Question Paper
Financial Management (CFA540): July 2008

- **Answer all 72 questions.**
- **Marks are indicated against each question.**

Total Marks : 100

1. Which of the following players can act as a borrower as a well as a lender in the call money market? <Answer>

   (a) LIC
   (b) SBI Mutual Fund
   (c) State Bank of India
   (d) ICICI
   (e) NABARD. **(1mark)**

2. Who among the following players in the international capital markets collect the rupee dividends on the underlying shares and repatriates the same to the depository in US dollars/foreign equity? <Answer>

   (a) Lead Managers
   (b) Underwriters
   (c) Custodian
   (d) Corporate borrowers
   (e) Lenders. **(1mark)**

3. By which of the following means, can Government Securities be held? <Answer>

   I. Stock certificates.
   II. Promissory notes.
   III. Bearer bonds.

   (a) Only (I) above
   (b) Only (II) above
   (c) Only (III) above
   (d) Both (I) and (III) above
   (e) All (I), (II) and (III) above. **(1mark)**

4. Which of the following instruments in the international capital market is fixed-interest securities having a maturity of over one year? <Answer>

   (a) Commercial Papers
   (b) Treasury Bills
   (c) American Depository Receipts
   (d) Medium-Term Notes
   (e) Global Depository Receipts. **(1mark)**

5. Which of the following does **not** act as a tool for RBI to maintain liquidity of the banking system? <Answer>

   (a) Open Market Operations
   (b) Statutory Liquidity Ratio
   (c) Cash Reserve Ratio
   (d) Bank Rate
   (e) Prime Lending Rate. **(1mark)**

6. Which of the following merger waves, is marked by large number of mega-mergers and cross-border mergers? <Answer>

   (a) First Wave
   (b) Second Wave
   (c) Third Wave
   (d) Fourth Wave
   (e) Fifth Wave. **(1mark)**

7. In which of the following active anti take-over measures, the target company makes a counter tender offer response to the raider's bid? <Answer >

(a) Greenmail
(b) White Knight
(c) Pac-Man Defense
(d) Crown Jewels
(e) White Squire. **(1mark)**

8. Which of the following is/are example of a capitalized expenditure? <Answer >

I. Funds spent last year to renovate a building that could be used to house a new project that is currently being evaluated.
II. Installation costs necessary to use a machine that is just purchased.
III. The necessary increase in inventories needed to support a project that is currently being implemented.

(a) Only (I) above
(b) Only (II) above
(c) Only (III) above
(d) Both (I) and (II) above
(e) Both (II) and (III) above. **(1mark)**

9. Which of the following is **true**? <Answer >

(a) Effective rate of interest is always lower than the nominal interest rate
(b) The effective rate of interest increases with increase in the frequency of compounding
(c) The nominal interest rate increases with increase in the frequency of compounding
(d) The effective and nominal interest rates are equal if the frequency of compounding is less than 4
(e) The frequency of compounding does not affect the effective and nominal interest rates. **(1mark)**

10. Which of the following is/are **true** regarding the capital recovery factor? <Answer >

I. It is the inverse of the PVIF factor.
II. It represents the amount that has to be invested at the end of every year for a period of 'n' years at the rate of interest 'k' in order to accumulate Re.1 at the end of the period.
III. It can be applied to find out the amount that can be withdrawn periodically for a certain length of time, if a given amount is invested today.

(a) Only (II) above
(b) Only (III) above
(c) Both (I) and (II) above
(d) Both (I) and (III) above
(e) Both (II) and (III) above. **(1mark)**

11. The doubling period for fixed deposit is 7 years and 3 months. The rate of interest that can be calculated from the rule of 69 is <Answer >

(a) 9.00%
(b) 9.50%
(c) 10.00%
(d) 10.50%
(e) 11.00%. **(1mark)**

12. The following information regarding the equity shares of M/s. Mars Ltd. is given: <Answer >

Market Price	=	Rs.58.33
Dividend per share	=	Rs. 5.00
Multiplier	=	7

According to the traditional approach to the dividend policy, the EPS for M/s. Mars Ltd., is approximately

(a) Rs. 5
(b) Rs.10
(c) Rs.15
(d) Rs.20
(e) Rs.25. **(2 marks)**

13. Which of the following theory considers that improvement in technology is a continuous process and the resulting invention and innovations in existing products give rise to trade between countries? <Answer>

(a) Imitation-Gap Theory
(b) Heckscher-Ohlin Theory
(c) International Product Life Cycle Theory
(d) Theory of Absolute Advantage
(e) Theory of Comparative Advantage. **(1mark)**

14. Which among the following is **not** a theory of international trade? <Answer>

(a) Theory of Comparative Advantage
(b) Theory of Absolute Advantage
(c) Imitation Gap Theory
(d) International Product Life Cycle Hypothesis
(e) Keynesian Theory of Interest and Employment. **(1mark)**

15. Which of the following statement is/are **not true?** <Answer>

I. Higher inflation in an economy may lead to reduction in competitiveness of domestic goods and services and hence decrease in their demand.
II. A lower value of the domestic currency may increase the demand for domestic goods and services internationally.
III. An appreciation of the domestic currency results in making imported goods and services expensive in terms of the domestic currency, hence decreasing their demand.

(a) Only (I) above
(b) Only (III) above
(c) Both (I) and (II) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above. **(1mark)**

16. The positive value to the firm, which adds debt to the capital structure in the presence of corporate taxes is <Answer>

(a) Due to the extra cash flow going to the investors of the firm instead of the tax authorities
(b) Due to the earnings before interest and taxes being fully taxed at the corporate rate
(c) Due to the willingness of the shareholders to protect the interests of the debt holders
(d) Because personal tax rates are the same as corporate tax rates
(e) Because shareholders prefer to let financial managers choose the capital structure thus making their value independent of it. **(1mark)**

17. The following information pertains to the balance of payments of a country for the year 2006-07: <Answer>

Particulars	Rs.
Merchandize imports	2,80,480
Merchandize exports	2,32,640
Services rendered to foreigners	4,60,020
Services rendered by foreigners to residents	2,50,468
Gifts sent to non-residents by the residents	4000
Cash remitted by non-residents for their family maintenance in India	8000
Income earned by residents on ownership of financial assets	2000
Foreign direct investment	4,00,000

Given the above information, the capital account balance is

(a) Rs. 3,24,682
(b) Rs. 3,47,644
(c) Rs. 4,00,000
(d) Rs. 5,71,712
(e) Rs. 7,45,985. **(2 marks)**

18. Which of the following is **not** a current account item in India's balance of payment? <Answer>

(a) Release of foreign exchange by Authorized Dealers to company executives on business visits abroad
(b) Freight charges collected and remitted by foreign shipping vessels
(c) Payments received by Indian musicians for the concerts rendered abroad
(d) Payments received on account of GDRs issued by Indian companies
(e) Dividends received on portfolio investments placed in New York by Indian mutual funds. **(1mark)**

