Question Paper
Financial Management (CFA540): October 2008

- Answer all 74 questions.
- Marks are indicated against each question.

Total Marks : 100

1. Sinking fund factor is the reciprocal of <Answer >

(a) Future value interest factor
(b) Present value interest factor
(c) Future value interest factor of annuity
(d) Present value interest factor of annuity
(e) Capital recovery factor. **(1 mark)**

2. In the APV method, if there is a strong probability of positive cashflows being generated, the discount rate used to calculate the benefit due to increased borrowing capacity is <Answer >

(a) Cost of capital for the parent company
(b) Nominal risk-free rate of interest in host country
(c) Nominal risk-free rate of interest in home country
(d) Market rate of interest in home country
(e) Market rate of interest in host country. **(1 mark)**

3. Which of the following is **not** among the daily activities of finance manager? <Answer >

(a) Sale of shares and bonds
(b) Cash management
(c) Inventory control
(d) The receipt and disbursement of funds
(e) Receivable management. **(1 mark)**

4. Which of the following statements fall under the Proposition III of Modigliani and Miller approach of capital structure? <Answer >

I. The investment and financing decisions of a firm are independent of each other.
II. The expected yield on common stock (cost of equity) is equal to the sum of the capitalization rate for a pure equity stream of a specific class and the premium based on the financial risk.
III. The market value of a firm is independent of its capital structure and is determined by capitalizing its expected return at the rate appropriate to its class.

(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. **(1 mark)**

5. If a firm with credit terms of 1/10 net 30 were to change its terms to 3/10 net 30, the most likely result would be <Answer >

(a) An increase in bank loans
(b) A decrease in the average level of accounts receivable
(c) A decrease in accounts payable
(d) A decrease in accounts receivable turnover
(e) A decrease in sales volume. **(1 mark)**

6. Which of the following is **not** a part of the economic appraisal of projects? <Answer >

(a) Impact of the project on income distribution
(b) Impact of the project on the extent of savings and investment
(c) Impact of the project on the wealth of the shareholders
(d) Impact of the project on employment generation
(e) Impact of the project on the self-sufficiency of economy. **(1 mark)**

7. The intervention of the government in the financial system to influence macro economic variables like interest rates or inflation is an example of which function of the financial system? <Answer>

(a) Savings Function
(b) Liquidity Function
(c) Payment Function
(d) Risk Function
(e) Policy Function.

(1 mark)

8. Which of the following will cause a decrease in the net operating cycle of a firm? <Answer>

(a) Increase in the average collection period
(b) Increase in the average payment period
(c) Increase in the finished goods storage period
(d) Increase in the raw materials storage period
(e) Increase in the work-in-progress period.

(1 mark)

9. An investor places an order with a broker in the stock exchange to sell 100 shares of Zion Ltd. at a fixed price of Rs.150 per share including brokerage charges of 1%. Such an order is referred to as <Answer>

(a) Limited discretionary order
(b) Best rate order
(c) Immediate order
(d) Limit order
(e) Stop loss order.

(1 mark)

10. Which of the following theories of international trade states that the improvement in technology is a continuous process and the resulting innovations give rise to trade between countries? <Answer>

(a) Theory of absolute advantage
(b) Theory of comparative advantage
(c) Hecksher-Ohlin model
(d) Imitation gap theory
(e) International product life cycle theory.

(1 mark)

11. Which of the following approaches supports the existence of a unique optimal capital structure? <Answer>

(a) Gordon Approach
(b) Net operating Income Approach
(c) Net Income Approach
(d) M&M Approach
(e) Realized yield Approach.

(1 mark)

12. Which of the following is **not** a relevant factor in cash management? <Answer>

(a) Prompt billing and mailing the same to the customers
(b) Branch wise collection of receivables
(c) Centralized purchases and payments to the suppliers
(d) Availing of term loans to the maximum possible limit
(e) Prompt depositing of the cheques received from customers in the bank.

(1 mark)

13. The relationship between the exchange rate and the prices of tradable goods is known as <Answer>

(a) Purchasing power parity theory
(b) Asset markets theory
(c) Monetary theory
(d) Balance of payments theory
(e) Price-specific-flow mechanism.

(1 mark)

14. In the presence of floatation costs, the cost of external equity is <Answer>

(a) More than the cost of existing equity capital
(b) Less than the cost of existing equity capital
(c) Equal to the cost of existing equity capital
(d) Equal to the cost of long-term debt
(e) Equal to the cost of short-term debt.

(1 mark)

15. If Rs./$ is 43.45/50 and Rs./£ is 69.20/25, then implied $/£ quote would be <Answer>

(a) 1.5908/38
(b) 0.6274/86
(c) 1.5920/26
(d) 0.6279/81
(e) 1.5926/38.

(1 mark)

16. Which of the following statements is/are **not** true with respect to internal rate of return? <Answer>

I. Internal rate of return gives the maximum net present value for any project.
II. The internal rate of return of a project does not change, as the cost of capital changes.
III. It ignores the cash flows of the project beyond payback period.

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

(1 mark)

17. Which of the following statements is **false**? <Answer>

(a) A firm with a high capital intensity relies more on long term debt and equity
(b) The capital structure of a firm should be built conservatively, if chances of obsolescence are high
(c) Term loan is the cheapest source of finance
(d) In a non-seasonal and non-cyclical business, investment in current assets is usually financed by short term debt
(e) An aggressive capital structure will be tilted more towards debt than equity.

(1 mark)

18. Consider the following data for Bits Telecommunications Ltd.: <Answer>

Earnings Per Share (EPS)	Rs.10
Dividend Payout Ratio	50%
Equity Capitalization Rate	10%
Rate of Return on Investments	12%

If the number of shares outstanding for the firm is 2,00,000, the market value of equity according to Walter model is

(a) Rs. 1,10,00,000
(b) Rs. 2,20,00,000
(c) Rs. 3,30,00,000
(d) Rs. 4,40,00,000
(e) Rs. 5,50,00,000.

(2 marks)

19. Agro Foods Ltd. posted a net income of Rs.15 million in the current year. Financial planners at Agro Foods anticipate having a capital budget of approximately Rs.18 million. The firm also anticipates retaining its target capital structure of 60% equity and 40% debt. If the firm follows a strict residual dividend policy, what is their expected dividend payout ratio? <Answer>

(a) 28%
(b) 36%
(c) 50%
(d) 64%
(e) 72%.

(2 marks)

20. Moccasin Leathers Ltd. has an equity of Rs.8,40,000 and 15% preference share capital of Rs.6,00,000. The face value of its shares is Rs.10 and market value is Rs.20 and it had posted a profit after tax of Rs.9,00,000 this year. The company paid Rs.3,36,000 by way of equity dividends. If the dividends grow at 5%, the cost of equity according to earning price ratio approach is <Answer>

(a) 25.01%
(b) 35.61%
(c) 45.51%
(d) 50.61%
(e) 55.01%.

