depends on the earnings per share of the company
- (e) Is free of cost.

(1 mark)

9. The following information is given about the debentures issued by M/s. Aradhana Furnishers Ltd.:

[< Answer >](#)

Face Value	=	Rs.1,000
Rate of interest	=	10% p.a.
Amount realized per debenture	=	Rs.950
Corporate tax rate	=	30%

Debenture is redeemable at a premium of 5% after 10 years. (Assume that the difference between the redemption price and the net amount realized can be written off evenly over the life of the debenture and the amount so written –off is allowed as tax deductible expense.) The cost of debenture capital is

- (a) 7.0%
- (b) 7.7%
- (c) 8.1%
- (d) 14.0%
- (e) 20.0%.

(2 marks)

10. Which of the following is **not** a merit of using book values as weights for calculating the weighted average cost of capital?

[< Answer >](#)

- (a) The book value weights are independent of the fluctuations of the market prices
- (b) The calculation of weights is simple
- (c) The book values of the different sources of finance are approximately related to their present economic values
- (d) The book value weights are suitable for a firm whose securities are not traded regularly
- (e) The book value weights are the most suitable for the unlisted firms.

(1 mark)

11. The management of Volga Corp. is trying to set an optimal capital structure for whom the cost of capital is the main consideration. The different proportions of equity capital in their capital structure as well as the cost of debt and equity are as follows.

[< Answer >](#)

Proportion of equity	Cost of equity (%)	Cost of debt (%)
1.00	11	–
0.90	10	5.50
0.70	9.5	5.75

0.50	8.5	6.00
0.30	8.0	7.00

Which of the following proportions of equity to total capital gives the optimal capital structure?

- (a) 100%
- (b) 90%
- (c) 70%
- (d) 50%
- (e) 30%.

(2 marks)

12. Mahavir Enterprises Ltd. has an equity of Rs.10,00,000 and 15% preference share capital of Rs.6,00,000. The face value of its equity shares is Rs.10 and market value is Rs.30. It had posted a profit after tax of Rs.6,50,000 this year. The company paid Rs.3,25,000 by way of equity dividends. If the earnings grow at 5% then the cost of equity according to earning price ratio approach is [< Answer >](#)

- (a) 18.67%
- (b) 19.60%
- (c) 21.67%
- (d) 22.75%
- (e) 24.00%.

(2 marks)

13. The following information relates to the sources of long term finance used by Pioneer Industries Ltd.:

[< Answer >](#)

Source	Book value (Rs. in lakh)	Market value (Rs. in lakh)
Paid-up equity share capital	200	400
Reserves and surplus	400	
Preference shares	150	159
Debentures	250	241

Cost of equity share capital	19.25%
Cost of preference share capital	12.19%
Cost of debenture capital	8%

The difference between the weighted average cost using book value weights and market value weights would be

- (a) 0.52%
- (b) 0.77%
- (c) 0.92%
- (d) 1.23%
- (e) 1.50%.

(2 marks)

14. The current price of a share of Amoolya Ltd. is Rs.50. The company proposes to issue right shares at Rs.45 per share and wants to keep the ex-right price of the share at least at Rs.49. At what ratio should the company offer the right to its shareholders? [< Answer >](#)

- (a) 2
- (b) 3
- (c) 4
- (d) 5
- (e) 6.

(2 marks)

15. Which of the following is **not** a source of long-term finance? [< Answer >](#)

- (a) Equity capital
- (b) Preference capital
- (c) Debenture capital
- (d) Commercial paper
- (e) Reserves and surplus.

(1 mark)

16. According to law, all public trading firms should employ the services of a stock registrar and the stock certificate should bear his signature. But the board of directors can appoint an officer for the above purpose instead of a registrar who is authorized to sign the certificate issued under

[< Answer >](#)

- I. Public issue.
 - II. Private placement.
 - III. Bonus issue.
 - IV. Right issue.
- (a) Only (I) above
 - (b) Only (II) above
 - (c) Only (III) above
 - (d) Both (I) and (II) above
 - (e) Both (III) and (IV) above.

(1 mark)

17. Mr. Rakesh Mohan, a retail investor is holding 100 shares in ABC Ltd. and the present market price of the share is Rs.50. He wants to exchange the above shares with the shares of XYZ Ltd. held by his friend. The beta factor of XYZ's shares is 1.5. The company has paid a dividend of Rs.4 in the current year which has been consistently growing at the rate of 12%. The risk-free rate is 6% and the market rate of return is 15%. How much extra amount should Rakesh Mohan has to pay his friend for 100 shares of XYZ Ltd. bought from him in addition to shares exchanged? (Assume the price of the shares of both the companies is at market equilibrium as per the CAPM approach)

[< Answer >](#)

- (a) Rs. 333
- (b) Rs. 973
- (c) Rs.1,200
- (d) Rs.1,585
- (e) Rs.1,863.

(2 marks)

18. The term agency costs in the context of capital structure means

[< Answer >](#)

- (a) The commission payable by a company to its purchasing agents
- (b) The commission payable by a company to its selling agents
- (c) The expenses incurred in distribution of the products of the company
- (d) The cost on account of restrictive covenants imposed on a company by its lenders
- (e) The dividends paid by a company to its shareholders.

(1 mark)

19. Which of the following approaches of capital structure support(s) the existence of a unique optimal capital structure?

[< Answer >](#)

- I. Traditional approach.
 - II. Net operating Income Approach.
 - III. Miller and Modigliani approach.
- (a) Only (I) above
 - (b) Only (II) above
 - (c) Both (I) and (II) above
 - (d) Both (I) and (III) above
 - (e) Both (II) and (III) above.

(1 mark)

20. The following information is available from the books of Malavika & Co.

[< Answer >](#)

Total assets of the company	Rs.4 crore
Return on asset	15%
Overall capitalization rate	14%
Equity capitalization rate	20%
Total interest on debt	Rs10,00,000

According to the net operating income approach, the debt-equity ratio of Malavika & Co. would be

- (a) 0.28
- (b) 0.60
- (c) 0.71
- (d) 0.83
- (e) 0.90.

(2 marks)

21. Avinash Ltd. and Aditya Ltd. are two companies belonging to the same risk class, identical in all respects except that Aditya Ltd. is a levered firm. It has Rs.5,00,000 debentures carrying 11% interest rate. Its equity capitalization rate is 20%. The EBIT of both the companies is Rs.4,00,000 and pay tax at 40%. The total value of Avinash Ltd. as per MM approach would be [< Answer >](#)

- (a) Rs. 7,50,000
- (b) Rs.15,35,000
- (c) Rs.18,15,000
- (d) Rs.20,00,000
- (e) Rs.21,50,000.

(2 marks)

22. Which of the following factor is **not** considered while a capital structure decision is being taken? [< Answer >](#)

- (a) Cost of capital
- (b) Cash flow projections of the company
- (c) Security
- (d) Dilution of control
- (e) Floatation cost.

(1 mark)

23. The following figures are collected from the annual report of Amrutha Distilleries Ltd.: [< Answer >](#)

Net profit	= Rs.60 lakh
Outstanding Preference shares	= Rs.200 lakh @ 12 percent per annum
Number of equity shares	= 600,000
Cost of equity shares	= 16 percent
Return on Investment	= 20 percent.

What should be the approximate dividend pay out ratio so as to keep the share price at Rs.40 by using Walter model?

- (a) Zero percent
- (b) 33.3 percent
- (c) 50.00 percent
- (d) 66.67percent
- (e) 73.33 percent.