19. Which of the following statements is **not correct**? <Answer>

(a) Important function of the International Monetary Fund (IMF) is to provide reserve credit to the member countries facing temporary balance of payment problems
(b) Oil facility is a type of IMF lending
(c) International Development Association (IDA) endeavors to finance those projects in developing countries which may not be financially profitable
(d) International Finance Corporation (IFC) insists on government guarantee for financing projects
(e) International Finance Corporation (IFC) helps the development of private sector in different countries. **(1mark)**

20. International Monetary Fund (IMF) lends to its member countries under various schemes. Which of the following statement is **true** with respect to Buffer stock financing facility scheme? <Answer>

(a) This scheme provides financial assistance to countries facing temporary shortfall in reserves
(b) This scheme allows countries to borrow on a medium-term basis for overcoming Balance of Payments(BoP) problems caused by structural imbalance
(c) This scheme provides special development loans on concessional terms to those 25 member countries which had the lowest per capita income
(d) This scheme provides financial assistance to countries facing serious BoP problems and having high external debt
(e) This scheme provides financial assistance to prevent countries suffering from price shock. **(1mark)**

21. Under a system of floating exchange rates, relatively high productivity and low inflation rates in India results in a /an: <Answer>

(a) Increase in the demand for foreign currency, a decrease in the supply of foreign currency and a depreciation in the rupee
(b) Increase in the demand for foreign currency, an increase in the supply of foreign currency and an appreciation in the rupee
(c) Decrease in the demand for foreign currency, a decrease in the supply of foreign currency and a depreciation in the rupee
(d) Decrease in the demand for foreign currency, an increase in the supply of foreign currency and an appreciation in the rupee
(e) Depreciation of rupee only. **(1mark)**

22. If the spot dollar price of one Swiss franc is \$ 0.9879, the expected price of Swiss franc is \$ 1.002 and the interest on U.S. bonds is 4 %. What should be the interest on Swiss franc bonds for the interest rate parity condition to hold good? <Answer>

(a) 0.98%
(b) 1.03%
(c) 2.54%
(d) 4.03%
(e) 7.06%. **(1mark)**

23. Consider the following exchange rates prevailing in Mumbai inter-bank market : <Answer>

Rs/\$	:	40.00/45
3 months forward	:	10/11 paise

If a bank wants to go for a buy-sell swap, the rates for the bank are

(a) Rs./\$ 40.40/50
(b) Rs./\$ 40.30/35
(c) Rs./\$ 40.40/55
(d) Rs./\$ 40.45/56
(e) Rs./\$ 40.45/55. **(1mark)**

24. The following spot rates are quoted in the market: <Answer>

$/£ : 1.9936/45
C$/$: 1.0054/60
The C$/£ spot rate should be

(a) 2.0075/78
(b) 2.0053/56
(c) 2.0044/65
(d) 2.0000/03
(e) 1.7645/48.

(2 marks)

25. The following information pertains to foreign transactions of a country called 'Green Islands': <Answer>

Exports	$ 120 million
Imports	$ 180 million
Investment income received from abroad	$ 213 million
Investment income paid to abroad	$ 260 million
Net transfer received	– $ 30 million

Given the above information compute the current account balance of 'Green Islands'.

(a) $137 million surplus
(b) $137 million deficit
(c) $77 million deficit
(d) $77 million surplus
(e) $69 million surplus.

(2 marks)

26. Interest rate parity implies that <Answer>

(a) Interest rate should change by an equal amount but in the opposite direction to the difference in inflation rates between two countries
(b) In the long run real interest rate between two countries will be equal
(c) Nominal interest rates in each country are equal to the required real rates plus compensation for expected inflation
(d) The interest rates between two countries start in equilibrium, any change in the differential rate of inflation between the two countries tend to offset over the long-term by an equal but opposite change in the spot exchange rate
(e) The difference in interest rates in different foreign currencies for securities of similar risk and maturity should be consistent with the forward rate discount or premium for the foreign currency.

(1mark)

27. Which of the following sets of spot quotations given by two banks A and B, give scope for arbitrage? <Answer>

	Quotation	Bank A	Bank B
I.	$/£	1.9936/40	1.9945/50
II.	Euro/£	1.5031/33	1.5032/34
III.	HK$/$	7.7904/08	7.7900/02

(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.

(2 marks)

28. The inter-bank market rates are as under <Answer >

Euro/$	Spot	0.6386/0.6388
	1 month	0.6375/0.6380
	2 months	0.6250/0.6254
	3 months	0.6125/0.6135

Compute the forward margin included in the rate quoted to a bank that wants to purchase Euro for option to be delivered over third month.

(a) 0.0261
(b) 0.0253
(c) 0.0250
(d) 0.0245
(e) 0.0236. **(1mark)**

29. Which of the following quotes is an American quote? <Answer >

(a) Euro 0.6386/$
(b) C$ 2.0044/£
(c) Rs 40.00/$
(d) $0.9947/C$
(e) S$ 1.3844/$. **(1mark)**

30. Which of the following is **true** about merchant quote? <Answer >

(a) It is a quote given by an authorized dealer to RBI
(b) It is a quote given by the authorized dealer to the scheduled cooperative banks
(c) It is a quote given by an authorized dealer to another authorized dealer
(d) It is a quote given by the bank to its retail customers
(e) It is the quote given by RBI to banks. **(1mark)**

31. In an option forward contract for an import transaction under direct quote, when the currency is at a discount, the bank will <Answer >

(a) Add maximum discount to the ask rate
(b) Add minimum discount to the ask rate
(c) Deduct maximum discount from the ask rate
(d) Deduct minimum discount from the ask rate
(e) Give more discount. **(1mark)**

32. A company declares a rights issue of 1 share for every 8 shares held. An investor, who holds 400 shares will have <Answer >

(a) 12 rights
(b) 25 rights
(c) 50 rights
(d) 75 rights
(e) 80 rights. **(1mark)**

33. Which of the following is/are **not true** regarding private placement of securities? <Answer >

I. It involves selling out a significant portion of securities to an investor or a group of investors with a view to make a public issue within an agreed time frame.
II. It involves fewer procedural formalities.
III. It enables the companies to have faster access to funds.

(a) Only (I) above
(b) Both (I) and (II) above
(c) Both (I) and (III) above
(d) Both (II) and (III) above
(e) All (I), (II) and (III) above. **(1mark)**

34. Martin & Company Ltd., recently issued 1 right share for every 4 shares held. If the price of the stock at the time of the issue was Rs.60 per share and the price after the rights issue was Rs.58 per share, the subscription price of each right share was <Answer>

(a) Rs.44
(b) Rs.50
(c) Rs.61
(d) Rs.65
(e) Rs.72. **(2 marks)**

35. The following details are available regarding the long term sources of finance of M/s. VK Ltd.: <Answer>

Source of finance	Range of new financing from the source (Rs. in crore)	Cost (%)
Equity	0 – 10 10 – 20 20 & above	15 16 17
Preference	0 – 2 2 & above	14 15
Debt	0 – 12 12 – 18 18 & above	9 10 11

The company is considering expanding its operations and requires Rs.50 crore for the same. It is planning to raise in the following proportions:

Equity shares	0.4
Debt	0.4
Preference shares	0.2

The weighted marginal cost of capital of new financing in the range of Rs.25 crore – 30 crore is

