MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS (STRATEGIC FINANCIAL MANAGEMENT) MODEL QUESTION PAPER

Instruction: Answer Question 1 which is compulsory and any four out of the remaining Questions

1. Answer all of the following –

(a) A firm is planning to invest in a project. It has collected the information relating to the Cash flows and its probability to occur over the life of the project. Considering the importance of the project, the firm wants to make the best use of its funds.

The firm has approached you to advice on this issue based on the information provided by the firm.

The information relating to the Project are —

- The Investment Proposal requires and outlay of Rs.40,000.
- The investment proposal is expected to have 2 year's economic life with no salvage value.

The probabilities of occurrence of various cash flows and the amount of cash flows for years 1 and 2 are given below—

	Cash Flow	Probability	Cash Flow	Probability
Year 1	25,000	0.4	30,000	0.6
Year 2	12,000	0.2	20,000	0.4
	16,000	0.3	25,000	0.5
	22,000	0.5	30,000	0.1

The firm uses a 10% discount rate for this type of investment.

The Cash Flows arising from the Project are independent.

Required —

- Construct a decision tree for the proposed investment project,

- What Net Present Value will the project yield if worst outcome is realized?
- What is the probability of occurrence of this NPV?
- What will be the best and the probability of that occurrence?
- Will the project be accepted?

10 Marks

(b) A Ltd wants to acquire T Ltd and has offered a swap ratio of 1:2 (0.5 shares for every one share of T Ltd). Following information is provided —

Particulars	A Ltd	T Ltd
Profit After Tax	Rs.18,00.000	Rs.3,60,000
Equity Shares Outstanding (Nos.)	6,00,000	1,80,000
Earnings Per Share	Rs.3	Rs.2
PE Ratio	10 Times	7 Times
Market Price per Share	Rs.30	Rs.14

Required —

- The number of equity shares to be issued by A Ltd., for acquisition of T Ltd.,
- What is the EPS of A Ltd., after the acquisition?
- Determine the equivalent earning per share of T Ltd.
- What is the expected market price per share of A Ltd., after the acquisition, assuming its PE multiple remains unchanged? Also, determine the market value of the merged firm.

6 Marks

(c) Lately companies are resorting to internal financing for their long term funds. Explain with arguments whether this is a healthy development. 4 Marks

2. Answer all of the following –

(a) An Indian Company has availed the services of two London based Interior Decorators and are required to pay GBP 50,000 in 3 Months. From the following information, advice the course of action to minimize rupee outflow —

Foreign Exchange Rates (Rs. / GBP)		
	Bid	Ask
Spot	Rs.81.60	Rs.81.90
3–Month Forward	Rs.82.70	Rs.83.00

Money Market Rates (p.a.)		
	Deposit	Borrowings
GBP	6%	9%
Rupees	8%	12%

12 Marks

(b) Briefly explain the various margins imposed on a Futures Contract. 4 Marks

(c) What are the differences between Factoring and Forfaiting? 4 Marks

3. Answer all of the following –

(a) Mr.X on 1.7.2000, during the initial offer of some Mutual Fund invested in 10,000 units having face value of Rs.10 for each unit. On 31.3.2001 the dividend operated by the M.F. was 10% and Mr.X found that his annualized yield was 153.33%.On 31.12.2002, 20% dividend was given. On 31.3.2003 Mr.X redeemed all his balance of 11,296.11 units when his annualized yield was 73.52%.

What are the NAVs as on 31.3.2001, 31.12.2002 and 31.3.2003? 10 Marks

(b) Company ABC and XYZ have been offered the following rate per annum on a $ 200 million five year loan;

		Fixed Rate	Floating Rate
Company	ABC	12.0	LIBOR + 0.1%
Company	XYZ	13.4	LIBOR + 0.6%

Company ABC requires a floating - rate loan; Company XYZ requires a fixed rate loan.

Design a swap that will net a bank acting as intermediary at 0.1 percent per annum and be equally attractive to both the companies. 6 Marks

(c) Sampath has invested in four securities A, B, C and D, the particulars of which are as follows —

Security	A	B	C	D
Amount Invested	Rs.1,25,000	Rs.1,50,000	Rs.80,000	Rs.1,45,000
Beta (β)	0.60	1.50	0.90	1.30

If RBI Bonds carries an interest rate of 5% and NIFTY yields 12%, what is the expected return on portfolio? If investment in Security C is replaced by investment in RBI Bonds, what is the corresponding change in Portfolio Beta and expected return? 4 Marks

4. Answer all of the following –

(a) Elixir Trading Company has a beta of 0.80 with BSE 500. Each BSE 500 Futures contract is worth 100 units. Ashwin anticipates a bearish market for the next three months and has gone short on shares of 25,000 Shares of ETC in the spot market. ETC Shares are traded at Rs.100. 3–Months' Future BSE 500 is quoted at 12,500.