(2 marks)

24. Karthik Industries Ltd. (KIL) purchases raw-materials from Precision Enterprises on the terms 1/10, net 45. KIL has requested for an increase in the cash discount by 1%. The period of cash discount will remain unchanged. Precision Enterprises wants to modify the terms in such a way that after obtaining the requested increase in cash discount by 1%, KIL faces at least three times the cost of not paying within the discount period as before. What should be the new credit period? [< Answer >](#)

- (a) 33 days
- (b) 34 days
- (c) 43 days
- (d) 44 days
- (e) 45 days.

(2 marks)

25. Walter's model on dividend policy assumes that [< Answer >](#)

- (a) The earnings per share is steadily increasing
- (b) The firm has a finite life
- (c) The cost of capital of the firm is variable
- (d) The internal rate of return on the firm's investments is gradually increasing
- (e) The retained earnings are the only source of finance available to the firm.

(1 mark)

26. Which of the following statements is **correct**? [< Answer >](#)

- (a) The optimal dividend policy strikes the balance between current dividends and future growth so as to maximize the stock price
- (b) Using the constant growth stock valuation model, we can see that increasing the dividend payout will always increase the stock price
- (c) The dividend payout ratio is the percentage of amount paid to stockholders to net income
- (d) Increase in earnings lead to increase in dividends
- (e) High volume of trading in the share result in capital gains to investors.

(1 mark)

27. Overseas Construction Ltd., is an all equity firm and reported net earnings of Rs.4,24,000 for the current year. It has a paid up capital of Rs.10,00,000 and the face value of each share is Rs.10. The company has a policy of retaining a part of its earnings and reinvesting them in various projects. If the company can earn 20% on such investments, the cost of equity capital is 15% and the growth rate is 5%, the price of the share as per the Gordon's model for dividend policy approximately is
- (a) Rs.21.20
(b) Rs.30.90
(c) Rs.31.80
(d) Rs.32.60
(e) Rs.35.00.

(2 marks)

28. Which of the following is an indirect method of financing current assets ?

[< Answer >](#)

- (a) Purchase/discount of bills
(b) Letter of credit
(c) Cash credit
(d) Overdraft
(e) Factoring.

(1 mark)

29. Which of the following is a spontaneous source of financing current assets?

[< Answer >](#)

- (a) Accrued wages and salaries
(b) Commercial paper
(c) Public Deposits
(d) Cash credit
(e) Overdraft.

(1 mark)

30. Which of the following is **true** with regard to the working capital financing policy of a company?

[< Answer >](#)

- (a) Working capital margin is generally provided by the short term borrowing by a company
(b) Negative net working capital implies that short term funds are used to finance long term assets
(c) A company that follows conservative working capital management policy generally maintains a very low current ratio in comparison to its peers
(d) Time value of money must be considered for the estimation of the working capital needs
(e) A company following aggressive working capital policy will maintain much of current assets in comparison to its sales.

(1 mark)

31. Total current assets of a company are Rs.960 lakh while the current liabilities (include bank borrowings Rs.300 lakhs) are Rs.850 lakh. The core current asset of the company is Rs.150 lakh. What is the amount of excess borrowings of the company under the method II of the Tandon committee recommendations?

[< Answer >](#)

- (a) Rs. 8 lakh
(b) Rs.130 lakh
(c) Rs.190 lakh
(d) Rs.243 lakh
(e) Rs.300 lakh.

(2 marks)

32. Precision Airlines is deciding whether to pursue a restricted or relaxed working capital investment policy. Precision's annual sales are expected to be Rs.3.6 million, its fixed assets turnover ratio equals 4.0, and its debt and common equity are each 50 percent of total assets. EBIT is Rs.150,000, the interest rate on the firm's debt is 10 percent, and the firm's tax rate is 40 percent. If the company follows a restricted policy, its total assets turnover will be 2.5. Under a relaxed policy, its total assets turnover will be 2.2. If the firm adopts a restricted policy, assuming that the capital structure remains the same, how much will it save in interest expense?

[< Answer >](#)

- (a) Rs. 3,233
(b) Rs. 6,175
(c) Rs. 9,818
(d) Rs. 7,200
(e) Rs.10,136.

(2 mark)

33. Consider the following data pertaining to Pramukh Engineering Ltd.

[< Answer >](#)

Raw-material storage period	30 days
Average stock of raw materials	Rs.4,20,000
Average balance of trade creditors	Rs.3,00,000

(Assume 360 days in a year and all purchases are made on credit.)

If the closing stock of raw-materials is 10% higher than the opening stock of raw-materials, the average payment period is

- (a) 18 days
- (b) 21 days
- (c) 25 days
- (d) 30 days
- (e) 45 days.

(2 marks)

[< Answer >](#)

34. Which of the following means of financing is backed by **neither** any primary **nor** any collateral security?

- (a) Cash credit from a private sector bank
- (b) Overdraft from a public sector bank
- (c) Cash credit from a co-operative bank
- (d) Public deposit
- (e) Term loan from a financial institution.

(1 mark)

[< Answer >](#)

35. Consider the following information regarding Pioneer Production Ltd.

Opening stock of raw-materials	5,00,000
Opening stock of Work-in Process	2,00,000
Closing stock of raw-materials	5,60,000
Closing stock of Work-in-process	2,50,000
Annual consumption of raw-materials	75,00,000
Manufacturing expenses	15,00,000
Depreciation	2,00,000
Selling and administration expenses	3,00,000
Excise duty	2,50,000

Assuming 360 days for an year , the work-in-process period of the company is(corrected to the nearest integer)

- (a) 7 days
- (b) 9 days
- (c) 10 days
- (d) 12 days
- (e) 14 days.

(2 marks)

[< Answer >](#)

36. The following information is related to the operations of a firm:

Raw material storage period	30 days
Average conversion period	5 days
Finished Goods storage period	10 days
Average collection period	45 days
Average payment period	40 days

The cash operating cycle of the firm is:

- (a) 35 days
- (b) 45 days
- (c) 50 days
- (d) 90 days
- (e) 130 days.

(1 mark)

[< Answer >](#)

37. Consider the following information pertaining to Mukherji Enterprises Ltd.:

Particulars	Amount (Rs.)
Opening Stock of Finished Goods	35,000
Closing Stock of Finished Goods	40,000
Cost of Production	83,000
Selling, Administration and Financial Expenses	75,000

Excise Duty	45,000
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The finished goods storage period, assuming 360 days in a year, is

- (a) 60 days
- (b) 63 days
- (c) 65 days
- (d) 68 days
- (e) 71 days.

(2 marks)

[< Answer >](#)

38. Technical insolvency refers to

- (a) The bankruptcy on the part of the firm
- (b) The inability of the firm to pay debts for the purchase of machinery
- (c) The inability of the firm to pay debts for the transfer of technology
- (d) The inability of the firm to pay debts to honor its' current liabilities
- (e) The obsolescence of manufacturing methods adopted by the firm.

(1 mark)

39. Which committee has recommended for doing away with the uniform formula for Maximum Permissible Bank Finance (MPBF) and allowing freedom to banks in devising their own flexible systems?

[< Answer >](#)

- (a) Chore Committee
- (b) Nayak Committee
- (c) Maratha Committee
- (d) Kannan Committee
- (e) Goiporia Committee.

(1 mark)

40. Under which type of factoring the factor **does not** render any other service than granting advance against receivables?

[< Answer >](#)

- (a) Non-recourse factoring
- (b) Maturity factoring
- (c) Invoice discounting
- (d) Recourse factoring
- (e) Full factoring.