(a) 12.4%
(b) 13.0%
(c) 13.5%
(d) 14.0%
(e) 14.5%. **(3 marks)**

36. Consider the following data for Beta Ltd.: <Answer>

Year	1	2	3	4	5
Earnings Per Share (Rs.)	6.80	6.00	5.00	7.00	6.60
Dividend Payout (%)	74	82	72	76	65
Capital appreciation (%)	4	8	-8	11	9

If the price at the beginning of year 1 is Rs.75, the approximate realized yield over the five year period is

(a) 17.08%
(b) 16.04%
(c) 15.06%
(d) 14.02%
(e) 10.36%. **(2 marks)**

37. Which of the following statements is **not true**? <Answer>

(a) Realized yield approach emphasizes that the past returns on a security are taken as a proxy for the return required by the investors in the future
(b) The return earned by the investors according to the bond yield plus risk premium approach is equal to the yield on the long-term bonds plus a risk premium
(c) The earnings price ratio approach emphasizes that the cost of equity is the ratio of the expected EPS for the next year and the current market price per share
(d) Cost of external equity comes into picture when there are certain flotation costs involved in the process of raising equity from the market
(e) Cost of retained earnings is always more than the cost of new issue of common stock. **(1mark)**

38. Rajesh Enterprises Ltd., has an equity of Rs.20,00,000. The face value and market price per share is Rs.10 and Rs.30 respectively. It had posted a profit after tax of Rs.6,50,000 this year. If the earnings grow at 5% p.a., then the cost of equity according to earning price ratio approach is <Answer>

(a) 12.70%
(b) 12.25%
(c) 11.38%
(d) 10.12%
(e) 9.08%.

(2 marks)

39. Which of the following statements related to the capital structure theories is **true**? <Answer>

(a) According to net income approach, the costs of equity and debt remain constant irrespective of the degree of leverage
(b) As per the traditional approach, the overall cost of capital for a firm remains same for all degrees of leverage
(c) A firm should choose the debt-equity ratio in such a way that it will avoid the tax liability
(d) The higher the degree of leverage, the lower the risk to the equity shareholders
(e) According to the net operating income approach, the overall cost of capital increases, as the degree of leverage increases.

(1mark)

40. Sail and Sail Shipping Private Ltd., has issued share capital of Rs.56 lakhs and retained earnings of Rs.90 lakhs. If the equity investors expect a rate of return of 16.5% p.a. and the cost of issuing fresh equity is 6%, cost of issuing external equity to the company is <Answer>

(a) 14.45%
(b) 15.55%
(c) 16.50%
(d) 17.55%
(e) 18.22%.

(1mark)

41. As per the records of Tata group of companies the following information is available: <Answer>

Total assets	Rs.1500 crore
Return on assets	18%
Cost of equity capital	15%

The total market value of the equity of Tata group of companies as per net income approach is

(a) Rs.1,900 crore
(b) Rs.1,800 crore
(c) Rs.1,700 crore
(d) Rs.1,600 crore
(e) Rs.1,500 crore.

(2 marks)

42. Which of the following statements is/are **true** with respect to bankruptcy cost when capital market is perfect? <Answer>

I. Assets of the bankrupt firm can be sold at their economic value.
II. Legal and administrative expenses are not present.
III. No cost is associated with bankruptcy.
IV. An impending bankruptcy entails significant costs in the form of sharply impaired operational efficiency.

(a) Only (I) above
(b) Both (I) and (II) above
(c) Both (I) and (III) above
(d) (I), (II) and (III) above
(e) All (I), (II), (III) and (IV) above.

(1mark)

43. If the tax rate on stock income is 25%, the tax rate on debt income is 30% and the corporate tax rate is 45%, the tax advantage associated with a debt capital of Rs.8,00,000 is <Answer>

(a) Rs.5.05,248
(b) Rs.4,65,264
(c) Rs.4,57,564
(d) Rs.3,28,571
(e) Rs.3,00,126.

(2 marks)

44. Following details are available about the irredeemable preference shares issued by M/s. Access Ltd.: <Answer>

Dividend	15%
Face value per share	Rs.100 per share
Floatation costs involved	5%

The cost of preference capital is

(a) 14.265%
(b) 15.789%
(c) 16.245%
(d) 17.654%
(e) 18.325%. **(1mark)**

45. The term agency cost 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. **(1mark)**

46. M/s. Suman-Chemicals Ltd., belongs to a risk-class for which the appropriate capitalization rate is 15%. The current market price per share of the firm is Rs.60. The company is expecting a net profit of Rs.60,000 and plans to declare a dividend of Rs.10 per share towards the end of the current year. The company also plans to invest Rs.2,25,000 in a project for which it intends to issue 6000 new shares. According to Modigliani and Miller approach, the existing number of outstanding shares of the company is <Answer>

(a) 20,385 shares
(b) 19,500 shares
(c) 18,900 shares
(d) 18,600 shares
(e) 17,500 shares. **(2 marks)**

47. Which of the following concepts of dividend policies considers that the market price may show some adjustments if the actual dividend declared is higher or lower than the expected level, otherwise there would be no impact of the dividend declaration on the market price of the share as long as it is at the expected rate? <Answer>

(a) Traditional approach
(b) Walter model
(c) Gordon model
(d) Miller and Modigliani model
(e) Rational expectations model. **(1mark)**

48. Consider the following data for BTC Ltd.: <Answer>

Earnings Per Share (EPS)	Rs.12
Dividend Payout Ratio	60%
Equity Capitalization Rate	12%
Rate of Return on Investments	15%

If the number of shares outstanding for the firm is 4,50,000, the market value of equity according to Walter Model is

(a) Rs.5,98,20,500
(b) Rs.4,95,00,000
(c) Rs.4,70,00,500
(d) Rs.3,78,50,200
(e) Rs.3,50,20,800. **(2 marks)**

49. The return on investment of a firm is 14% and cost of equity capital is 12%. According to Walter Model, in order to maximize the value of the firm the firm should <Answer>

(a) Adopt 100% dividend pay-out policy
(b) Not pay dividends at all
(c) Be indifferent as to the dividend policy
(d) Plough back 50% of profits and pay the rest as dividends
(e) Leave the decision of dividend payment to the discretion of Board of directors. **(1mark)**

50. If the Net Present Value (NPV) of an investment is positive, the impact on Benefit Cost Ratio (BCR), Net Benefit Cost Ratio (NBCR), Internal Rate of Return (IRR) and cost of capital (K) would be <Answer>

(a) IRR = K and NBCR > 1
(b) IRR = K and BCR > 1
(c) IRR > K and NBCR > 1
(d) IRR > K and BCR > 1
(e) NBCR > BCR and K > IRR. **(1mark)**

51. Which of the following will most likely to result in an increase in the net operating cycle of a firm? <Answer>

(a) An increase in the consumption of the raw materials
(b) Synchronizing the various processes in the production system for a better volume
(c) Incremental demand for the product owing to a favorable government policy
(d) Negotiating with the suppliers for a special discount in lieu of a shorter credit period
(e) Searching for the new customers to sell the product against cash. **(1mark)**

52. Surekha India Ltd., is planning to purchase a punching machine having the following details: <Answer>

Cost of machine	Rs.30,00,000
Annual cost of operations	Rs.2,50,000 for the first four years
	Rs.3,00,000 for the subsequent years
Useful life	10 years

The annual capital charge of the machine at a cost of capital of 10 percent p.a is approximately

(a) Rs.7,62,082
(b) Rs.7,62,182
(c) Rs.7,62,432
(d) Rs.7,62,682
(e) Rs.7,62,782. **(2 marks)**

53. Which of the following is/are **false** with regard to the Internal Rate of Return (IRR)? <Answer>

I. It considers the cash flows over the entire project life.
II. It considers the time value of money.
III. It is the rate of return at which the present value of benefits is equal to the present value of costs.
IV. It is uniquely defined in case of projects which entail cash inflows and outflows that are interspersed with each other.