(2 marks)

21. You have invested Rs.3,000 in a deposit scheme paying 12.4% p.a., compounded semi-annually. How much would you have in your account after 4 years? <Answer>

(a) Rs.4,788.36
(b) Rs.4,682.18
(c) Rs.4,854.20
(d) Rs.4,600.00
(e) Rs.6,280.50.

(1 mark)

22. 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 that follows aggressive working capital management policy generally experiences lower profitability.

(1 mark)

23. The following figures are collected from annual report of Hindustan Textiles Ltd.: <Answer>

	2007 (in Rs. '000)	2008 (in Rs. '000)
Raw materials inventory – Closing Balance	160	192
Work in process inventory – Closing Balance	25	45
Finished Goods inventory – Closing Balance	30	50
Purchases of raw materials during the year	1135	1242
Manufacturing expenses during the year	1125	1230
Depreciation	75	100
Selling, administration and financial expenses during the year	200	230
Excise Duty paid during the year	120	150

Assuming 360 days in a year, what should be the average finished goods storage period of Hindustan textiles for the year 2008?

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

(2 marks)

24. Pioneer chemicals Ltd. purchased raw materials from its suppliers on credit for 45 days. However, the supplier has offered a discount of 2% on early payment. If the cost associated with such credit terms is 21%, the discount period is approximately (assume 360 days in a year) <Answer>

(a) 8 days
(b) 10 days
(c) 13 days
(d) 15 days
(e) 26 days.

(1 mark)

25. Vishay Fertilizers Ltd. keeps excess cash on hand in case of an industrial accident in the manufacturing of its fertilizer. This is an example of a <Answer>

(a) Compensating need for holding cash
(b) Precautionary need for holding cash
(c) Speculative need for holding cash
(d) Deterministic need for holding cash
(e) Transactions need for holding cash.

(1 mark)

26. Which of the following statements is/are **true**? <Answer>

I. Other things being equal, as the expected growth rate in dividend increases, the expected return depends more on the capital gain yields and less on the dividend yield.
II. Other things being equal, the price-earning ratio decreases as the expected growth rate in dividend increases.
III. High dividend yield and low price-earning ratio imply limited growth prospects.

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

(1 mark)

27. Charmin Tobacco Ltd. (CTL) has the following capital structure: <Answer>

Particulars	Rs.
Equity Shares (2,00,000)	40,00,000
10% Preference Shares	10,00,000
14% Debentures	30,00,000

The current market price of the share is Rs.20. The expected dividend next year is Rs.2 per share, which will grow at 7% forever. If the company raises an additional Rs.20,00,000 debt by issuing 15% debentures, the expected dividend increases to Rs.3 and the price of share falls to Rs.15. The growth rate remains the same. The weighted average cost of capital for the firm, assuming a tax rate of 30% is

(a) 12.37%
(b) 15.71%
(c) 16.84%
(d) 17.00%
(e) 27.00%.

(2 marks)

28. Which of the following is **not** an assumption underlying the Modigliani and Miller approach to capital structure? <Answer>

(a) Information is freely available to investors
(b) The transaction cost is constant irrespective of the value of the transactions in securities
(c) Firms can be divided into classes in such a way that all the firms falling within one class have the same degree of business risk
(d) There is no corporate or personal income tax
(e) Investors make rational investment decisions.

(1 mark)

29. Which of the following statements is/are **true** with respect to cash management?

I. A cash management system, which minimizes collection float and maximizes payment float is better than the one with higher collection float and lower payment float.
II. A cash management system, which maximizes collection float and minimizes payment float is better than the one with lower collection float and higher payment float.
III. If interest rates are increasing, it should be a cause of concern for a finance manager to review his cash management system.

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

(1 mark) <Answer>

30. As a general rule, the capital structure that maximizes the market value of a company also

(a) Maximizes its average cost of capital
(b) Maximizes its earnings per share
(c) Maximizes the chance of bankruptcy
(d) Minimizes the cost of capital of the company
(e) Minimizes the cost of debt capital of the company.

(1 mark) <Answer>

31. Sagar textiles Ltd. follows a policy of fixed dividend payout of 80%. The earning per share for the year is Rs.4.50 per share and the same is expected to grow by 20% in future. The firm earns a return of 18% on its investments. The cost of equity of the company is 15%. The value of the share based on Gorden model would be approximately

(a) Rs.31.58
(b) Rs.33.85
(c) Rs.35.75
(d) Rs.39.55
(e) Rs.40.00.

(1 mark) <Answer>

32. The following information is given for a project:

Year	0	1	2	3
Initial Investment (Rs.)	2,10,000			
Net Cash Inflows (Rs.)		30,000	45,000	75,000

Assuming that salvage value at the end of the 3rd year is zero, the accounting rate of return for the project is

(a) 59.96%
(b) 54.56%
(c) 47.62%
(d) 43.56%
(e) 39.80%.

(2 marks) <Answer>

33. The market value of debt and equity of a firm are Rs.80 lakh and Rs.120 lakh and the costs of equity and debt are 16% and 14% respectively. Assuming the firm follows 100% dividend payout ratio and there is no income tax, corporate or personal, the net operating income for the firm is

(a) Rs.27.2 lakh
(b) Rs.28.4 lakh
(c) Rs.30.4 lakh
(d) Rs.31.6 lakh
(e) Rs.32.4 lakh.

(2 marks)

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

(a) If the current account is in surplus, then capital account must also be in surplus
(b) If the capital account is in deficit, then current account must also be in deficit
(c) The overall sum of all the entries in the balance of payments must be positive
(d) The overall sum of all the entries in the balance of payments must be negative
(e) The overall sum of all the entries in the balance of payments must be zero.

(1 mark)

35. Which of the following is **not** considered as a capital component for the purpose of calculating the weighted average cost of capital (WACC) in capital budgeting? <Answer>

(a) Long-term debt
(b) Common stock
(c) Accounts payable and accruals
(d) Preferred stock
(e) Convertible bonds.

(1 mark)

36. If the outright forward rate of US $ for 3 months is Rs.46.10/13 and the relevant swap points are 5/6 paise, then the spot rate is <Answer>

(a) 46.15/19
(b) 46.16/18
(c) 46.05/07
(d) 46.04/07
(e) 46.05/08.