(1 mark)

41. M/s Uthappa Flour Mills is a small scale industry enjoying working capital facility with Good Peoples Bank. Their current years sales were Rs.30 lakh and the projected sales for the next year are Rs.40 lakh. According to Nayak Committee's recommendation, the maximum working capital that can be allowed to Uthappa Flour Mills is

[< Answer >](#)

- (a) Rs. 6.0 lakh
- (b) Rs. 7.5 lakh
- (c) Rs. 8.0 lakh
- (d) Rs.10.0 lakh
- (e) Data insufficient.

(1 mark)

42. Which of the following is **not** an assumption of the basic Economic Order Quantity (EOQ) model?

[< Answer >](#)

- (a) Purchase price per unit is constant
- (b) Carrying cost per unit is constant
- (c) Ordering cost per order declines as the order size increases
- (d) Delivery is instantaneous
- (e) Demand is uniform over the planning period.

(1 mark)

43. Which of the following is/are advantages of the ABC system of inventory management?

[< Answer >](#)

- I. The stock turnover rate can be maintained at a comparatively higher level through scientific control of inventories.
 - II. It ensures closer control on costly items.
 - III. It analyzes the items according to their importance in the production process.
- (a) Only (I) above
 - (b) Only (II) above
 - (c) Both (I) and (II) above
 - (d) Both (I) and (III) above

- (e) Both (II) and (III) above.

(1 mark)

44. Which of the following **does not** form part of the total carrying costs?

[< Answer >](#)

- (a) Cost of insurance
- (b) Rent of warehouse
- (c) Salaries of storekeeper
- (d) Cost involved in processing the invoice, counting, inspection etc. of arrived goods
- (e) Financing cost of money locked up in inventories.

(1 mark)

45. M/s Marvel Industries is engaged in the production of nuts and bolts and the main raw-materials used is steel rod. The annual usage of steel is 9000 tonnes. The lead-time for procuring material is 10 days, the average quantity per order is 100 tonnes and the reorder level is 475 tonnes. What is the stock out acceptance factor? (Assume 360 days in a year)

[< Answer >](#)

- (a) 1.0
- (b) 1.1
- (c) 1.2
- (d) 1.5
- (e) 1.6.

(2 marks)

46. The average daily usage rate of an inventory, lead time and their respective probabilities are as follows:

[< Answer >](#)

Daily usage rate (in units)	Probability	Lead time (in days)	Probability
100	0.5	10	0.30
200	0.5	15	0.70

What is the total probability of stock-out?

- (a) 0.15
- (b) 0.25
- (c) 0.35
- (d) 0.38
- (e) 0.42.

(2 marks)

47. Which of the statements is **not true** with respect to Economic Order Quantity?

[< Answer >](#)

- (a) It is the quantity, which minimizes both ordering costs and carrying costs
- (b) The magnitude of safety stock depends upon the uncertainty in usage rate and lead time
- (c) As inflation increases, carrying costs increase and EOQ increases
- (d) The EOQ model can be modified to include varying unit prices
- (e) If delivery is not instantaneous, inclusion of a safety stock can modify EOQ model.

(1 mark)

48. The annual usage of a raw material for Global Infotech Ltd. is 25,000 units. The ordering cost is Rs.250 per order and the unit price is Rs.20 per unit. The storage cost of the raw material is 25% of the unit price. It is found that the Economic Order Quantity (EOQ) of the material is 1581 units. What is the net incremental benefit the company gets, if it avails a discount of 3% for placing an order for 1750 units and above?

[< Answer >](#)

- (a) Rs.14,580
- (b) Rs.15,091
- (c) Rs.15,500
- (d) Rs.16,221
- (e) Rs.17,110.

(2 marks)

49. Which of the following is **not** a cost of maintaining receivables?

[< Answer >](#)

- (a) Cost of additional funds required by the company
- (b) Cash discounts
- (c) Administrative cost
- (d) Collection cost
- (e) Defaulting cost.

(1 mark)

50. Which of the following statements is **true** regarding 'Numerical Credit Scoring'?

[< Answer >](#)

- (a) It is a method for computing the cash discount to be extended to the customer
- (b) It is a method of computing the credit period
- (c) It is an index that is used to study the creditworthiness of a customer
- (d) It is an index used to study the efficiency of the credit standards of the firm
- (e) It is a technique for evaluating the effort of a company in collecting the receivables.

(1 mark)

51. The finance manager of Avishkar Ltd. is considering changing its credit terms of 1/10, net 30 to 1/10, net 45. With the change in the credit period it expects the sales to increase from Rs.40 lakh to Rs.60 lakh and the average collection period from 40 days to 55 days. The selling price of the product and its variable costs are Rs.10 and Rs.7 respectively. Assuming a cost of capital of 12%, the increase in the cost of funds locked in receivables is

[< Answer >](#)

- (a) Rs.45,720
- (b) Rs.56,710
- (c) Rs.60,575
- (d) Rs.75,600
- (e) Rs.82,430.

(2 marks)

52. The current sales of Aradhana Enterprises are Rs.100 lakh and variable cost accounts for 60% of the sales. The firm wants to change the credit terms from net 30 to 1/10 net 30 days. It is expected that sales would increase by Rs.20 lakh and bad debt loss would decrease from 3% to 2%. About 40% of the customers (existing and new) are expected to avail themselves of the discount and the average collection period would decline from 40 to 30 days. If the cost of fund is 12% the impact of the above policy is that profitability will increase by

[< Answer >](#)

- (a) Rs. 45,600
- (b) Rs. 51,620
- (c) Rs. 56,720
- (d) Rs. 59,360
- (e) Rs.1,07,000.

(2 marks)

53. Navaratna Electronics Ltd is on the final stage of granting credit to the Sealord Hotels, which is likely to place a repeat order for the same number of television sets. The probability of payment in the first order is considered to be 0.80. But in case the Sealord Hotels pays for the first order the probability of default for the repeat order is 0.10. The revenue from each order is Rs.10 lakhs where as the cost of sales for each of these orders is Rs.6 lakhs. The net expected profit from this deal to Navaratna Electronics Ltd.would be

[< Answer >](#)

- (a) Rs.3.4 lakh
- (b) Rs.4.4 lakh
- (c) Rs.5.4 lakh
- (d) Rs.2.4 lakh
- (e) Rs.1.4 lakh.

(2 marks)

54. When high degree of uncertainty is associated with the future cash flows of a firm

[< Answer >](#)

- (a) The firm should invest all the cash in equity shares
- (b) The firm should maintain adequate cash balance or have an overdraft arrangement with a bank
- (c) The firm should postpone the loan repayments which fall due after the current period
- (d) The firm should make less cash sales
- (e) The firm should maintain huge cash balance and have an overdraft arrangement with a bank.

(1 mark)

55. Which of the following statements is/are **false**?

[< Answer >](#)

- I. Payment float is the amount of cheques that have been deposited but not credited to the firm's accounts.
 - II. Collections float is the value of cheques written that have not been debited to the firm's account.
 - III. Net float is the difference between the firm's cash book balance and the balance as per bank's book.
 - IV. The net float is said to be positive when cash book balance is less than the balance as per bank's book.
- (a) Only (I) above
 - (b) Both (I) and (II) above
 - (c) Both (II) and (III) above
 - (d) (I), (II) and (III) above
 - (e) All (I), (II), (III) and (IV) above.

(1 mark)

56. In inventory management, the time period between the purchase of inventory on credit and the payment of cash to the

[< Answer >](#)

supplier is called

- (a) Creation Lag
- (b) Storage Lag
- (c) Sale Lag
- (d) Purchase Lag
- (e) Payment Lag.