(a) Only (I) above
(b) Only (IV) above
(c) Both (I) and (III) above
(d) Both (II) and (IV) above
(e) (I), (II) and (III) above. **(1mark)**

54. A company is considering the following project for investment. The cost of capital for the company is 12%. The projected post tax net cash flow stream of the project is given below: <Answer>

(Rs. in lakhs)

Year	0	1	2	3	4	5	6
Cash flow	(25)	5	6	7	8	9	10

You are **required** to find the benefit cost ratio

(a) 1.1495
(b) 1.1796
(c) 1.1825
(d) 1.1895
(e) 1.9254. **(1mark)**

55. Which of the following issues is **not** considered while appraising a market in capital expenditure decisions? <Answer>

(a) Structure of competition
(b) Consumer requirements
(c) Production constraints
(d) Optimality of the scale of operations
(e) Present and prospective supply position. **(1mark)**

56. A machine is available for purchase at a cost of Rs.1,20,000. It has an expected life of five years and have a scrap value of Rs.20,000 at the end of five year period. The firm depreciates it's assets under straight line method. The profits over the life of the machine are as follows: <Answer>

Amount in (Rs.)

Years	1	2	3	4	5
Profit before depreciation	30,000	50,000	40,000	20,000	7,000

Compute the accounting rate of return

(a) 14.89%
(b) 14.22%
(c) 13.43%
(d) 12.11%
(e) 10.65%. **(2 marks)**

57. Following are the data on a capital project being evaluated by the management of Kolkata Industries Ltd., (KIL): <Answer>

Annual cash inflow	Rs.60,000
Useful life	6 years
IRR	18%
Cost of capital	15%

The Net Present Value (NPV) of the project is

(a) Rs.21,420
(b) Rs.20,800
(c) Rs.18,520
(d) Rs.17,220
(e) Rs.15,254. **(2 marks)**

58. The average collection period for M/s. Amrita Ltd., is 60 days and the average accounts receivables of the company is Rs.45,000. The sales of the company consist of only credit sales. With this respect compute the annual sales assuming 360 days in a year <Answer>

(a) Rs.3,15,000
(b) Rs.2,70,000
(c) Rs.2,50,000
(d) Rs.2,45,000
(e) Rs.2,34,567. **(2 marks)**

59. Homemaker, a reputed washing machine manufacturer, plans to manufacture and sell 12,000 sets of washing machines for the next year. The cost components are as follows: <Answer>

Item	Unit Cost (Rs.)
Raw Material	5,000
Manufacturing Expenses (expected to incur evenly)	2,000
Selling, administrative and financial expenses	1,000

The selling price per unit is Rs.10,000 and sales may be assumed to be uniform throughout the year. The durations at various stages of the operating cycle are given below:

Raw material stage	2 months
Work in process stage	1 month
Finished goods stage	1 month
Debtors stage	3 months

If the minimum cash balance required is Rs.10,00,000, what is the estimate for the working capital requirement of the company?

(a) Rs.350 lakh
(b) Rs.400 lakh
(c) Rs.450 lakh
(d) Rs.500 lakh
(e) Rs.550 lakh. **(3 marks)**

60. Which of the following statements is/are **true** regarding inventory turnover ratio? <Answer>

I. If the inventory turnover ratio has decreased from past, it means that either inventory is decreasing or cost of goods sold is increasing.
II. If a firm has an inventory turnover that is slower than for its industry, then the inventory stocks may be low.
III. Low inventory turnover has impact on the liquidity of the business.

(a) Only (I) above
(b) Only (II) above
(c) Only (III) above
(d) Both (I) and (III) above
(e) All (I), (II) and (III) above. **(1mark)**

61. The following data are available in respect of material X for the current year: <Answer>

Opening stock	Rs.4,80,000
Purchases during the year	Rs.12,60,000
Closing stock	Rs.6,40,000

Given the above information compute the inventory turnover ratio

(a) 2.233
(b) 2.184
(c) 1.992
(d) 1.964
(e) 1.862. **(2 marks)**

62. Alps Inc. has average inventory of Rs.10 million. Its estimated annual sales are Rs.160 million. The firm wants to decrease its inventory conversion period by 14 days. It believes that it can reduce its average inventory to Rs.6 million, while maintaining the same level of sales. Assuming a 365-day year, compute the further decrease in inventory conversion period required to meet its goal of 14-day reduction in its inventory conversion period (rounded off to the nearest integer)? <Answer>

(a) 23 days
(b) 22 days
(c) 9 days
(d) 5 days
(e) 3 days. **(2 marks)**

63. Consider the following data: <Answer>

Gross operating cycle	80 days
Net operating cycle	55 days
Raw-material storage period	40 days
Conversion period	2 days
Finished goods storage period	20 days

The average collection period is

(a) −87 days
(b) −37 days
(c) 07 days
(d) 18 days
(e) 62days. **(2 marks)**

64. Which of the following statements is **not true** with respect to companies following a conservative approach to working capital management? <Answer>

(a) They are subjected to a lower degree of risk of insolvency
(b) Less amount of funds is locked in current assets
(c) Turnover of current assets is less than that in an aggressive approach
(d) They will have a low percentage of operating profitability
(e) Cost of financing is high. **(1mark)**

65. In which of the following arrangements, the bank assumes the risk of default while the supplier provides the credit? <Answer>

(a) Cash credit
(b) Overdraft
(c) Letter of credit
(d) Pledge
(e) Hypothecation. **(1mark)**

66. The report submitted by which committee has suggested 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. **(1mark)**

67. Mercury Computers Ltd., dealing in computer hardware products has annual sales of Rs.60 lakh and is currently extending 40 days credit to the dealers. The company, with an intention of increasing profits is considering increasing the average collection period from 40 days to 55 days. The variable costs amount to 70% of sales. With such a change, the sales are expected to increase to Rs.70 lakh. If the required rate of return is 18%, the incremental gain or loss to the company owing to a change in the credit policy is (Assume 360 days in a year) <Answer>

(a) Rs. 95,200
(b) Rs.1,50,500
(c) Rs.1,92,930
(d) Rs.2,35,758
(e) Rs.2,50,000. **(3 marks)**

68. Which of the following factors influences the choice of liquidity mix to be maintained by a company? <Answer>

(a) Nature of control with the managers
(b) Extent of leverage
(c) Marginal cost of capital
(d) Quality of the product of the company
(e) Uncertainty in cash flows. **(1mark)**