(2 marks)

37. Visual Printers Ltd. (VPL) currently uses a machine, whose book value is Rs.12 lakh with the remaining useful life of 5 years and a salvage value of Rs.2 lakh at the end of the useful life. VPL is proposing to replace the machine by a new machine costing Rs.20 lakh and has a useful life of 5 years and salvage value of Rs.4 lakh at the end of 5 years. The new machine is expected to reduce the annual operating costs by Rs.0.5 lakh and increase the annual income by Rs.1 lakh. The old machine, if sold now, can realise Rs.9 lakh. EPL follows straight-line method of depreciation and is in the tax bracket of 40%. The net incremental cash flows of the new machine during year 0 and year 5 respectively are <Answer>

(a) –Rs.20 lakh, Rs.3.38 lakh
(b) –Rs.11 lakh, Rs.3.38 lakh
(c) –Rs.11 lakh, Rs.4.10 lakh
(d) –Rs.20 lakh, Rs.2.10 lakh
(e) –Rs.11 lakh, Rs.2.10 lakh.

(2 marks)

38. Which of the following is/are **true** regarding the choice of the mix of cash and near cash assets? <Answer>

I. If the degree of uncertainty surrounding cash flow projections is low, the companies will be tilted more towards marketable securities and intercorporate deposits.
II. If the attitude of the management towards risk is conservative, the portfolio tends to have a higher proportion of intercorporate deposits.
III. If the company has access to non-bank sources of funds, it will tend to have a higher proportion of intercorporate deposits and marketable securities.

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

(1 mark)

39. Sringar Paints Ltd. has 10 lakh equity shares outstanding and these shares are presently traded in NSE at Rs.150 each. The rate of capitalization appropriate to the risk class to which the firm belongs is 12%. The net income for the year is Rs.2 crore and the investment budget is Rs.4 crore. Assume that no dividend will be declared and the additional fund requirement will be financed by new issue of equity shares. If Modigliani-Miller hypothesis holds good, the number of equity shares to be issued by the company is <Answer>

(a) 1,09,048
(b) 1,09,248
(c) 1,19,048
(d) 1,19,248
(e) 1,29,348.

(2 marks)

40. Which of the following are **true** with respect to poison pill strategies? <Answer>

I. Shareholders are given a common stock dividend in the form of rights for each share they own.
II. The Flip-in poison pill plan permits the current shareholders to buy more shares of the acquiring company at a discount.
III. The Flip-over poison pill plan allows the current shareholders to purchase the shares of the target company at a heavy discount.
IV. A poison pill program is created by the Board of Directors and the board has the authority to redeem it.

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

(1 mark)

41. Which of the following statement(s) is/are **true**? <Answer>

I. If there is synergy, the value of the combined firm should be greater than the value of the companies operating independently.
II. When two firms merge and do not use their additional borrowing capacity, there will be a transfer of wealth from bond holders to stock holders.
III. The value of control is greater for a badly managed firm than for a well-managed firm.

(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.

(1 mark)

42. Which of the following is a part of the control function of the finance manager? <Answer>

(a) Negotiating with the banks and financial institutions for loans
(b) Negotiating with the merchant banks for issue of shares and debentures
(c) Reporting on the performance of individual departments within the organization
(d) Appraisal of investment proposals given by various departments
(e) Deciding on the manner of deployment of funds in various assets.

(1 mark)

43. Which of the following is a disadvantage of bought-out-deal? <Answer>

(a) It is more expensive than public issue
(b) It involves a time consuming procedure
(c) It is difficult to convince a wholesale investor
(d) Promoters are not assured of immediate funds
(e) Sponsor may misuse their power.

(1 mark)

44. The minimum cash flow that must be received at the end of year three, with an initial investment of Rs.40,000 with cash flows for the first and second year of Rs.13,000 each and an opportunity cost of capital of 12.5%, is <Answer>

(a) Rs.18,173
(b) Rs.18,275
(c) Rs.19,284
(d) Rs.25,875
(e) Rs.30,565.

(2 marks)

45. Modi Finance Ltd. offers a deposit scheme where the investor is required to deposit Rs.100 at the end of every month for a period of 4 years 2 months in order to get an amount of Rs.7,500 at the end of 5 years. What is the effective rate of interest? <Answer>

(a) 11.30 percent
(b) 12.30 percent
(c) 13.30 percent
(d) 14.30 percent
(e) 15.30 percent.

(3 marks)

46. The following information regarding the equity shares of Venus Pharmalabs Ltd. is given: <Answer>

Market price per share	Rs.17.00
DPS	Rs. 3.00
Multiplier	3.40

According to the traditional approach to the dividend policy, the EPS for Venus Pharmalabs Ltd. is approximately

(a) Rs. 2
(b) Rs. 4
(c) Rs. 6
(d) Rs. 8
(e) Rs.10.

(1 mark)

47. A firm buys goods on credit terms of 2/10, net 45 days and it always pays on the 45th day. If you calculate that this policy effectively costs your firm Rs.1,59,621 each year, the firm's average accounts payable balance is (Assume 365 days in a year) <Answer>

(a) Rs. 12,340
(b) Rs. 75,000
(c) Rs.1,57,500
(d) Rs.6,25,000
(e) Rs.7,50,000.

(2 marks)

48. Which of the following statements is **false** with regard to a public limited company? <Answer>

(a) It is a distinct legal entity separate from its shareholders
(b) It can raise equity capital by issuing shares to the general public
(c) At least seven persons are required to form a public limited company
(d) There is no limit on the maximum number of shareholders
(e) There is no limit on the total managerial remuneration payable by the company.

(1 mark)

49. Which of the following companies generally provide risk capital to the technology oriented and highly risky businesses? <Answer>

(a) Venture capital funding companies
(b) Lease finance companies
(c) Hire purchase finance companies
(d) Commercial banks
(e) Insurance companies.

(1 mark)

50. International trade in the same product is called <Answer>

(a) Trade based on economies of scale
(b) Inter-Industry trade
(c) Intra-Industry trade
(d) Trade based on imitation gaps
(e) Trade based on product cycles.

(1 mark)

51. The discount rate that equates the present value of cash flows with the initial outlay is called <Answer>

(a) The net present value
(b) The internal rate of return
(c) The sum of the present value of cash flows
(d) The terminal value of the cash flows
(e) The profitability index.

(1 mark)

52. 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.

(1 mark)

53. Which of the following foreign exchange exposures refers to the impact on the value of firm's operations due to unanticipated changes in the exchange rates? <Answer>

(a) Transformation exposure
(b) Transaction exposure
(c) Translation exposure
(d) Currency exposure
(e) Economic exposure.

(1 mark)

54. RKL is market leader in ball bearing segments. It is contemplating to acquire a sick company named BBL. The number of shares outstanding in RKL is three times that of BBL. Had the number of shares in RKL been same as that of BBL, the market capitalization of RKL at the existing share price would have been Rs.100 crore. The combined earnings of the companies are Rs.30 crore. The expected price-earnings ratio in the post merger time would be 20. The maximum exchange ratio acceptable to RKL is <Answer>

(a) 2.0
(b) 2.5
(c) 3.0
(d) 3.5
(e) 4.0.