(1 mark)

[< Answer >](#)

57. The sales figures for M/s.Bhargava Ltd. are as follows:

Month	Sales in Rs.
July 2007	1,00,000
August 2007	1,50,000
September 2007	1,60,000

The receivables from the credit sales are expected to be collected in the following manner: 30% of the receivables are collected in the month of sales, 60% of the sales are collected one month after the month of sale and 10% after two months from the date of sale. The total cash receipts from sales in the month of September 2007 were

- (a) Rs. 48,000
- (b) Rs.1,00,000
- (c) Rs.1,48,000
- (d) Rs.1,60,000
- (e) Rs.1,80,000.

(1 mark)

[< Answer >](#)

58. Agro Tech Ltd. is planning for its cash to be maintained during the month of September. The manager has analysed the daily cash outgo during the month of August. Ten largest daily cash outflows are as follows:

Date	3rd August	7th August	10th August	12th August	15th August	16th August	18th August	22nd August	26th August	28th August
Cash outflow (Rs.)	35,000	40,000	45,000	48,000	20,000	58,000	44,000	35,000	60,000	30,000

It is expected that the pattern of cash outflows in the month of September will remain same as that of the month of August but the magnitude of cash outflows will be 10% more. If the finance manager desires sufficient cash to cover payments of 5 peak days during the month, the safety level of cash to be maintained in the month of September would be (corrected to thousand)

- (a) Rs. 46,000
- (b) Rs. 51,000
- (c) Rs.2,55,000
- (d) Rs.2,81,000
- (e) Rs.3,30,000.

(2 marks)

[< Answer >](#)

59. Jayalakshmi Sarees Ltd. expects its total cash payments over the planning period (3 months) to be Rs.5,00,000 while the fixed cost per transaction is Rs.250 and the interest rate on marketable securities is 10% p.a. If the future cash flows are known with certainty, the optimal level of cash to be maintained by the firm, based on EOQ model ,is

- (a) Rs.10,000
- (b) Rs.14,600
- (c) Rs.18,000
- (d) Rs.20,000
- (e) Rs.21,000.

(2 marks)

[< Answer >](#)

60. AXES bank has offered to set up a collection system to process credit card payments from customers of TRAXON Ltd. for an annual fee of Rs.150,000 plus Rs 0.05 per payment. Total collections are Rs.547.5 million annually—consisting of an average of 10 payments per year from 1,100,000 credit card customers. Average mailing time for customers would be reduced from 3.5 days currently to 2 days with the new system. Cheque processing and clearing time also would be reduced from 5 days presently to 1.5 days with the new arrangement. Establishment of the new system would reduce annual payment processing costs at the Mumbai headquarters of AXES by Rs.250,000 and reduce the compensating balance at its Mumbai bank by Rs.500,000. The AXES bank will not require TRAXON Ltd. to maintain a compensating balance if it establishes the new system. Funds released by the new arrangement can be invested elsewhere in the firm to earn 15% per annum pretax. The net pretax benefits to TRAXON Ltd. of establishing the new system with the AXES bank are expected to be

- (a) Rs.5,00,000
- (b) Rs.6,75,000
- (c) Rs.7,50,000
- (d) Rs.8,75,000
- (e) Rs.9,25,000.

(2 marks)

61. If the cost of an investment is Rs.1,00,000 and it results in a net cash inflow of Rs.5,000 per annum perpetual, the Net Benefit Cost Ratio of that investment is (Assume a discount rate of 10 percent)

[< Answer >](#)

- (a) 0.5
- (b) 1.0
- (c) 1.5
- (d) – 0.5
- (e) Data insufficient.

(2 marks)

62. Kiran Industries Limited is planning for a capital investment at a cost of Rs.150 crore where the projected cash inflows are as follows:

[< Answer >](#)

(Rs. in crore)				
Year	1	2	3	4
Cash inflows	35.0	40.0	60.0	50.0

The internal rate of return (IRR) of the project is

- (a) 6.50%
- (b) 7.25%
- (c) 8.30%
- (d) 9.20%
- (e) 12.15%.

(2 marks)

63. Which of the following is **not** a disadvantage of the pay-back period appraisal method?

[< Answer >](#)

- (a) The cut off period is chosen arbitrarily
- (b) The cut-off period is uniformly applied to all the competing projects irrespective of their life span
- (c) It does not help in weeding out risky projects as it favors projects with substantial cash flows in the earlier years
- (d) It does not consider the time value of money
- (e) The pay-back period criterion cannot be considered as a measure of profitability.

(1 mark)

64. KSEB is a Kerala state government board who needs equipment for the construction of a hydro-electric project in the state.

[< Answer >](#)

Three companies came forward to supply the machines whose quotations are as given below. (in crore)

	A	B	C
Initial cost	40	35	32
Maintenance cost per year	2.5	3.5	4.5
Life (in years)	10	10	10
Salvage value	5	3	2

If the cost of funds is 10%, the priority for the organization is

- (a) A>B>C
- (b) B>C>A
- (c) A>C>B
- (d) B>A>C
- (e) C>B>A.

(2 marks)

65. How should a financial manager select one of two mutually exclusive projects that have different risk?

[< Answer >](#)

- (a) Select the project with the larger risk-adjusted net present value
- (b) Choose the project with the least relative risk
- (c) Choose the project with greater return even if that project has greater risk
- (d) Choose the project with less risk even though that project has less return
- (e) Choose any of the two projects.

(1 mark)

66. Other things remaining the same, which of the following project appraisal criteria will remain unchanged, even though the cost of capital is changed?

[< Answer >](#)

- (a) Net present value
- (b) Internal rate of return
- (c) Benefit cost ratio
- (d) Net benefit cost ratio
- (e) Discounted payback period.

(1 mark)

67. In what manner does depreciation expense affect investment projects?

[< Answer >](#)

- (a) It reduces cash flows by the amount of the depreciation expense
- (b) It increases cash flows by the amount of the depreciation expense
- (c) It reduces taxable income by the amount of the depreciation expense
- (d) It reduces taxes by the amount of the depreciation expense
- (e) It increases taxable income by the amount of the depreciation expense.

(1 mark)

68. M/s Malini Printers Ltd.(MPL) currently uses a machine whose book value is Rs.15 lakhs and has a remaining useful life of 3 years and a salvage value of Rs.3 lakhs at the end of the useful life. The company has been following straight line method of depreciation and an amount of Rs.4 lakh has been written-off on the machine every year.

[< Answer >](#)

MPL is proposing to replace the machine by a new machine costing Rs.30 lakhs and has a useful life of 3 years and salvage value of Rs.9 lakhs at the end of 3 years. The new machine is expected to reduce the annual operating costs by Rs.2,00,000 and increase the annual income by Rs.3,00,000. The old machine if sold now can realize Rs.9 lakhs. MPL is in the tax bracket of 40%.

The net incremental cash flows of the new machine during year 0 and year 3 respectively are

- (a) –30 lakh; 13.2 lakh
- (b) –21 lakh; 13.2 lakh
- (c) –30 lakh; 10.2 lakh
- (d) –21 lakh; 10.2 lakh
- (e) –21 lakh; 16.2 lakh.

(2 marks)

69. Which of the following elements of internal audit judges the efficiency and effectiveness of the system when put into operation?

[< Answer >](#)

- (a) Totality
- (b) Expertise
- (c) Independence
- (d) Objectivity
- (e) Utility.

(1 mark)

Suggested Answers

Financial Management – II (MSF1B4): October 2007

1. Answer : (c)

[<TOP >](#)

Reason : Raw-materials form part of the working capital and is a short term use of fund. All others are long term needs for setting up a project.