69. Which of the following elements of internal audit represents the professional aspects of the job? <Answer>

(a) Totality
(b) Expertise
(c) Independence
(d) Objectivity
(e) Utility. **(1mark)**

70. Ravi Industries is committing a capital investment of Rs.55 lakhs. The cash inflows from this project during its lifetime are as follows: <Answer>

(Rs. in lakhs)

Year	1	2	3	4	5
Cash inflows	15	24	30	45	32

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

(a) 25%
(b) 35%
(c) 37%
(d) 40%
(e) 51%. **(2 marks)**

71. Karan Plastics Ltd. (KPL) is merged with Rahul Tyres Ltd. (RTL). Before the merger, the market values of the companies were respectively Rs. 12 crores and Rs. 120 crores. RTL paid a premium of Rs. 10 crores to the shareholders of KPL. Expenses of the acquisition process were Rs. 4 crores. If the combined value of merged entity is Rs. 150 crores, the Net Acquisition Value (NAV) of the RTL is <Answer>

(a) Rs. 4 crores
(b) Rs. 8 crores
(c) Rs.12 crores
(d) Rs.14 crores
(e) Rs.18 crores. **(2 marks)**

72. Consider the following information regarding Sahni & Co. Ltd.: <Answer>

Net operating income	Rs.150 lakh
Overall capitalization rate	15%
Interest on debt	Rs.14 lakh
Equity capitalization rate	17%

According to the assumptions of capital structure theories, the debt-equity ratio of Sahni & Co. Ltd. is

(a) 1:5
(b) 1:4
(c) 1:3
(d) 1:2
(e) 2:1. **(2) marks**

END OF QUESTION PAPER

Suggested Answers
Financial Management (CFA540): July 2008

ANSWER	REASON
1. C	Commercial banks (SBI) can act both as lenders and borrowers in the call money market but the financial institutions like LIC, ICICI, and NABARD and mutual funds like SBI mutual fund can act only as lenders in the market. <TOP

2. C Custodians hold the underlying shares and collect rupee dividends on the underlying shares and repatriates the same to the depository in US dollars/foreign equity. <TOP

Hence (c) is the answer.

Lead managers undertake activities like preparation of offer circular, marketing the issues etc.

Underwriters of the issue bear interest rate or market risks moving against the issuer before they have placed bonds or depository receipts.

3. E Government securities can be held in three forms viz., Stock Certificates, Promissory Notes and Bearer Bonds. <TOP

Hence, option (e) is the answer.

4. D Medium-Term Notes (MTNs) are defined as sequentially issued fixed-interest securities which have a maturity of over one year. It enables an issuer to issue Euronotes for different maturities, from one year up to the desired level of maturity. <TOP

Hence (d) is the correct choice.

Commercial Papers are short-term, unsecured promissory notes issued by well known companies that are financially strong and carry a high credit rating.

American Depository Receipts (ADRs) are dollar denominated negotiable certificates and they represent a non-US company's publicly traded equity.

Treasury Bills are short-term instruments issued by the government. Global depository receipts are negotiable instruments which represents publicly traded local currency equity share.

Hence, options (a), (b), (c) and (e) are false.

5. E Prime lending rate is the rate fixed by respective commercial banks as benchmark for lending interest rates. It is not a tool to control liquidity of the banking system by RBI. RBI controls liquidity of the banking system through SLR, CRR, Bank rate and open market operations. <TOP

Hence, option (e) is the answer.

6. E The first wave (1897–1904) is known for its role in creating large monopolies. So alternative (a) is not the answer. <TOP

The second wave (1916–1929) resulted in an oligopolistic industry structure rather than monopolies. So, the alternative (b) is not the answer.

The third wave (1965–1969) is known as a conglomerate merger period, as small or medium sized firms adopted a diversification strategy into business activities outside there traditional areas of interest. So the alternative (c) is not the answer.

In the fourth wave (1981–1989) hostile mergers played a significant role. This wave was the period of mega mergers. So, the alternative (d) is not the answer.

Fifth wave (1992–Till date) is marked by large number of mega-mergers and cross-border mergers.

7. C Pac-Man defense strategy is highly aggressive technique which is rarely used. Here the target company makes a counter tender offer in response to the raider's bid for the target. This defensive technique is named after the popular video game. So the alternative (c) is the answer. <TOP

Greenmail: It refers to the buying back of shares at a substantial premium from the stockholder holding a significant majority of shares in return for an agreement that he will not initiate a bid for control of the company. So the alternative (a) is not the answer.

White Knight: When a corporation is the target of an unwanted bid or the threat of a bid from a potential acquirer, it may seek the help of a white knight that is, another company that would be a more acceptable suitor for the target. So the alternative (b) is not the answer.

Crown Jewels: This strategy involves creating a mechanism which ensures that a raider, in the event of a hostile takeover, is denied access to the jewels of the firm. It is based on the argument that a particular aspect of the firm is so highly valued that it attracts raiders. It is made known that even after takeover of the firm, the acquirer would not acquire these jewels and there by the firm becomes less vulnerable. So the alternative (d) is not the answer.

White Squire: Here, the target company seeks to implement a strategy that will preserve the target company's independence. A white squire is a firm that consents to purchase a large block of the target company' stock. The stock selected is often convertible preferred stock. So the alternative (e) is not the answer.

8. B The example of a capitalized expenditure is installation costs necessary to use a machine that is just purchased. <TOP

9. B The interest rate usually specified on an annual basis in a loan agreement or security is known as the nominal rate of interest. If compounding is done more than once a year, the actual rate of interest paid (or received) is called effective interest rate. Effective interest rate would be higher than the nominal interest rate. The effective rate of interest increases with increase in the frequency of compounding. For example, the effective rate of interest under quarterly compounding will be more than the effective rate of interest under semi-annual compounding. Hence option (b) is correct. <TOP

10. B Capital recovery factor is the inverse of the PVIFA factor. It can be applied to find out the amount that can be withdrawn periodically for a certain length of time, if a given amount is invested today. Hence (I) and (II) is not true and (III) is true and the answer is (b). <TOP

11. C <TOP

According to the rule of 69, the doubling period = $0.35 + \frac{69}{\text{int erest rate}}$

Doubling period of fixed deposit = 7 years + 3 months $= 7 + \frac{3}{12} = 7.25$ years.

$\therefore 7.25 = 0.35 + \frac{69}{\text{int erest rate}}$ or $6.9 = \frac{69}{\text{int erest rate}}$ or interest rate = $\frac{69}{6.9} = 10$ percent.

12. B According to the traditional approach <TOP

$$P = m\left(D + \frac{E}{3}\right)$$

$$58.33 = 7\left(5 + \frac{E}{3}\right)$$

or, $5 + \frac{E}{3} = 8.3328$

or, $\frac{E}{3} = 3.3328$

or, E = 9.99 = Rs.10

13. A Imitation-Gap theory considers that improvement in technology is a continuous process and resulting invention and innovations in existing products give rise to trade between these countries. <TOP

14. E Keynesian theory of interest and employment is not a theory of international trade. Therefore option (e) is the correct answer. <TOP

15. B Following statements are **true**. <TOP

I. Higher inflation in an economy may lead to reduction in competitiveness of domestic goods and services and hence decrease in demand.