(2 marks)

55. Telesoft Corporation's budgeted sales for each month of a quarter are Rs.3,00,000. Forty percent of its customers pay in the first month and take 2 percent discount. The remaining sixty percent pay in the month following the sale and don't receive any discount. Purchases for next months' sales are constant each month at Rs.1,50,000. If other payments for wages, rent, and taxes are constant at Rs.70,000 per month, the average cash gain/(loss) during a typical month for Telesoft Corporation will be <Answer>

(a) Rs.2,60,000
(b) Rs. 80,000
(c) Rs. 77,600
(d) Rs. (74,000)
(e) Rs. (72,800).

(2 marks)

56. If the cost of an investment is Rs.25,000 and it results in a net cash inflow of Rs.1,800 per annum forever. Assuming that the discount rate is 8%, the net benefit cost ratio of that investment is <Answer>

(a) – 0.11
(b) – 0.10
(c) – 0.09
(d) 0.10
(e) 0.11.

(2 marks)

57. The following information is related to the operations of a firm: <Answer>

Raw material storage period	70 days
Average conversion period	8 days
Finished Goods storage period	18 days
Average collection period	39 days
Average payment period	45 days

The operating cycle of the firm is:

(a) 180 days
(b) 135 days
(c) 90 days
(d) 88 days
(e) 45 days.

(1 mark)

58. Which of the following is/are the primary purpose of the cash budget? <Answer>

I. To break down income statement into monthly periods.
II. To determine monthly cash receipts.
III. To determine the collection pattern.
IV. To allow the firm to anticipate the need for outside funding.

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

(1 mark)

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

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

(1 mark)

60. Which of the following euro instruments is a medium-term legally binding commitment under which, a borrower can issue short-term paper of up to one year? <Answer>

(a) Note Issuance Facilities (NIFs)
(b) Commercial paper
(c) Straight debt bonds
(d) Floating Rate Notes (FRNs)
(e) Medium-term notes.

(1 mark)

61. The current sales and income of Sunlight Tubes Ltd. are Rs.25 lakh and Rs.4 lakh respectively. It is expected to increase its sales by 30%. If the company maintains the net profit margin ratio, pay out 30% as dividends and does not resort to external equity, but maintains the debt-equity ratio of 1.75, the increase in borrowings will be <Answer>

(a) Rs.2.10 lakh
(b) Rs.3.64 lakh
(c) Rs.5.20 lakh
(d) Rs.6.37 lakh
(e) Rs.9.10 lakh.

(2 marks)

62. Consider the following data of Monark Bakery Ltd.: <Answer>

Market Value of Debt	Rs.5,00,000
Interest	Rs. 30,000
Net Operating Income	Rs.1,00,000
Cost of Equity Capital	14%

If debt-equity ratio increases to 6:5, the revised equity capitalization rate according to net operating income approach is

(a) 10.0%
(b) 12.4%
(c) 14.0%
(d) 14.8%
(e) 20.0%.

(3 marks)

63. A company is offered a contract according to which it has to make an immediate cash outlay of Rs.25,000. The company would receive Rs.47,900 after 5 years. Which of the following indicates the rate of return earned by the company? <Answer>

(a) 11.39%
(b) 12.88%
(c) 13.89%
(d) 14.88%
(e) 15.88%.

(1 mark)

64. Mr. Rohit Rathod plans to purchase a 91-day Treasury Bill of face value Rs.100, maturing after 65 days. If on maturity he wants an-yield of 14%, what is the purchase price of the T-Bill? <Answer>

(a) Rs.95.00
(b) Rs.96.50
(c) Rs.97.27
(d) Rs.97.57
(e) Rs.97.90.

(2 marks)

65. The current price of a share of Deshmukh Pharmaceuticals Ltd. is Rs.150. The company is planning to go for rights issue. The subscription price for one rights share is proposed to be Rs.125. If the company targets that the ex-rights value of a share shall not fall below Rs.145, it should issue 1 rights share for every ________ equity shares. <Answer>

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

(2 marks)

66. The cost of capital of Sonata software Incorporation is 16% and its cost of debt is 11%. If the equity capitalization rate of the firm according to the net operating income approach is 20%, what is the proportion of equity in the total assets of the firm? <Answer>

(a) 45.0%
(b) 47.5%
(c) 50.0%
(d) 55.5%
(e) 57.5%.

(2 marks)

67. Which of the following functions is/are served by the primary capital market of an economy? <Answer>

I. It allows the corporate houses to raise the long term capital by issuing new securities.
II. It offers a market to trade for the outstanding long term securities.
III. It offers a market to trade for the outstanding short term securities.
IV. It offers an excellent exit route for the venture capital funding companies.

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

(1 mark)

68. Which of the following is a measure undertaken to avoid a situation of under trading in a company? <Answer>

(a) Increasing the debt equity ratio
(b) Hastening the collection process
(c) Increasing the levels of inventory
(d) Increasing the asset base
(e) Buying back of equity shares.

(1 mark)

69. Under which of the following types of factoring does the client get total credit protection? <Answer>

(a) Recourse Factoring
(b) Non-Recourse Factoring
(c) Maturity Factoring
(d) Advance Factoring
(e) Invoice discounting.

(1 mark)

70. Which of the following statements is/are **correct** for a project with a negative net present value? <Answer>

I. Cost of capital is less than internal rate of return.
II. Net benefit cost ratio is less than zero.
III. Benefit cost ratio is less than 1.

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

(1 mark)

71. Which of the following is **not** the motive for divestures? <Answer>

(a) Focus on core businesses for the divesting firm
(b) Declining profitability of business(es) in which firm is operating
(c) Getting rid of profitable businesses
(d) Need for funds for other activities
(e) Transfer of wealth from debt holders to stockholders.

(1 mark)

72. The least expensive form of financing for the firm is <Answer>

(a) Existing common stock
(b) Preferred stock
(c) Debenture
(d) New common stock
(e) Retained earnings.

(1 mark)

73. You are required to contribute Rs.2,000 per year in a pension plan for 10 years from the end of the current year. The plan will pay pension annually for a period of 20 years and the first payment will start after 16 years from now. If this plan is arranged through a savings bank that pays interest @ 7% per annum on the deposited funds, what is the size of the yearly pension? <Answer>

(a) Rs.2,578
(b) Rs.2,945
(c) Rs.3,456
(d) Rs.3,570
(e) Rs.3,659.

(2 marks)

74. Shalimar Oil Ltd. presently sells 3,00,000 liters of its' product "Shawmin" in a year at a price of Rs.100 per liter. The variable cost is Rs.80 per liter. The company presently sells at credit terms of 'net 30' and its' average collection period is 40 days. Bad debt losses amount to 1 percent of sales and the cost of funds invested in the receivables is 12 percent. The Director of the company feels that the company should expand its sales volume by increasing the credit period to 40 days. As a result of increasing the credit period, the sales volume is expected to increase by 20 percent. The average collection period for the company may increase to 50 days, while bad debt losses on the new sales will be 5 percent (the percentage of bad debt losses on the existing sales will be unchanged). What will be overall impact on the profit of the company due to the change in credit period? (Ignore taxes and assume 360 days in a year) <Answer>

(a) Rs.6,20,000 (increase in profit)
(b) Rs.7,20,000 (increase in profit)
(c) Rs.8,20,000 (increase in profit)
(d) Rs.7,20,000 (decrease in profit)
(e) Rs.6,20,000 (decrease in profit).