2. Answer : (d)

[<TOP >](#)

Reason : If a firm uses its short term funds for financing fixed assets this will result in serious asst-liability mismatch(I) .An asset –liability mismatch will lead to interest rate risk thereby enhancing the interest burden of the firm and liquidity risk with the short term funds being held up in long term projects(IV).

3. Answer : (c)

[<TOP >](#)

Reason : The shareholders can not only surrender the offer but can renounce their right and transfer it in favor of any other person at market determined rate. When affirm issues additional equity capital it has to first offer to the existing shareholders on a pro-rata basis

This right offer should be kept open for a period of 60 days and should be announced within 1 month of the closure of the books. The cost of floating the right issue is comparatively less than that of public issue and the right issue is priced lower than public issue.

4. Answer : (d)

[<TOP >](#)

Reason : As this methods involves direct selling to a limited number of institutional or high net worth investors, the investor base is not widened. All others are advantages of private placements.

[<TOP >](#)

5. Answer : (e)

Reason : The company can attach both a put option and a call option to the debenture. Hence option (e) is false. All other statements are true.

Debentures are usually secured by a charge on the immovable properties of the company. A trustee is usually appointed to ensure that the company fulfils its contractual obligations to the debenture holders. For debentures with maturity of more than 18 months years, the company has to create a debenture Redemption Reserve. The debenture redemption reserve should at least be half of the issue amount before the redemption commences.

6. Answer : (c)

[<TOP >](#)

Reason : Dividend =Rs.10, Redemption value =Rs.105, Amount realized=Rs.95, Maturity =10 years.

Cost of preference capital (Kp) = $\frac{10}{105} = \frac{95}{105} = 0.11$ i.e., 11%.

7. Answer : (b)

[<TOP >](#)

Reason : Price at the beginning of the 3rd year =Rs.15

Price at the end of the 3rd year = Rs.17

Capital gain = 17-15 =Rs.2

Dividend received in the 3rd year = Rs.2

Wealth ratio for the year = (2+2) / 15 = 26.66 % $\approx$ 27% .

8. Answer : (c)

[<TOP >](#)

Reason : The cost of raising fresh equity involve the flotation cost which increases its cost more than the cost of retained earnings. So it is not equal to the existing cost of retained earnings. It is not free of cost , and it does not depends on the earning per share of the company.

Hence (c) is the correct answer.

9. Answer : (b)

[<TOP >](#)

Reason : Cost of debenture (Kd) = $\frac{10}{130} = 7.7\%$.

10. Answer : (c)

[<TOP >](#)

Reason : The book values of the different sources of finances may not be related to their current economic values e.g. the land price may appreciate, the machine may become obsolete, etc. The reasons stated in the other options are the advantages of using book values as the basis of the weights for the calculation of the cost of capital.

11. Answer : (d)

[<TOP >](#)

Reason :

Prop. of equity (%)	Proportion of debt %	Wt.cost of equity %	Wt.cost of debt %	Wt.average cost %
100	0	11.00	--	11.00
90	10	9.00	0.55	9.55
70	30	6.65	1.73	8.38
50	50	4.25	3.00	7.25
30	70	2.40	4.90	7.30

12. Answer : (b)

[<TOP >](#)

Reason : No. of equity shares =10,00,000/10 =1,00,000

Profit after tax = 6,50,000

Preference dividend = 90,000

Equity earnings = 5,60,000

Earnings per share = 5,60,000/1,00,000 =Rs.5.60

Expected earnings per share = 5.60(1.05) = Rs.5.88

Market price per share =Rs.30

Cost of equity according to Earning/price E(E/P) ratio= 5.88/30 =19.6%.

13. Answer : (c)

[<TOP >](#)

Reason : Weighted Average Cost of Capital (WACC) using book value weights

Sum of book values of all sources of capital used is

200 + 400 + 150 + 250 = 1000

$\therefore$ Weight for equity capital (w_e) = $\frac{200}{1000} = 0.2$

Weight for reserves and surplus (w_r)= $\frac{400}{1000} = 0.4$

$$\text{Weight for preference capital (w}_p\text{)} = 150/1000 = 0.15$$

$$\text{Weight for debenture capital (w}_d\text{)} = 250/1000 = 0.25$$

$$\therefore \text{WAC} = w_e k_e + w_r k_r + w_p k_p + w_d k_d = 0.2 \times 19.25 + 0.4 \times 19.25 + 0.15 \times 12.19 + 0.25 \times 8.00$$

$$= 15.38\% \text{ (approx.)}$$

Weighted average cost of capital (WAC) using market value weights

$$\text{Sum of market values of all sources of capital used} = 400 + 159 + 241 = 800$$

$$\text{Weight of equity capital} = 400/800 = 0.5$$

$$\text{Weight of preference capital} = 159/800 = 0.19875 \approx 0.20$$

$$\text{Weight of debenture capital} = 241/800 = 0.30125 \approx 0.30$$

$$\therefore \text{WAC} = 0.5 \times 19.25 + 0.2 \times 12.19 + 0.3 \times 8.00$$

$$= 14.46\% \text{ (approx.)}$$

The difference between the WAC using book value weights and market value weights =
(15.38-14.46)%=0.92%

14. Answer : (c)

[<TOP >](#)

Reason : Ex-rights price of a share = Rs.49

Assume x as the ratio of existing shares to right.

Therefore, = 49.

$$X = 49 - 45 = 4.$$

15. Answer : (d)

[<TOP >](#)

Reason : Commercial papers are instruments for raising short term finance. All other alternatives represent sources/instruments of long term finance.

16. Answer : (b)

[<TOP >](#)

Reason : The board of directors can appoint an officer for the above purpose instead of a registrar who is authorized to sign the certificate issued under private placement and hence the correct option is (b).

17. Answer : (b)

[<TOP >](#)

Reason : Cost of equity share of XYZ Ltd. as per CAPM(K_e)

$$= r_f + \beta (K_m - r_f) = 6 + 1.5(15 - 6) = 19.5\%$$

$$\text{Fair value of the share} = \text{Rs.59.73}$$

$$\text{The difference in the price of two shares} = 59.73 - 50 = \text{Rs.9.73}$$

$$\text{Additional amount to be paid by Rakesh Mohan} = 9.73 \times 100 = \text{Rs.973}.$$

18. Answer : (d)

[<TOP >](#)

Reason : Agency cost are cost on account of restriction imposed by creditors on the firm in the form of some protective covenants. Commission payable by the company to its purchasing and selling agents, the expenses incurred in distribution of the products of the company, or the dividends paid by the company does not come under the agency cost.

19. Answer : (a)

[<TOP >](#)

Reason : According to traditional approach, the optimal capital structure would occur at a point where the value of the firm is maximum and the overall cost of capital is minimum. Hence, option (a) is the correct choice. According to Net operating income approach, the overall cost of capital remains constant throughout all degrees of leverage. Hence, as per the approach there is no unique optimal capital structure. According to MM approach, the total market value of the firm which is equal to the total market value of debt and equity is independent of the degree of leverage and hence there is no optimal capital structure based on the cost of capital.