II. A lower value of the domestic currency may increase the demand for domestic goods and services internationally.

III. An appreciation of the domestic currency results in making imported goods and services cheaper in terms of the domestic currency, hence increasing their demand.

Hence the correct answer is (b).

16. A Positive value to the firm, which adds debt to the capital structure in the presence of corporate taxes is due to the extra cash flow going to the investors of the firm instead of the tax authorities. <TOP

17. C Capital account balance = Foreign direct investment i.e. Rs.4,00,000. <TOP

18.	D	Loans include concessional loans received by the government or public sector bodies, long-term and medium term borrowings from commercial capital in the form of loans, bond issues, etc. are a capital nature in Balance of Payment account.	<TOP
19.	D	Statements in options (a), (b), (c) and (e) are correct. It is incorrect that IFC insists on government guarantee for financing projects. In fact IFC does not insist on government guarantee. Correct answer is option (d).	<TOP
20.	E	**Compensating financing facility**-This scheme provides financial assistance to countries facing temporary shortfall in reserves **Extended facility**-This scheme allows countries to borrow on a medium-term basis for overcoming balance of payments problems caused by structural imbalance **Trust fund** - This scheme provides special development loans on concessional terms to those 25 member- countries which had the lowest per capita income **Supplementary financing facility** -This scheme provides finance to countries facing serious BoP problems and having high external debt **Buffer stock financing facility -** This scheme provides financial assistance to prevent countries suffering from price shock. So the correct answer is (e)	<TOP
21.	D	Under a system of floating exchange rates, relatively high productivity and low inflation rates in the India results in a (an) decrease in the demand for foreign currency, increase in the supply of foreign currency and an appreciation in the rupee. Hence, option (d) is the correct answer.	<TOP
22.	C	$\frac{1+0.04}{1+r_f}=\frac{1.002}{0.9879}$ $r_f = 2.54\%$	<TOP
23.	E	Bank giving for a buy-sell swap will get \$ at selling rate of Rs.40.45. (as the bank would be dealing in the inter bank market, it would have to buy at the ask rate). As the swap points are in low/high order, the Dollar is at premium. The bank will get 60 points premium if it sells Dollar forward. Hence the rate for the forward sale will be Rs. 40.55/\$ (40.45+0.10).	<TOP
24.	C	$(C\$ / £)_{bid}$: $(C\$ / \$)_{bid} \times (\$ / £)_{bid}$ 1.0054 x 1.9936 2.0044 $(C\$ / £)_{ask}$: $(C\$ / \$)_{ask} \times (\$ / £)_{ask}$ 1.0060 x 1.9945 2.0065 C\$ / £ : 2.0044 / 2.0065	<TOP
25.	B	(Exports + Investment income received) – (Imports + investment income paid + Net transfer paid) = (120 + 213) – (180 + 260 + 30) = \$137 million deficit.	<TOP
26.	E	Interest rate parity (IRP) implies that the difference in interest rates in different currencies for securities of similar risk and maturity should be consistent with the forward rate discount or premium for the foreign currency.	<TOP
27.	D	The bid rate of \$ / £ of Bank B is more than the ask rate of \$ / £ of Bank A. Hence there is scope for arbitrage. The ask rate of HK \$/ \$ of Bank B is less than the bid rate of HK \$ / \$ of Bank A. Hence there is scope for arbitrage. The correct answer is (d).	<TOP

28. A The forward margin is in discount and discount is to be deducted from the spot rates to arrive at the forward rates. The bank assumes that the option for purchase of foreign currency (from the customer) is exercised on the last day of the option period. Hence the maximum discount of 3 months is given. The forward bid rate with option to deliver in 3rd month is spot bid rate – 3 months discount <TOP

=	0.6386
=	Less 0.6125
	0.0261

29. D An Americal quote is the number of dollars expressed per unit of any other currency. While a European quote is the number of units of any other currency expressed per dollar. Quote in option (d) is an American quote. <TOP

30. D Merchant quote is a quote given by the banks to its retail customers. <TOP

31. D The principle to be followed in the case of a direct quote is buy low – sell high. Discount is to be deducted either from the bid rate or ask rate depending on whether bank is buying or selling the currency. In an option forward contract, for an import transaction, the banker sells currency to the importer so it will deduct minimum discount from ask rate assuming that the importer may ask for the delivery of foreign currency on the first day of the option period. Hence the correct answer is (d). <TOP

32. C The no. of right shares to be received by an investor holding 400 shares of a company <TOP

= (400/8)= 50 right shares.

33. A The private placement method of financing involves direct selling of securities to a limited number of institutional or high networth investors. This avoids the delay involved in going public and also reduces the expenses involved in a public issue. <TOP

The major advantage of privately placing the securities are:

- Easy access to any company

Fewer procedural formalities

Lower issue cost

Access to funds is faster.

Hence statements (II) and (III) are true but statement (I) is incorrect and the answer is (a).

34. B <TOP

Ex-rights value of share = $\frac{NP_0 + S}{N+1}$

Where N, P_o and S have their usual meanings

Given: N = 4

P_o = Rs. 60 per share

Ex-rights price = Rs. 58 per share

$\therefore \quad 58 = \frac{4(60)+S}{4+1}$

or S = 58 (5) – 60 (4)

or S = Rs. 50 per share.

35. B Calculation of breaking point: <TOP

Source of finance	Cost (%)	Range of new financing	Breaking point	Range of total new financing
		(Rs. in crore)	(Rs. in crore)	(Rs. in crore)
Equity	15	0 – 10	10/0.4 = 25	0 – 25
	16	10 – 20	20/0.4 = 50	25 – 50
	17	20 and above	–	50 and above
Preference	14	0 – 2	2/0.2 = 10	0 – 10
	15	2 and above	–	10 and above
Debt	9	0 – 12	12/0.4 = 30	0 – 30
	10	12 – 18	18/0.4 = 45	30 – 45
	11	18 and above	–	45 and above

If the new financing is in the range of Rs.25 – 30 crore

Cost of equity = 16%

Cost of preference = 15%

Cost of debt = 9%

Weighted marginal cost of capital in the above range

= 0.16 x 0.4 + 0.15 x 0.2 + 0.09 x 0.4 = 13%

Hence, answer is (b).

36. E <TOP

Wealth ratio (w_t) = $\frac{D_t + P_t}{P_{t-1}}$

Year	1	2	3	4	5
DPS	5.032	4.92	3.60	5.32	4.29
Price at the beginning	75.00	78.00	84.24	77.50	86.03
Price at the end	78.00	84.24	77.50	86.03	93.77
Wealth ratio	1.1071	1.1431	0.9627	1.1787	1.1398

Yield for an n-year period is $(W_1 \times W_2 \times \ldots\ldots\ldots \times W_n)^{1/n} - 1$

Yield = $(1.1071 \times 1.1431 \times 0.9627 \times 1.1787 \times 1.1398)^{1/5} - 1$

= 1.1036 – 1

= 0.1036

= 10.36%.