(3 marks)

END OF QUESTION PAPER

Suggested Answers

Financial Management (CFA540): October 2008

	ANSWER	REASON	
1.	C	Sinking fund factor is the reciprocal of FVIFA. Hence, (c) is the correct answer.	< TOP
2.	C	In the APV method if there is a strong probability of positive cash flows being generated, then the discount rate used to calculate the benefit due to increased borrowing capacity is nominal risk-free rate of interest in home country.	< TOP
3.	A	Of the alternatives given, sale of shares and bonds are not the daily activities of the finance manager.	< TOP
4.	A	Under proposition III, it is mentioned that the investment and financing decision of a firm are independent of each other. A firm should exploit an investment opportunity, if and only if, the rate of return on the investment is greater than the cost of capital. Thus the cut of point for investment by the firm should in all cases be the capitalization rate for that class. So, (a) would be the correct answer.	< TOP
5.	B	In this scenario the average level of accounts receivable would decrease, because credit customers would have a larger incentive to pay their accounts within the 10 day discount period.	< TOP
6.	C	The economic appraisal of projects does not consider the impact of the project on the wealth of the shareholders. Alternatives (a), (b), (d) and (e) are parts of the economic appraisal of projects.	< TOP
7.	E	The intervention of the government in the financial system to influence macro economic variables like interest rates or inflation is an example of policy function of the financial system.	< TOP
8.	B	Increase in the average collection period, increase in the finished goods storage period, increase in the raw materials storage period and increase in the work-in process period all result in increasing the operating cycle of the firm. Only increase in the average payment period decreases the net operating cycle of the firm. Hence option (b) is correct.	< TOP
9.	D	Limit order is a type of order where it is limited by fixed price which may or may not include brokerage. Hence, (d) is the answer. Limited discretionary order is to provide discretion to the broker to execute order at price which almost is the approximate price fixed by the client. Best rate order is to execute the buy/sell order at the best possible price. In Immediate order get canceled if not executed immediately at the quoted price. In Stop loss order, a particular limit is given for sustenance of loss to the broker.	< TOP
10.	D	According to Imitation gap theory, improvement in technology is a continuous process and the resulting inventions and innovations in existing products give rise to trade between such countries.	< TOP
11.	C	According to the net income 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 (c) 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. Gordon approach and Realized yield approach are models of dividend policy not of capital structure. As per M&M approach value of the firm is independent of capital structure.	< TOP
12.	D	Whether or not to avail of term loans and to what extent is related with the borrowing policy of a firm; it is not related with cash management.	< TOP
13.	A	The relationship between the exchange rate and the prices of tradable goods is known as the purchasing power parity theory.	< TOP

14. A In the presence of floatation costs, the cost of external equity will always be more than the cost of existing equity capital (a). It has no logical connection with cost of long-term or short-term debt. Hence (b), (c), (d) and (e) are incorrect. < TOP

15. A < TOP

$$(\$/£)_{bid} = (\$/Rs)_{bid} \times (Rs/£)_{bid}$$

$$= \frac{1}{(Rs/\$)_{ask}} \times (Rs/£)_{bid} = \frac{69.20}{43.50} = 1.5908$$

$$(\$/£)_{ask} = (\$/Rs.)_{ask} \times (Rs/£)_{ask}$$

$$= \frac{1}{(Rs/\$)_{bid}} \times (Rs/£)_{ask} = \frac{69.25}{43.45} = 1.5938$$

16. C Internal rate of return gives zero net present value for any project. < TOP

The internal rate of return of a project does not change, as the cost of capital changes.

It considers the cash flows of the project for the whole life of the project.

As statement (I) and (III) are false, alternative (c) is answer.

17. D Forecasting is difficult in a non-seasonal and non-cyclical business and thus long-term finance is preferable instead of short-term debt. Because after a short period of time the debt has to be refunded. So the correct answer is (d). < TOP

18. B < TOP

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

$$= \frac{5}{0.10} + \frac{1.2(10-5)}{(0.10)}$$

$= 50 + 60$

$= 110$

∴ Market value of equity $= 110 \times 200,000$

$=$ Rs.2,20,00,000

19. A < TOP

Capital budget = Rs.18 million

Debt equity ratio = 40:60

Therefore debt $= 18 \times \frac{40}{100}$ = Rs.7.2 million

Capital = Rs.18 million – Rs.7.2 million

= Rs.10.8 million

Net income = Rs.15 million

Therefore residual dividend = Rs.15 – 10.8

= Rs.4.2 million

Dividend payout ratio $= \frac{\text{Rs.4.2 million}}{\text{Rs.15million}}$

= 28%

20. D Number of equity shares of the company = Rs.8,40,000/10 = Rs.84,000. < TOP

Preference dividend paid = $15 \times 6,00,000/100$ = Rs.90,000

Earnings per share = Net profit – Preference dividend/no of equity shares

= Rs.9,00,000 – Rs.90,000/Rs.84,000

= Rs.8,10,000/Rs.84,000 = Rs.9.64

Accord into earnings price ratio approach cost of equity = E_1/P

= E_1 = Earnings per share for the next year

P = Market price per the share

= $E_1 = E(1+g) = 9.64(1+0.05) = 10.122$

Cost of equity = 10.122/20=0.5061=50.61%.

21. C $3000(1 + 0.124/2)^8$ = Rs.4854.20 < TOP

Hence, option (c) is the answer.

22. B 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. 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 and low profitability in comparison to its peers while the opposite thing occurs in case of aggressive working capital management policy. < TOP

23. D The amount of raw materials consumed = Opening balance + Purchases during the year – Closing balance = (1,60,000 + 12,42,000 – 1,92,000) = Rs.12,10,000 < TOP

Annual cost of production = Opening work in process + Consumption of raw materials + Manufacturing expenses + Depreciation – Closing work in process

= 25,000 + 12,10,000 + 12,30,000 + 1,00,000 – 45,000 = Rs.25,20,000

Annual cost of sales = Opening stock of finished goods + Cost of production + Selling, administration and financial expenses + Customs and Excise duties – Closing stock of finished goods = 30,000 + 25,20,000 + 2,30,000 + 1,50,000 – 50,000 = Rs.28,80,000

Average cost of goods sold per day = $\frac{\text{Rs.}28,80,000}{360}$ = Rs.8,000

Average inventory of finished goods = $\frac{(30,000+50,000)}{2}$ = Rs.40,000

So, the finished goods storage period = $\frac{\text{Rs.}40,000}{8,000}$ = 5 days.