20. Answer : (c)

[<TOP >](#)

$$\text{Reason : Return on assets} = 4 \text{ crore} \times .15 = 60 \text{ lakh}$$

$$\text{Market value of the firm} = 60 / 0.14 = \text{Rs.428.57 lakh}$$

$$\text{Equity earnings} = 60,00,000 - 10,00,000 = \text{Rs.50 lakh}$$

$$\text{Equity capitalization rate} = 20\%$$

$$\text{Market value of equity} = 50 / .20 = \text{Rs.250 lakh}$$

$$\text{Market value of debt} = \text{Market value of the firm} - \text{market value of equity}$$

$$= 428.57 - 250 = \text{Rs.178.57 lakh}.$$

$$\text{Debt/equity ratio} = 178.57/250 = 0.71$$

21. Answer : (b) [<TOP>](#)

Reason :	EBIT of Aditya Ltd.	4,00,000	
	Interest @11% on 5,00,000	<u>55,000</u>	
		3,45,000	
	Tax @ 40%	<u>1,38,000</u>	
	Equity earnings	2,07,000	
	Equity capitalization rate = 20%		
	Market value of equity =	<u>2,07,000</u>	= <u>10,35,000</u>
		0.20	
	Market value of the company = Market value of debt + Market value of equity		
	= 5,00,000 + 10,35,000 = Rs.15,35,000.		

Since under MM approach, value of an unlevered firm will be the same as a levered firm, if they belong to the same risk/return class and are identical in all respects, the value of Avinash Ltd is also Rs.15,35,000.

22. Answer : (c) [<TOP>](#)

Reason : Security is a factor considered by an investor and not by a borrower. Hence option (c) is false and is the right answer. All other options like cost of capital, cash flow projections of the company, dilution of control, floatation cost. and size of the company are the important factors considered in capital structure decision.

23. Answer : (e) [<TOP>](#)

Reason : Net profit = Rs.60 lakh

Less: Preference Dividends	=	Rs.24 lakh
Earnings for the equity shareholders	=	Rs.36 lakh
Therefore, earnings per share = 36/ 6	=	Rs.6.00

Let, the dividend pay out ratio be x and so the share price will be:

$$P = \frac{\text{Earnings per share}}{k_e}$$

Here, D = 6x, E = Rs.6, r = 0.20 and $k_e = 0.16$ and P = Rs.40

Hence, Rs 40 =

$$\text{Or, Rs.40} = 37.50x + 46.875(1 - x) \text{ or, } 9.375x = 6.875 \text{ or, } x = 0.7333.$$

So, the required dividend pay-out ratio will be = 73.33 percent.

24. Answer : (a) [<TOP>](#)

Reason : The cost of credit at present = 10.39%

The cost of not paying after revision of the discount to 2% = $10.39 \times 3 = 31.17\%$

This can be achieved by reducing the credit period

$$\text{The reduced credit period (C)} = \frac{360}{1 + \frac{31.17}{10.39}} = 31.17$$

$$2 \times 360 = (98C - 980) \times 0.3117 = 30.5466C - 305.466$$

$$30.5466C = 1025.46$$

$$C = 1025.46/30.5466 = 33.57 \text{ days.}$$

Say, 33 days.

Note: Rounding off should be done downward as otherwise the cost of not paying will become less than the required rate

25. Answer : (e) [<TOP>](#)

Reason : The assumptions under Walter's model are as follows:

Retained earnings is the only source of finance available to a firm, with no outside debt or additional equity used

Cost of capital and return on investment are constant for a firm

Firm has an infinite life

For a given value of the firm, the dividend per share and earnings per share remain constant

Hence, the option (e) is the answer.

26. Answer : (c) [<TOP>](#)

Reason : The dividend payout ratio is the percentage of net income paid out to stockholders as cash dividends. It is calculated as DPS/EPS. The optimal dividend policy does not strikes a balance between current dividends and future growth. In constant growth stock valuation model the increase in dividend payout does not always increase the stock price. Increase in earnings doesn't result in increase in dividends. High stock market operations doesn't mean capital gains to investors. Thus option (c) is correct. Rest are incorrect.

27. Answer : (c)

[<TOP>](#)

Reason : According to the Gordon's model for dividend policy,

Where, E = EPS

b = retention ratio

k_e = Cost of equity capital

r = return on investment

Net earnings	Rs.4,24,000
Number of shares (Rs.10,00,000/10)	1,00,000
EPS	Rs. 4.24

Given $g = br = 0.05 = b \times 0.20 \Rightarrow b = 0.25$

$k_e = 15\%$

Therefore the price of the share

P = Rs.31.8.

28. Answer : (b)

[<TOP>](#)

Reason : In letter of credit, a bank assures the payment to be made to the supplier, in case of default committed by the buyer, the client of the bank. Hence, it may be termed as an indirect method of financing current assets with the support of a bank. In cash credit, overdraft and purchase or discount of bills, the banks generally offer direct cash to the client. Factoring services are offered by the factors, not the banks.

29. Answer : (a)

[<TOP>](#)

Reason : Spontaneous liabilities generally occur during the normal course of business operations where a company will usually have a ready access to certain sources for financing its current assets. But a company is required to take proper initiative for the sources of finance as mentioned in the other options to finance its current assets.

30. Answer : (b)

[<TOP>](#)

Reason : A firm generally employs long term sources of funds to finance its working capital margin that is the difference between the current assets and current liabilities. A negative net working capital implies that current assets are less than current liabilities and hence the option (b) is true. A current ratio of less than unity means current liabilities are more than current assets that signifies the usage of the short term funds for financing the long term assets. A company that follows a conservative working management policy generally maintains a very high current ratio in comparison to its peers while the opposite thing occurs in case of aggressive working capital management policy.

31. Answer : (b)

[<TOP>](#)

Reason : Under method II, MPF = 75% of the total current assets minus current liabilities excluding bank borrowings .

Total current assets	=	960
Less 25%		<u>240</u>
		720

Less current liabilities

(other than bank borrowings) 550

MPBF 170

Bank borrowings 300

Excess borrowings 130.

32. Answer : (c)

[<TOP>](#)

Reason : Step 1:

Calculate net fixed assets, which will be the same under either policy.

FA turnover = 4.0

FA = Rs.900,000.

Step 2:

Determine total assets under each policy, given the total assets turnover ratio for each one.

Restricted: Total assets turnover = 2.5

$$TA = \text{Rs}1,440,000.$$

Relaxed: $2.2 = TA = \text{Rs}1,636,364.$

Step 3:

Develop balance sheets for each policy to determine the debt level.

	Restricted	Relaxed
Current assets	Rs 540,000	736,364
Fixed assets	900,000	900,000
Total assets	Rs1,440,000	1,636,364
Debt	Rs 720,000	818,182
Equity	720,000	818,182
Total liabilities & equity	Rs1,440,000	Rs1,636,364

Step 4:

Determine interest under each policy:

Restricted: $\text{Rs}720,000 \times 0.10 = \text{Rs}72,000.$

Relaxed: $\text{Rs}818,182 \times 0.10 = \text{Rs}81,818.$

Step 5:

Calculate the difference in interest expense (the savings) between the 2 policies:

$$\text{Rs.}81,818 - \text{Rs.}72,000 = \text{Rs.}9,818.$$

33. Answer : (b)

[<TOP >](#)

Reason : Let opening stock = x

Closing stock = 1.10 x

Then = 4,20,000

Therefore opening stock = Rs.4,00,000

Closing stock = 1.10x
= Rs.4,40,000

Raw material storage period =

Or, 30 =

Or, Stock Consumed daily = Rs.14,000

Annual consumption of raw-materials = $14,000 \times 360 = 50,40,000$

Purchases = Stock Consumed + Closing stock – Opening stock
= $50,40,000 + 4,40,000 - 4,00,000$
= Rs.50,80,000

Daily purchase of materials = $50,80,000/360 = 14,111$

Average Payment Period =

$$= 3,00,000/14,111 = 21.26 \approx 21 \text{ days.}$$

34. Answer : (d)

[<TOP >](#)

Reason : Public deposit may be raised by a company by duly following certain norms as per the Companies Act. 1956 without the requirement of any collateral security. While in the other cases, security is to be provided compulsorily.