37. E Realized yield approach emphasizes that the past returns on a security are taken as a proxy for the return required by the investors in the future. Statement (a) is true. <TOP

The return earned by the investors according to the bond yield plus risk premium approach is equal to the yield on the long-term bonds plus a risk premium. Statement (b) is true.

The earnings price ratio approach emphasizes that the cost of equity is the ratio of the expected EPS for the next year and the current market price per share. Statement (c) is true.

Cost of external equity comes into picture when there are certain floatation costs involved in the process of raising equity from the market. Statement (d) is true.

Cost of retained earnings is always less than the cost of new issue of common stock due to absence of floating costs. Statement (e) is not true.

Hence (e) is the answer.

38. C No. of equity shares =20,00,000/10 =2,00,000 <TOP

Profit after tax = Rs.6,50,000

Equity earnings = Rs.6,50,000

Earnings per share = 6,50,000/2,00,000 =Rs.3.25

Expected earnings per share = 3.25(1.05) = Rs.3.4125

Market price per share =Rs.30

Cost of equity according to Earning/price (E/P) ratio approach = 3.4125/30 =11.38%.

39. A According to net income approach, the costs of equity and debt remain constant irrespective of the degree of leverage. As per the traditional approach, the overall cost of capital for a firm increases as the degree of leverage increases. A firm should choose the debt-equity ratio in such a way that it will minimize the cost of capital, not to avoid tax liability. The higher the degree of leverage, the more the risk of insolvency and hence correspondingly the higher will be risk to the equity shareholders. According to the net operating income approach, the overall cost of capital remains the same at any degree of leverage. <TOP

40. D Cost of external equity $k_e^{'} = \frac{k_e}{1-f}$ where f is the issue expense. <TOP

In the case of this company, $k_e^{'} = \frac{0.165}{1-0.06} = \frac{0.165}{0.94} = 0.1755 = 17.55\%$.

41. B Net operating income =Total assets × Return on asset <TOP

=1500 × 0.18 =Rs.270 crores

Market value of equity =Net operating income/cost of equity capital

=270/0.15 = Rs.1800 crore.

42. D When capital market is perfect, no cost is associated with bankruptcy. Assets of a bankrupt firm can be sold at their economic value and legal and administrative expenses are not present. So, the answer would be (d). <TOP

43. D Tax advantage associated with debt capital = $\left[1-\frac{(1-t_c)(1-t_{ps})}{(1-t_{pd})}\right] \times B$ <TOP

= $\left[1-\frac{(1-0.45)(1-0.25)}{(1-0.30)}\right] \times 8,00,000$ = Rs. 3,28,571.

44. B Cost of irredeemable Preference Shares, <TOP

$k_p = \frac{\text{Preference dividend}}{\text{Price realised per share}}$

Price realised per share = 100 (1-0.05) = Rs. 95 = $\frac{15}{95} = 15.789\%$.

45. D 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. <TOP

46. C Value of the firm according to MM hypothesis can be computed as: [<TOP](#)

$$nP_0 = \frac{(n+\Delta n)P_1 - I + E}{(1+k_e)}$$

where n is the number of shares outstanding at the beginning of the period

P_0 is the prevailing market price of the share (Hence nP_0 is the total capitalized value of the firm).

Δn is the change in the number of outstanding shares during the period

P_1 is the price next year

I is the total investment required

E is the earnings of the firm during the period

k_e is the capitalization rate.

The price per share next year can be computed as:

$$P_0 = \frac{1}{(1+k_e)}(D_1 + P_1)$$

$$60 = \frac{1}{(1+0.15)}(10+P_1)$$

Solving for P_1, we get P_1 = Rs.59.

According to MM hypothesis

$$nP_0 = \frac{(n+\Delta n)P_1 - I + E}{(1+k_e)}$$

i.e. n x 60 = $\frac{(n+6000)\times 59 - 2,25,000 + 60,000}{(1+0.15)}$

Solving for n, we get n = 18,900 shares. Hence (c) is the answer.

47. E The rational expectations model states that the market price may show some adjustments if the actual dividend declared is higher or lower than the expected level. Otherwise, there would be no impact of the dividend declaration on the market price of the share as long as it is at the expected rate. Hence the option (e) is correct. [<TOP](#)

48. B [<TOP](#)

According to Walter model P0 = $\dfrac{\frac{D}{Ke} + \frac{r(E-D)/Ke}{Ke}}{}$

$$= \frac{7.2}{0.12} + \frac{0.15(12-7.2)}{(0.12)^2}$$

= 60 + 50

= 110

$\therefore$ Market value of equity = 110 × 4,50,000

= Rs.4,95,00,000

49. B As per Walter Model [<TOP](#)

$$P_0 = \frac{D + (E-D)r/k}{k}$$

Where, the notations are in their standard use.

As the given return on investment (r) > cost of equity (k) the company will maximize the value of share if no dividends are paid.

50. D When NPV is positive, the Internal rate of return is greater than the cost of capital and benefit cost ratio is greater than 1. Hence option (d) is correct. When NPV is positive IRR cannot be equal to cost of capital, and NBCR is not greater than 1and cost of capital is not greater than IRR. Therefore option (a), (b),(c)and (e) are incorrect. [<TOP](#)

51. D The gross operating cycle of a business entity is defined as the sum of raw material storage period, work-in-process period, finished goods storage period and average collection period. An increase in the consumption of the raw materials will reduce the raw materials storage period while synchronization of the various processes of productions for a better volume will reduce the work in process period. Incremental demand for the product of the company will reduce the finished goods storage period and the proposition for selling the products against cash payment will shorten the debtors' payment period. The average payment period is to be deducted from the gross operating cycle to get the net operating cycle. Hence, a decrease in the average payment period will increase the net operating cycle. <TOP

52. C Present value of the costs associated with the machine will be <TOP

Rs.30,00,000 + Rs.250,000 × PVIFA(10 percent, 4 years) + Rs.300,000 × PVIFA(10 percent, 6 years) × PVIF(10 percent, 4 years)

= Rs.30,00,000 + Rs.250,000 × 3.170 + Rs.300,000 × 4.355 × 0.683

= Rs.46,84,839.50

The required annual capital charge will be

$$= \frac{\text{Rs.}46,84,839.50}{\text{PVIFA (10\%, 10 years)}} = \frac{\text{Rs.}46,84,839.50}{6.1446} = \text{Rs.}7,62,432 \text{ (approximately)}$$

53. B IRR considers the cash flows over the entire project life (I). It considers the time value of money (II). It is the rate of return at which the present value of benefits is equal to the present value of costs (III). It is not uniquely defined when the project entails cash inflows and outflows that are interspersed with each other. Hence (IV) is false. So the correct answer is (b). <TOP

54. B <TOP

$$\text{Benefit cost ratio} = \frac{\textit{present value of benefits}}{\textit{Investment}}$$

presentvalueofbenefits

$$= \frac{5}{(1.12)} + \frac{6}{(1.12)^2} + \frac{7}{(1.12)^3} + \frac{8}{(1.12)^4} + \frac{9}{(1.12)^5} + \frac{10}{(1.12)^6}$$

= Rs.29.49 lakh

Investment = Rs.25 lakh

Benefit cost ratio = 29.49/25

= 1.1796

55. D Optimality of the scale of operations is not considered while performing market appraisal, it is considered while performing technical appraisal. Hence (d) is the answer. <TOP

56. C Total profit before depreciation over the life of the machine = Rs.1,47,000 <TOP

Average profit p.a = Rs.1,47,000/5 = Rs.29,400

Total depreciation over the life of the machine = Rs.1,20,000 – Rs.20,000

Average depreciation p.a = Rs.1,00,000/5 = Rs.20,000

Average annual profit after depreciation = Rs.29,400 – Rs.20,000 = Rs.9,400

Average net book value of investment = Rs. (1,20,000 + 20,000)/2 = 70,000

Accounting rate of return = (9,400/70,000) ×100 = 13.43 %

So option (c) is the answer.