24. B Cost of Trade Credit < TOP

$$= \frac{\text{Discount rate}}{1-\text{Discount rate}} \times \frac{360}{(\text{Credit Period} - \text{Discount Period})}$$

$$0.21 = \frac{0.02}{1-0.02} \times \frac{360}{(45-x)}$$

$$\frac{0.21}{0.02} = \frac{360}{(45-x)}$$

x = 10.01 ⇒ 10 days

Hence option (b) is the correct choice.

25. B Keeping excess cash in hand in case of an industrial accident is a precautionary Motive - the need to hold cash as a safety margin to act as a financial reserve. Option (b) is the correct answer. < TOP

26. D As the expected growth rate in dividends increases, other things being equal, the price increases to a greater extent than dividends. So the capital gains yield is more than the dividend yield. Hence the expected return depends more on the capital gains yield and less on the dividend yield. Therefore statement I is true. Also for the same expected earnings an increase in the expected growth rate in dividends causes the P/E ratio to increase. Hence statement II is not true. When the growth prospects are limited the expected return depends more on dividend yield and less on capital gains yield, and the P/E ratio is low. Hence high dividend yield and low P/E ratio indicate limited growth prospects. Therefore statement III is true. Hence option (d) is the answer. < TOP

27. B The capital structure of CTL after the issue of 15% debentures will be < TOP

	Source	Amount (in Rs.)
	Ordinary shares (2,00,000 × Rs.15)	30,00,000
10%	Preference shares	10,00,000
14%	Debentures	30,00,000
15%	Debentures	20,00,000
	Total	90,00,000

Cost of equity prior to this change can be calculated as follows:

$$k_e = \frac{D_1}{P_o} + g = \frac{2}{20} + 0.07 = 17\%$$

Cost of equity after the change in capital structure

$$k_e = \frac{3}{15} + 0.07 = 27\%$$

$$\text{WACC} = w_e k_e + w_p k_p + w_d k_d (1 - T)$$

Substituting (3/9) × 0.27 + (1/9) × 0.10 + (3/9) × 0.098 + (2/9)× 0.105 = 0.1571 = 15.71%.

28. B The MM approach to capital structure assumes that < TOP

i. information is freely available to all the investors and there are no transaction costs and all securities are infinitely divisible

ii. firms can be classified in such a way that firms falling within a class have the same degree of business risk

iii. there are no corporate or personal income taxes

iv. investors make rational investment decisions and that there are no transaction costs.

29. D Net float = Payments float – Collections float; therefore the larger the payments float and the lower the collections float the better the cash management system. If interest rates are increasing, it increases the opportunity cost of idle cash and hence should be a cause of concern for a finance manager. So both the statements (I) and (III) are correct. Hence, answer is (d). < TOP

30. D In general when cost of capital of the company is minimum, market value of the firm is maximum. < TOP

31. A Retention ratio of the firm =1- pay out ratio < TOP

=1-0.80 =0.20

According to the Gordon model, the expected value of the share is

$$P_0 = \frac{Y_0(1-b)}{k - br}$$

$$= \frac{4.50(1-0.2)}{0.15 - 0.2 \times 0.18}$$

= 3.6/0.114 =Rs.31.58.

32. C [< TOP](#)

Average investment $= \dfrac{2,10,000 + 0}{2}$ = Rs.1,05,000

Average profit $= \dfrac{30,000 + 45000 + 75000}{3}$ = Rs.50,000

Accounting rate of return $= \dfrac{\text{Average profit}}{\text{Averageinvestment}} = \dfrac{50,000}{1,05,000} =$ 47.62%

33. C Capitalization rate for the company, [< TOP](#)

$k_0 = k_d \dfrac{B}{B+S} + k_e \dfrac{S}{B+S}$, where the notations are in their standard use

$k_0 = 14 \times \dfrac{80}{80+120} + 16 \times \dfrac{120}{80+120} = 15.2\%$

Further, $k_0 = \dfrac{\text{Net operating income}}{\text{Market value of firm}} = 0.152$

Net operating income = 0.152 × 200 = Rs.30.4 lakh.

34. E The overall sum of all the entries in the balance of payments must be zero. [< TOP](#)

35. C The WACC includes all investor supplied capital which includes long-term debt, preferred stock, and common stock. It is due to the fact that capital budgeting decision is long term in nature where as accounts payable and accruals are short term in nature. Hence, they will not be considered. [< TOP](#)

36. C Outright forward rate for Rs./$ [< TOP](#)

Spot rate + premium = Forward rate

Spot rate = Forward rate – premium

Forward rate	46.10 / 13
Less Premium	0.05 / 06
Spot rate	46.05 / 07

37. B Net incremental cash flow during year 0 is [< TOP](#)

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

= –(20–9) = -Rs.11 lakh

Net incremental cash flow during year 5 is

= Incremental PAT + Incremental Depreciation + Incremental realizable value

Depreciation of old machine $= \dfrac{12-2}{5} = \text{Rs.}2,00,000$

Depreciation of new machine $= \dfrac{20-4}{5} = \text{Rs.}3,20,000$

Incremental depreciation = Rs.3,20,000–2,00,000 = Rs.1,20,000

Net incremental cash flow during year 5

= (50,000 + 1,00,000 – 1,20,000) 0.6 + 1,20,000 + 2,00,000 = Rs.3,38,000

Hence, answer is (b).

38. D Statement (I) is true because low degrees of uncertainty surrounding the cash flow projections implies that there will be less uncertainty surrounding the availability of cash from operations. Hence the firm may reduce the amount of cash (because it earns no return) and invest funds in liquid assets like marketable securities and intercorporate deposits, which earn returns. < TOP

Statement (II) is not true because a conservative attitude, on the part of management, towards risk means that the firm will avoid investing its funds in intercorporate deposits, which are unsecured instruments.

Statement (III) is true because a company, which has access to non-bank sources of funds, will not tend to keep idle cash and will invest its funds in intercorporate deposits and marketable securities, which earn returns. Hence, there will be a higher proportion of investment in intercorporate deposits and marketable securities.

39. C The market price per share is given by < TOP

$P_o = \frac{P_1 + D_1}{1 + k_e}$ where, symbols are in standard use.

If no dividends are declared

$150 = \frac{P_1 + 0}{1.12}$

P_1 = Rs.168

Net Income = Rs.2 crore

Investments budget = Rs.4 crore

Amount to be raised by issue of new shares = Rs.2 crore

$\therefore$ Number of shares to be issued = $\frac{2,00,00,000}{168} = 1,19,048$ shares.