35. Answer : (b)

[<TOP >](#)

Reason : Opening stock of work-in-process	2,00,000	
Add. Annual consumption of raw-materials	<u>75,00,000</u>	77,00,000
Less closing stock of work-in-process	<u>2,50,000</u>	74,50,000
Add. Manufacturing expenses	15,00,000	
Depreciation	<u>2,00,000</u>	
Annual Cost of production	91,50,000	
Daily cost of production = $91,50,000/360 =$	25,417	
Average work-in-process =	= Rs.2,25,000	
Work –in-process period =	=	= 8.85 $\approx$ 9 days.

36. Answer : (c)

[<TOP >](#)

Reason : Operating cycle = Raw-materials storage period + Conversion period + finished goods period + Receivable collection period – Payment period .

$$= 30 + 5 + 10 + 45 - 40 = 50 \text{ days.}$$

37. Answer : (d)

[<TOP >](#)

Reason :	Opening stock of finished goods	35,000
	Add. Cost of production	83,000
	“ Excise duty	45,000
	“ Selling and administration expenses	<u>75,000</u>
		2,38,000
	Less closing stock of finished goods	40,000
	Cost of goods sold	1,98,000
	Daily cost of goods sold = 1,98,000/360 = 550	
	Average stock of finished goods	
=	=	= 37,500.

Finished goods storage period = Average stock of finished goods /daily cost of goods sold
 $= 37,500/550 = 68.18 \approx 68 \text{ days.}$

38. Answer : (d)

[<TOP >](#)

Reason : Technical insolvency refers to the inability of the firm to honor it's current liabilities.

39. Answer : (d)

[<TOP >](#)

Reason : The Kannan committee has recommended for doing away with the uniform formula for Maximum Permissible Bank Finance (MPBF) and allowing freedom to banks in devising their own flexible systems to finance the working capital requirements of their clients.

40. Answer : (c)

[<TOP >](#)

Reason : Under invoice discounting the factor does not render any other service than granting advance against receivables and hence strictly speaking cannot be considered as a factoring.

41. Answer : (c)

[<TOP >](#)

Reason : According to Nayak Committee recommendation, the working capital limit that can be sanctioned in favour of SSI unit is 20 per cent of its projected sales turnover. Hence the working capital limit that Uthappa Flour Mills can enjoy is $40 \times .20 = \text{Rs.8 lakh.}$

42. Answer : (c)

[<TOP >](#)

Reason : The basic EOQ model assumes constant ordering cost irrespective of the order size. Alternatives (a), (b), (d) and (e) represent assumptions behind the EOQ model.

Hence (c) is the answer.

43. Answer : (c)

[<TOP >](#)

Reason : Advantages of ABC Analysis:

- It ensures closer control on costly items in which a large amount of capital is invested
- It helps in developing a scientific method of controlling inventories
- It helps to reduce clerical costs while maintaining stock at optimum level
- It helps in achieving the main objective of inventory control at minimum control

Statements I and II are the direct benefits of the ABC system. Statement III is not an advantage of the ABC system.

Hence (c) is the answer.

44. Answer : (d)

[<TOP >](#)

Reason : Carrying costs are the expenses incurred for storing goods. These costs include insurance, rent/ depreciation of warehouse, salaries of storekeeper and security personnel, financing cost of money locked up in inventories, obsolescence, spoilage and taxes.

Hence options (a), (b), (c) and (d) are included in carrying costs.

Processing the invoice, inspection ,counting etc. of the arrived goods are part of the ordering cost. .

Hence, option (d) is the answer.

45. Answer : (e)

[<TOP >](#)

Reason : Average daily usage = Annual usage / 360 = = 25 tonnes

Reorder level = $475 = 25 \times 10 + F$

$F = = 1.58 \approx 1.6$

Hence (e) is the answer.

46. Answer : (c)

[<TOP>](#)

Reason : The possible levels of usage and their corresponding probabilities are computed in the following table:

Daily usage rate		Lead time		Possible levels of usage	
Units (1)	Probability (2)	No. of days (3)	Probability (4)	Possible levels of usage (1) x (3)	Probability (2) x (4)
100	0.5	10	0.3	1,000	0.15
		20	0.7	2,000	0.35
200	0.5	10	0.3	2,000	0.15
		20	0.7	4,000	0.35

Normal Usage during lead time = Average Daily Usage rate x Average Lead Time

Average Daily Usage rate = $100 \times 0.50 + 200 \times 0.50 = 150$ units.

Average Lead Time = $10 \times 0.3 + 20 \times 0.7 = 17$ days

Normal Usage during lead time = $150 \times 17 = 2550$ units.

Stock outs will occur if the usage is above 2550 units. From the table computed above, we can infer that stock-outs will occur when the usage level is 4,000 (with probability 0.35). Therefore the total probability of stock out is 0.35 i.e., 35%. Hence, (c) is the answer.

47. Answer : (c)

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Reason : As inflation increases, interest rates increase causing an increase in the carrying costs and consequently decreasing the EOQ. Hence statement (c) is not true.

EOQ is the quantity, which minimizes both order costs and carrying costs.

The magnitude of safety stock depends upon the uncertainty surrounding the usage rate and lead time.

The EOQ model can be modified to include varying unit prices.

If delivery is not instantaneous, inclusion of a safety stock can modify EOQ model.

Hence (c) is the answer.

48. Answer : (b)

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Reason : Given that $Q^* = 1581$ units.

Total amount of discount available:

$UD = 25,000 \times 20 \times 0.03 = \text{Rs.}15,000 \dots (1)$

Savings due to reduction in ordering costs:

=

$\times 250 = [15.81 - 14.28] \times 250 = 382.5 \dots (2)$

Incremental carrying cost:

=

=

$= 4243.75 - 3952.50 = 291.25 \dots (3)$

Net incremental benefits = $(1 + 2 - 3)$

$= \text{Rs.}15,000 + \text{Rs.}382.5 - \text{Rs.}291.25$

$= \text{Rs.}15091.25 \approx 15,091$

49. Answer : (b)

[<TOP>](#)

Reason : Cash discount is a cost item which is incurred by a firm to induce early payments by the debtors. It is not a cost of maintaining receivables. All other alternatives represent costs of maintaining receivables.

50. Answer : (c)

[<TOP>](#)

Reason : Numerical credit scoring is an index based on several factors that is used to study the creditworthiness of a customer. It is the weighted sum of the facts that ostensibly have a bearing on the credit worthiness of the customer. Hence (c) is the answer.

51. Answer : (a)

[<TOP>](#)

Reason : Existing sales = Rs.40 lakh

Increase in sales = Rs.20 lakh

Increase in average collection period = 15 days

Existing accounts receivables = Rs.4.44 lakh

Increase in accounts receivables on the existing sales = =1.67 lakh

Accounts receivables on the new sales = = 2.14 lakh

Increase in accounts receivables = $1.67 + 2.14 = 3.81$ lakh

Cost of capital = 12%

Increase in cost of funds locked up in receivables = $3.81 \times 0.12 = \text{Rs.}45,720$.