Required —

1. No. of BSE 500 Futures Contract to be taken by Ashwin if he wants to hedge price risk to the extent of — (a) 60%, (b) 100%; (c) 125%.
2. If price of ETC falls or increases by 20% in the spot market, how is Ashwin protected in the above three cases?
3. If price of ETC falls by 30% in the spot market and BSE 500 is quoted at 12000 on the same day, what is Ashwin's position in Case 1(b) above? What is the inference drawn in this case with reference to cross hedging? 8 Marks

(b) Dhanishta is contemplating investment in the shares of Praveena Motors Ltd. Praveena Motors had earned Rs.137.50 per share, and had paid out 20% of its earnings in the form of dividends. Industry standard for distribution and retention is 1 : 3. Company's return on net investment is expected to be 16% p.a. Ascertain the price to be paid for the share if the Company will follow industry norms for dividend distribution hereinafter and the required rate of return on investment for the Company is — (a) 15%; (b) 18%; (c) 20%; and (d) 24%. 8 Marks

(c)What are the differences between Issue of shares through Book Building Process and Offer of Shares through Normal Public Issue? 4 Marks

5. Answer all of the following –

(a) India Clothing Mills (ICM) is planning to foray into the business of establishing and running malls all around India, as it sees tremendous opportunity in that area. Presently, only one Company (OSS Bazaar Ltd) is in that line, establishing malls of size comparable to ICMs proposed malls.

The cost of establishing a single mall, on an average, works out to Rs.125 Crores. It has ascertained the estimated operating cash inflows from each of those malls.

ICM's share is quoted at Rs.540, its equilibrium price, for a return of Rs.81 (for both Dividends and Capital Appreciation). ICM's share has a Beta of 1.50. Its Capital Structure is 40% Equity: 60% Debt, and applies this measure to each of its projects / business. Average Tax rate as applicable to ICM is 35%.

Particulars relating to OSS Bazaar Ltd are — (a) Equity Beta of 1.85; (b) Capital for its projects financed 40% by Debt; (c) Effective Tax Rate – 20% [Government has provided tax sops to companies engaged in establishing malls]

The Company's management is at a loss as to what discount rate should be applied for undertaking a financial feasibility study. Recommend the appropriate discount rate if the Risk Free Rate of Return is 6%, Cost of Debt is 9% (not carrying any risk factor). 12 Marks

(b) Write short notes on Certificate of Deposit (CD). 4 Marks

(c) Explain the terms "Intrinsic value of an option" and "Time value of an option". 4 Marks

6. Answer all of the following –

(a) Your client whose pre–tax opportunity cost of capital is 20% (when tax rate was 40%), is considering a laser technology cutting machine, which at the end of its economic life is expected to be replaced by an identical machine, and so on, continuously for an infinite period.

The machine has a maximum life of four years. But its productivity starts decreasing in the third year and the fourth year, and therefore, can be replaced after two years or three years or four years. While replacing the original supplier will take it back. The cost of the machinery is Rs.3.60 Crores, including cenvatable duties of Rs.80 Lakhs, which can be availed as a benefit at the end of Year 1.

Following are the information relating to the machine — (Rs.Lakhs) (net of duties)

Years	1	2	3	4
Revenue	400	550	440	350

Cost	280	350	320	280
Salvage Value	220	170	120	30

Depreciation for Income Tax Purposes is WDV at 15% per annum normally Plus an additional depreciation of 20% for the first year alone.

If expected future tax rate is 30%, identify the appropriate replacement cycle. Assume that tax rate is 20% for Capital Gains (no tax benefits for capital loss), and that post tax returns expectation are based on future tax rates.

12 Marks

(b) Explain the Participating Notes. What is the risk involved in its issue? 4 Marks

(c) Sundar Ramanujam had entered into 2 Put Options and 2 Call Options in different securities, the particulars of which are given below, along with their exercise price and actual market price on the date of exercise —

Security	Exercise Price	Actual Market Price	Nature of Option
A	Rs.120	Rs.122	Put Option
B	Rs.758	Rs.758	Put Option
P	Rs.369	Rs.376	Call Option
Q	Rs.450	Rs.444	Call Option

What is his position on the date of exercise and what would he do? 4 Marks

The answers to the above questions and the Scheme of Valuation for the above paper will be uploaded on the 20^{th} of April, 2009.