40. B Poison pills are shares issued by a firm to its shareholders to make them firm less valuable in the eyes of a hostile bidder. These shares have no value till the happening of a triggering event (acquisition of certain percentage of the firm's voting stock by the bidder). There are generally two triggering events first for issuing the rights and second for exercising them. There are basically two types of poison pills flip-over and flip-in. < TOP

In a Flip-in plan shareholders are given a common stock dividend in the form of rights for each share they own. Statement (I) is true. Whenever the bidder acquires a certain percentage of stock the rights are activated. The flip-in poison poll plan permits the current shareholders, except the acquirer, to buy more shares of the issuing company not acquiring company at a discount. Hence, statement (II) is false.

In a Flip-over plan, the shareholders are given a common stock dividend in the form of rights to acquire the firm's common or preferred stock at an exercise price above the market price. Whenever the bidder acquires a certain percentage of stock the rights are activated. The rights flip over and allow the holders to purchase the acquirer's shares not target company's at a heavy discount. Hence, statement (III) is false.

The Board of Directors creates a poison pill program and it has the authority to redeem it. Statement (IV) is true. Hence, alternative (b) is the answer.

41. C The following statements are true i.e., when two firms merge and do not use their additional borrowing capacity, there will be a transfer of wealth from stock holders to bond holders; If there is synergy, the value of the combined firm should be greater than the value of the companies operating independently; and the value of control is greater for a badly managed firm than for a well-managed firm. Statement (II) is false. Alternative (c) is the answer. < TOP

42.	C	The management of an organization exercises its control on the overall performance of the organization on the basis of the reports sent by the finance manager on the performance of the individual departments. Since this function of the finance manager helps the management to exercise control over the overall performance of the organization it is considered to be a part of the control function of the finance manager.	< TOP
43.	E	Since, in a bought-out-deal, the shares are initially offered to the sponsor and the sponsor has the discretion to offload the shares to the public at an appropriate time, it may misuse its discretion to disinvest the shares in favor of the public; this may affect the interests of the promoters of the company.	< TOP
44.	D	$40{,}000 = 13{,}000/(1.125)^1 + 13{,}000/(1.125)^2 + X/(1.125)^3$ or, $40{,}000 = 11{,}555.55 + 10{,}271.60 + X/(1.125)^3$ or, $X/(1.125)^3 = 18{,}172.84$ or, $X = 18{,}172.84 \times (1.125)^3$ = Rs. 25,875.00.	< TOP
45.	E	Let, the required rate of return be r per month The present value of all the payments = Rs.100 × PVIFA (r, 50) So, by the condition, 100 × PVIFA (r, 50) = 7,500 PVIF (r, 60) Or,PVIFA (r, 50) – 75 PVIF (r, 60) = 0 If r = 1.00 percent, left hand side = 39.196 – 75 × 0.550 = – 2.054 and at r =2, left hand side = 31.424 – 75 × 0.305 = 8.549 By interpolation, we get, $\frac{r-1}{2-1} = \frac{0+2.054}{8.549+2.054}$ or, r = 1.1937 So, the effective annual rate of interest $= \left\{\left(1+\frac{1.1937}{100}\right)^{12} - 1\right\} \times 100$ = 15.30 %	< TOP
46.	C	The traditional approach to dividend policy establishes a relationship between the market price and the dividends in the following manner: P=m(D+E/3) where, m is a multiplier, D is the Dividend Per Share (DPS) and E is the Earnings Per Share (EPS). Hence, 17 = 3.4 (3+E/3) So EPS = Rs.6. Hence, option (c) is the correct choice.	< TOP
47.	E	Approximate percentage cost = $\frac{2}{98} \times \frac{365}{35}$ = 0.212828. Accounts payable = $\frac{159{,}621}{0.212828}$ = Rs.750,000.	< TOP
48.	E	A public limited company is a legal entity, different from its shareholders, which can be formed with at least 7 members. Generally, a public limited company raises capital against the issue of equity shares among the general public. However, the managerial remuneration payable by the company cannot exceed 11 percent of net profit earned by the company.	< TOP
49.	A	Venture capital funding companies generally provide risk capital to the technology oriented and highly risky businesses. No other entities, as mentioned in the other options, do the same.	< TOP

50.	C	Trade in differentiated products is called Intra-Industry trade.	< TOP
51.	B	The discount rate that equates the present value of cash flows with the initial outlay is called. The internal rate of return.	< TOP
52.	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

53. E < TOP

Economic exposure refers to the impact on the value of firms operations due to unanticipated changes in the exchange rates.

Transaction exposure arises out of day-to-day activities of a company.

Transaction exposure arises due to the need to translate the foreign currency values of assets and liabilities into the domestic currency

Currency exposure refers to the currency which is to be received/or paid.

Correct answer is (e).

54. C < TOP

The maximum exchange ratio acceptable to acquirer is

$$-\left(\frac{S_1}{S_2}\right)+\left[\left(E_1+E_2\right)P/E_{12}\right]/P_1S_2$$

$$= -3+\frac{30\times 20}{100}$$

$= -3 + 6$

$= 3$

So, the answer is 3.

55. C < TOP

Annual budgeted sales = Rs.3,00,000

	(in Rs.)	
Collections (same month's sales)	1,17,600	(0.98 × 0.40 × Rs.300,000)
Collections (last month's sales)	1,80,000	(1.00 × 0.60 × Rs.300,000)
Total collections	2,97,600	
Purchases payments	1,50,000	
Other payments	70,000	
Total payments	2,20,000	
Net cash gain (loss)	Rs. 77,600	

56. B < TOP

The present value of the cash flows will be = $\frac{\text{Rs.}1,800}{0.08}$ = Rs.22,500

NPV of that investment = Rs.22,500 – Rs.25,000 = - Rs.2500.

Hence, the net benefit cost ratio for that investment = $-\frac{\text{Rs.}2,500}{\text{Rs.}25,000}=-0.1$ = - 0.10

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

57. C < TOP

The operating cycle of a firm is defined as:

Raw material storage period + Average conversion period + Finished Goods storage period + Average collection period – Average payment period = 70 + 8 + 18 + 39 - 45 = 90 days

58. C < TOP

The primary purpose of the cash budget is to allow the firm to anticipate the need for outside funding at the end of each month. Hence the option (c) is the answer.

59. C Custodians hold the underlying shares and collect rupee dividends on the underlying shares and repatriate the same to the depository in US dollars/foreign equity. Hence (c) is the answer. < TOP

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.

60. A Note Issuance Facility (NIF) is a medium-term legally binding commitment under which a borrower can issue short-term paper, of up to one year. Hence (a) is the answer. Commercial papers are short-term unsecured promissory notes, which pay a fixed amount. Straight debt bonds and floating rate notes are long-term instruments having a maturity of over one year. < TOP

61. D New sales = 25 (1.3) = Rs.32.5 lakhs < TOP

NPM = $\frac{4}{25} = 16\%$,

New PAT = 32.5 x 0.16 = Rs.5.2 lakhs

Dividends = 30% of 5.2 = Rs.1.56 lakhs

Retained earnings = Rs.3.64 lakhs

Increase in borrowings = 3.64 x 1.75 = Rs.6.37 lakhs

Hence, option (d) is the answer.