52. Answer : (d) [<TOP >](#)

Reason : Discount on sales allowed lakhs = $120 \text{ lakhs} \times 0.4 \times 0.01 = \text{Rs.}48,000$

Existing bad debts = $100 \times 0.03 = \text{Rs.}30,000$

New bad debt = $120 \text{ lakhs} \times 0.02 = \text{Rs.}24,000$

Decrease in bad debt loss = $30,000 - 24,000 = \text{Rs.}6,000$

Profit on new sales = $20 \text{ lakhs} \times 0.4 = \text{Rs.}80,000$

Reduction in accounts receivables :

Existing accounts receivables = = Rs.11.11 lakh

Accounts receivables under new policy = = Rs.9.33 lakh

Reduction in accounts receivables = $11.11 - 9.33 = 1.78$ lakh

Reduction in cost of funds locked up in accounts receivables = $1.78 \times .12 = \text{Rs.}21,360$

Net increase in profit = $6,000 + 80,000 + 21360 - 48,000 = \text{Rs.}59360$.

53. Answer : (b) [<TOP >](#)

Reason : The net expected benefit from the deal

= $(0.8 \times 4 - 0.2 \times 6) + [0.8(0.9 \times 4 - 0.10 \times 6)]$

= $2 + 2.4$

= 4.4 lakhs.

54. Answer : (b) [<TOP >](#)

Reason : Investing all cash in shares would be more riskier. Postpone of loan repayment and making less cash sales is also dangerous. The firm should either maintain adequate cash balance or have an overdraft arrangement with a bank. The firm should not keep huge cash balance as idle.

55. Answer : (b) [<TOP >](#)

Reason : Payment float is the amount of cheques that have issued in the account but not presented for payment .Hence statement (I) is false .Collections float is the value of cheques deposited in the account but not yet collected and credited in the account. So statement (II) is also false.

Net float is the difference between the firm's cash book balance and the balance as per bank's book and the net float is said to be positive when cash book balance is less than the balance as per bank's book

56. Answer : (a) [<TOP >](#)

Reason : The time period between the purchase of inventory on credit and the payment of cash to the supplier is called creation lag.

57. Answer : (c) [<TOP >](#)

Reason : Cash received in September = 10 % of July sales + 60% of August sales +

30 % of September sales = $1,00,000 \times 0.1 + 1,50,000 \times 0.6 + 1,60,000 \times 0.3 = \text{Rs.}1,48,000$.

58. Answer : (d) [<TOP >](#)

Reason : The average cash outflow during the 5 peak days in the month of August was

= 51,000

As the magnitude of cash out flows in the month of September is 10% more than that in the month of August , the expected average cash out flows during the 5 peak days in the month of September would be

$\text{Rs.}51,000 \times 1.1 = \text{Rs.}56,100$

So the safety level of cash to be maintained is $5 \times 56,100$ or $\text{Rs.}2,80,500 \approx 2,81,000$.

59. Answer : (a) [<TOP >](#)

Reason : Usage of cash during the planning period (3 months) =Rs,5,00,000

Transaction cost = Rs.250 per transaction

Interest is 10% p.a or 2.5% for 3 months

As per EOQ model, C = = Rs.10,000.

60. Answer : (c) [<TOP >](#)

Reason : Reduction in collection time = $(3.5 - 2) + (5 - 1.5) = 5.0$ days

Amount of funds released = $(\text{Rs.}547,500,000/365) \times 5.0 + \text{Rs.}500,000 = \text{Rs.}8,000,000$

Cost of new system = $1,100,000 \times 10 \times (\text{Rs.}0.05) + \text{Rs.}150,000 - \text{Rs.}250,000$
= Rs.450,000

Net pretax benefits = $\text{Rs.}8,000,000 \times 0.15 - \text{Rs.}450,000 = \text{Rs.}750,000$

61. Answer : (d) [<TOP >](#)

Reason : The present value of annuity perpetual = $1/K = 1/0.10 = 10$

The present value of the cash flows will be = $5,000 \times 10 = \text{Rs.}50,000$

and so the NPV of that investment is

= $\text{Rs.}1,00,000 - \text{Rs.}50,000 = -50,000$

Hence, the net benefit cost ratio for that investment will be = -0.50

So, the option (d) is the correct choice.

62. Answer : (c) [<TOP >](#)

Reason : Initial Investment = Rs.150 crore

Let the IRR of the project be k

So, Rs.150 crore = $35 \text{ PVIF}(k,1) + 40 \text{ PVIF}(k,2) + 60 \text{ PVIF}(k,3) + 50 \text{ PVIF}(k,4)$

At k = 10 percent, the RHS = 144.10 while at k = 8 percent, the RHS = 151.07

By interpolation,

= $\frac{151.07 - 144.10}{151.07 - 144.10} \times (10 - 8)$

K = $8 + 0.15 \times 2 = 8.30$ percent.

63. Answer : (c) [<TOP >](#)

Reason : In fact, one of the main advantages of Pay-back period appraisal criteria is that it helps in weeding out risky projects as it favors projects with substantial cash flows in the earlier years. Hence option (c) is not a disadvantage and is the right answer. The cut off period is chosen arbitrarily and is uniformly applied to all the competing projects irrespective of their life span

It does not consider the time value of money and since it leads to discrimination against projects which generate substantial cash flows in later years, pay-back period criterion cannot be considered as a measure of profitability.

64. Answer : (a) [<TOP >](#)

Reason :

Project Name	Initial Cost (Rs.)	Maintenance Cost (Rs.)	PVIFA (10%,10)	PV of maintenance cost (Rs.)	Salvage value (Rs.)	PVIF (10%,10)	PV of S. V. (6x7) (Rs.)	Total cash out flow (Rs.)	Annual capital charge (Rs.)
1	2	3	4	5 = (3x4)	6	7	8 = (6x7)	9 = 2+5-8	10 = (9/4)
A	40	2.5	6.1446	15.36	5	0.3855	1.93	53.43	8.86
B	35	3.5	6.1446	21.51	3	0.3855	1.16	55.35	9.01
C	32	4.5	6.1446	27.65	2	0.3855	0.77	58.88	9.58

The annual capital charge of C > B > A.

Therefore the priority for organization is A > B > C. Hence (a) is the correct answer

65. Answer : (a) [<TOP >](#)

Reason : To make a good financial decision, the project with the higher risk-adjusted net present value should be chosen.

66. Answer : (b) [<TOP >](#)

Reason : The internal rate of return is calculated by equating the present values of all the inflows and outflows. But in other cases, the inflows and outflows are discounted with the cost of capital. Hence, IRR is independent of the cost of capital.

67. Answer : (c) [<TOP >](#)

Reason : Depreciation expense reduces taxable income by the amount of the depreciation expense.

68. Answer : (d)

[<TOP>](#)

Reason : Net incremental cash flow during year 0 is

= – (Investment for new machine – present realizable value of old machine)

= – (30 – 9) = – Rs.21 lakhs

Net incremental cash flow during year 3 is

= Incremental PAT + Incremental Depreciation + Incremental realizable value

Depreciation of old machine = = Rs.4 lakh

Depreciation of new machine = Rs.7 lakh

Incremental depreciation = Rs.7,00,000 – 4,00,000 = Rs.3,00,000

Net incremental cash flow during year 3

= (3,00,000 + 2,00,000 – 3,00,000) 0.6 + 3,00,000 + 6,00,000

= Rs.10,20,000 = Rs.10.2 lakh.

Hence, answer is (d).

69. Answer : (d)

[<TOP>](#)

Reason : Successful audit of internal audit depends on the following elements of internal audit:

Totality – This concept demands that all aspects of the organization should be considered for the purpose of review and control.

Expertize – This concept stresses that only those professional qualifications, experience are appointed as internal auditors.

Independence – This means that the internal auditors have the opportunity and permission to report directly to the senior management.

Objectivity – This aspect judges the efficiency and effectiveness of the system when put into operation.

Utility – All the systems when put into practice should be ultimate utility to the management.

Therefore (d) is the answer.

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