57. D

Given: <TOP

NPV = PV of cash inflows – Cost of the project

Annual cash inflow = Rs.60,000

Useful life = 6 years

IRR = 18%

At IRR (18%), the total PV of cash inflows = Initial cash outlay.

Initial cash outlay = Rs.60,000 x $PVIFA_{(18\%, 6)}$ = 60,000 x 3.498 = Rs.2,09,880

PV of cash inflows when (Kc is 15%) = Rs.60,000 x $PVIFA_{(15\%, 6)}$= 60,000x3.785 = Rs. 2,27,100.

NPV = 2,27,100 – 2,09,880 = Rs.17,220

Hence (d) is the answer.

58. B <TOP

$$\text{Average collection period} = \frac{\text{Average accounts receivable}}{\text{Average daily sales}}$$

Hence average daily sales = Average accounts receivable/ Average collection period

= 45000/60.

Hence annual sales= 360 x 45000/60 = Rs. 2,70,000.

59. E

(in Rs. Lakh) <TOP

Input	Period (months)	Raw materials	Work in Process	Finished Goods	Debtors	Total
Raw Material						
In stock	2	100				
In W I P	1		50			
In finished Goods	1			50		
In debtors	3				150	350
Manufacturing Expenses						
In WIP	1/2		10			
In finished goods	1			20		
In debtors	3				60	90
Selling, Administrative and financial expenses						
In finished goods	1			10		
In debtors	3				30	40
Profit						
In debtors	3				60	60
Total		100	60	80	300	540

Hence, the amount of working capital requirement is Rs.540 lakh + Rs.10 lakh = Rs.550 lakh

60. C

If the inventory turnover ratio has decreased from past, it means that either inventory is growing or cost of goods sold sales are dropping. So statement (I) is incorrect. <TOP

If a firm has an inventory turnover that is slower than for its industry, then there may be obsolete goods on hand, or inventory stocks may be high. So statement (II) is incorrect.

Low inventory turnover has impact on the liquidity of the business because most of the current assets are tied up in inventory. So statement (III) is correct.

Hence option (c) is the answer.

61. D

1. Raw material consumed = Opening stock + Purchases made during the year – Closing stock <TOP

= 4,80,000 + 12,60,000 – 6,40,000

= Rs.11,00,000

2. Average stock = (opening stock + closing stock)/2 = (4,80,000+6,40,000)/2=Rs.5,60,000

$$\text{Inventory turnover ratio} = \frac{\text{Raw material consumed}}{\text{Average stock}} = \frac{11,00,000}{5,60,000} = 1.964$$

Hence (d) is the answer.

62. D Inventory Conversion Period (ICP) = 365 days/(Rs.160 million/Rs.10 million) = 22.8125 days. <TOP

New inventory conversion period = 365/(Rs.160 million/Rs.6 million) = 13.6875 days.

Net change in inventory conversion period = –9.125 days.

Total reduction in inventory conversion period required = 14 days.

Further reduction in inventory conversion period required = 14 – 9.125 = 4.875 days i.e. 5 days

63. D Average collection period = Gross operating cycle – (RM storage period + Conversion period + FG storage period) = 80 – (40 + 2 + 20) = 18 days. <TOP

Hence (d) is the answer.

64. B Companies following a conservative approach to working capital management are subjected to a lower degree of risk of insolvency because more amount of funds are locked in current assets and the turnover of current assets is less than that in an aggressive approach. They will have a low percentage of operating profitability and the cost of financing is high. Hence statement (b) is not true and is the answer. <TOP

65. C In the letter of credit arrangement the bank undertakes the responsibility to honor the obligation of its customer, when the customer fail to do so. Hence the bank assumes the risk of default while the supplier provides the credit. <TOP

66. D 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. <TOP

67. D Incremental contribution = Rs.10 lakh x 0.3 = Rs.3.0 lakh <TOP

$$\text{Increase in receivables} = \Delta I = (ACP_N - ACP_O)\left[\frac{S_0}{360}\right] + V(ACP_N)\frac{\Delta S}{360}$$

$$= (55 - 40)\left[\frac{60}{360}\right] + 0.7(55)\frac{10}{360}$$

$$= 2.50 + 1.069 = \text{Rs.}3.569 \text{ lakhs.}$$

Increase in cost of funds locked in receivables = 0.18 x 3.569 = Rs.64,242

Therefore incremental gain = Incremental contribution – Increase in cost of funds locked in receivables = Rs.3,00,000 - Rs.64,242 = Rs.2,35,758.

Hence (d) is the answer.

68. E A company generally choose the liquidity mix on the basis of the level of uncertainty in the cash flows. Nature of control with the managers, extent of leverage, marginal cost of capital and the quality of the products of the company does not play any role in this respect. <TOP

69. B The elements of the internal audit represent the basic procedures that will simplify the completion of internal audit. <TOP

Expertize represents the professional aspects of a job. Hence (b) is the answer.

70. C Let the IRR project = k, then <TOP>

$$55 \text{ lakh} = \frac{15}{(1+k)^1} + \frac{24}{(1+k)^2} + \frac{30}{(1+k)^3} + \frac{45}{(1+k)^4} + \frac{32}{(1+k)^5}$$

Let k = 37%

= 10.94 + 12.78 + 11.66 + 12.77 + 6.620

= 54.78 = 55 (approx.)

Therefore, IRR = 37% (approx.)

71.	A	$NAV = V_{AB} - [V_A + V_B] - [P + E]$ Where, V_{AB} = The combined value of the firm V_A = The market value of the Firm A V_B = The market value of the Firm B P = Premium paid for B E = Expenses of the acquisition process Here, NAV = 150 – (120 + 12) – (10 + 4) = 4 crores.	<TOP>
72.	B	As per the assumptions of capital structure theories, Total market value of the firm (V) = $\frac{\text{Net operating income}}{\text{overall cost of capital}} = \frac{150}{0.15} = \text{Rs.1,000 lakh}$ Market value of equity (S) = $\frac{\text{Equity income}}{\text{equity cost of capital}}$ $\frac{\text{Net Operating income - Interest on debt}}{\text{equity cost of capital}} = \frac{150-14}{0.17} = \text{Rs.800 lakh}$ Market value of debt (B) = Total market value of the firm - Market value of equity = Rs.1,000 – Rs.800 lakh = Rs.200 lakh Debt-equity ratio = 200/800 = 1:4 Hence (b) is the answer.	<TOP>

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