62. D As per Net Operating Income Approach < TOP

$k_e = \frac{\text{NOI} - \text{INT}}{\text{S}}$

where symbols are in their standard use

$\therefore\ \text{S} = \frac{1,00,000 - 30,000}{0.14} = \text{Rs.}5,00,000$

Market value of Debt = Rs.5,00,000 (given)

$\therefore$ Value of the firm = Rs.10,00,000

Overall cost of capital $k_o = \frac{\text{NOI}}{\text{V}} = \frac{1,00,000}{10,00,000} \times 100 = 10\%$

$K_d = \frac{30,000}{5,00,000} \times 100 = 6\%$

As per NOI approach, overall cost of capital will remain constant even if the debt-equity ratio changes.

$$k_e = k_o + (k_o - k_d)\ {}^{D}\!/_{E}$$

$$\therefore \quad k_e = 0.10 + (0.10 - 0.06)\ {}^{6}\!/_{5}$$

= 0.10 +0.048 = 0.148 = 14.8%.

63. C The amount of Rs.25,000 cash outflow may be treated as a principal which the company deposits into an account that pays an unknown rate of interest but returns a compounded amount of Rs.47,900 after 5 years. < TOP

$\therefore$ FV = $PV(1+r)^n$

47,900 = 25,000 $(1+r)^5$

1.916 = $(1+r)^5$

r = 13.89%

Therefore the company earns a return of 13.89%.

64. D < TOP

T-Bill yield = $\frac{F-P}{P} \times \frac{365}{d}$

F = Face value

p = Purchase price

d = maturity period in days.

$0.14 = \frac{100-p}{p} \times \frac{365}{65}$

9.1 p = 36,500 – 365p

374.1p = 36,500

P = Rs.97.57.

65. C < TOP

Ex-right price of a share = $\frac{NP_0 + S}{N+1}$ where

N = Number of equity shares required for rights issue

P_0 = Cum-rights price per share

S = Subscription price at which rights are issued

$145 = \frac{Nx150 + 125}{N+1}$

145N+145=150N+125

20=5N

N=4

Therefore the company should issue 1 rights share for every 4 equity shares.

66. D According to the Net Operating Income Approach, < TOP

$k_e = k_0 + (k_0 - k_d)\frac{B}{S}$

$0.20 = 0.16 + (0.16 - 0.11)x\frac{B}{S}$

0.04 = 0.05 x B/S

$1 + \frac{B}{S} = 1 + \frac{4}{5}$

$\frac{S+B}{S} = \frac{9}{5}$

$\frac{S}{B+S} = \frac{5}{9} = 0.555 = 55.5\%$

Therefore total assets of the firm comprises of 55.5% equity.

67. A Primary market allows the corporate houses to raise long term funds by issuing new securities like, shares – equity and preference as well as debentures. The venture capital funding companies generally dilute their stakes in a company by selling their holdings in any company to the investors through secondary capital market route. < TOP

68. B Under trading indicates that the funds of the company are locked up in current assets resulting in a lower turnover of working capital. Hence in such a situation hastening of the collection process, reducing the debt-equity ratio and reducing the level of inventory will be some precautionary measures. < TOP

On the other hand, a over-trading situation can be noticed from the disproportionately high turnover of assets compared to the volume of sales. Precautionary measures can be taken by initially reducing the sales to a level commensurate with the amount of assets and a final solution lies in increasing the asset base through additional finances raised through the issuance of shares and/ or obtaining loan funds.

Hence, option (d) and (e) are precautionary measures for over-trading situation. Therefore (b) is the answer.

69. B < TOP

a. Under recourse factoring, the factor purchases the receivables on the condition that any loss arising out of irrecoverable receivables will be borne by the client. Alternative (a) is wrong.

b. Under the non-recourse or full factoring, the factor has no recourse to the client if the receivables are not recovered. The client gets total credit protection. Alternative (b) is true.

c. Under maturity factoring, the factor does not make any make any pre-payment. The factor pays the client either on a guaranteed payment date or on the date of collection from the customer. Alternative (c) is wrong.

d. Under advance factoring, the factor makes pre-payment of around 80% of the invoice value to the client. Alternative (d) is wrong.

e. Under invoice discounting, the factor provides a pre-payment to the client against the purchase of accounts receivables and collects interest for the period extending from the date of pre-payment to the date of collection. Alternative (e) is wrong.

Therefore (b) is the answer.

70. E IRR is the rate at which NPV of the project is zero. If NPV is positive then it implies that IRR exceeds the cost of capital of the project and vice versa. < TOP

Hence statement (I) is incorrect.

$$\text{NBCR} = \frac{\text{Net present value of inflows}}{\text{Initial investment}}$$

$$\text{BCR} = \frac{\text{Present value of inflows}}{\text{Initial investment}}$$

Therefore a negative NPV indicates that the present value of inflows is less than the initial investment, in other words it implies that BCR < 1 and NBCR <0. Hence, statement (II) and (III) are true.

Hence option (e) is the answer.

71. C Some of the main reasons why firms are forced to divest are: efficiency gains, refocusing the business goal, information effects, wealth transfers and tax reasons. So, clearly alternative (c) is the answer. < TOP

72. C The debt capital is the cheapest source of financing but it should be used within reasonable limits. < TOP

73 E Future value of the 10-payments annuity = 2000 × FVIFA (7,10) = 2000 × 13.816 = Rs.27632. < TOP

The amount of Rs.27632 is available immediately after the last payment. The future value of this at the end of the 15th year

FV = 27632 × FVIF (7,5) = 27632 × 1.403 = Rs.38768

The annuity amount of the retirement annuity = $\frac{38768}{PVIFA\ (7,20)} = \frac{38768}{10.594}$ =Rs.3659

74 B Increase in contribution = 3,00,000 × 20 percent × Rs.20 = Rs.12,00,000 < TOP

Additional investment in the receivables due to the increase in credit period =

$$= \left(ACP_N - ACP_o\right) \times \frac{S_o}{360} + V.ACP_N \times \frac{\Delta S}{360}$$

$$= \left(50 - 40\right) \times \frac{3,00,000 \times 100}{360} + 0.8 \times 50 \times \frac{60,000}{360} \times 100$$

=Rs.15,00,000

So, increase in the cost of funds invested in the receivables = Rs.15,00,000 × 0.12 = Rs.1,80,000

Increase in the cost of bad debts = Rs. 100 × 3,00,000 × 20% × 5 % = Rs.3,00,000.

Hence, the profit of the company will increase by

Rs.12,00,000 – 1,80,000 – 3,00,000 = Rs.7,20,000.

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