Question Paper
Financial Management (CFA540): January 2008

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

Total Marks : 100

<Answer>

1. Which of the following statements is **true** with respect to the mobilization of funds by a finance manager?

(a) Analysis of variance between the targeted costs and actual costs incurred and reporting on the same
(b) Assessing the costs and benefits of a project under consideration
(c) Interacting with banking agencies for procuring funds
(d) Appraisal of investment proposals given by various departments
(e) Deciding the optimum quantity of raw materials to be ordered for procurement. **(1 mark)**

<Answer>

2. Which of the following functions of the financial system allows for the exchange of current income for future income and transformation of savings into investments?

(a) Savings function
(b) Liquidity function
(c) Payment function
(d) Risk function
(e) Policy function. **(1 mark)**

<Answer>

3. Which of the following is **not** a feature of Certificate of Deposit (CDs)?

(a) CDs are issued at a discount to face value
(b) CDs are freely transferable by endorsement and delivery
(c) CDs cannot be issued in demat form
(d) CDs offer higher yields compared to conventional deposits
(e) CDs are maturity-dated obligations of banks forming a part of time liabilities and are subjected to usual reserve requirements. **(1 mark)**

<Answer>

4. The face value of a T-Bill is Rs.100. Mr. Varun made a bid for a 364-day T-Bill yielding 6.95% p.a. and maturing after 182 days. The price paid by Mr. Varun for this bill is

(a) Rs.92.84
(b) Rs.94.56
(c) Rs.95.88
(d) Rs.96.65
(e) Rs.98.76. **(1 mark)**

<Answer>

5. Which of the following statements is/are **true**?

I. Effective rate of interest is always lower than the nominal interest rate.
II. The effective rate of interest increases with increase in the frequency of compounding.
III. The effective and nominal interest rates are equal if the frequency of compounding is one.

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

<Answer>

6. Which of the following is/are **not** diversifiable risk(s)?

I. Sector risk.
II. Credit risk.
III. Market risk.
IV. Management risk.

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

<Answer>

7. Mr. Anil wants to invest in two stocks A and B in the proportion of 1:3. The variance of the returns on his portfolio is $144(\%)^2$. The variances of the returns on the stocks A and B are $169(\%)^2$ and $196(\%)^2$ respectively. The correlation coefficient between these two stocks is

(a) -0.36
(b) -0.25
(c) 0.27
(d) 0.34
(e) 0.56. **(2 marks)**

<Answer>

8. Mr. Bhaskar purchased a bond with face value of Rs.1,000 for Rs.950. The coupon rate on the bond is 9.5%. If he sells the bond one year later for Rs.960, the holding period return for Mr. Bhaskar is

(a) 1.05%
(b) 5.65%
(c) 11.05%
(d) 13.68%
(e) 15.45%. **(1 mark)**

<Answer>

9. Consider the following data:

Net operating cycle	55 days
Raw-material storage period	40 days
Conversion period	2 days
Finished goods storage period	20 days
Average payment period	25 days

The average collection period is

(a) 7 days
(b) 18 days
(c) 22 days
(d) 25 days
(e) 37 days. **(1 mark)**

<Answer>

10. Which of the following orders is limited by a fixed price?

(a) Limited Discretionary Order
(b) Cancel Order
(c) Limit Order
(d) Stop Loss Order
(e) Open Order. **(1 mark)**

<Answer>

11. If the risk free rate of return is expected to increase in future and the investors become more risk averse, the security market line (SML) will

(a) Shift up and the slope will increase
(b) Shift up and the slope will decrease
(c) Shift down and the slope will increase
(d) Shift down and the slope will decrease
(e) Remain unchanged. **(1 mark)**

<Answer>

12. Which of the following statements is/are **not true**?

I. Beta of a security decreases with an increase in the variance of market returns.
II. Beta greater than 1 indicates an asset of average risk.
III. Beta of a security increases with an increase in the value of the correlation coefficient between the security's return and market return.
IV. Beta of a security increases with a decrease in standard deviation of the security's return.

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

<Answer>

13. 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.45,000 after 5 years. Which of the following indicates the rate of return earned by the company?

(a) 11.39%
(b) 12.47%
(c) 13.89%
(d) 14.58%
(e) 15.65%. **(1mark)**

<Answer>

14. Mr. Joseph has taken a loan of Rs.10,00,000 to be repaid in 60 equal monthly installments. The rate of interest is 12% p.a. What is the monthly installment paid by Mr. Joseph?

(a) Rs.15,531
(b) Rs.16,237
(c) Rs.18,721
(d) Rs.20,985
(e) Rs.22,244. **(1mark)**

<Answer>

15. The following information is given for a project:

(Rs.)

Year	0	1	2	3
Initial Investment	(2,10,000)			
Profit After Tax		30,000	45,000	75,000

The Accounting Rate of Return (ARR) for the project is

(a) 59.96%
(b) 54.56%
(c) 47.62%
(d) 43.56%
(e) 39.80%. **(2marks)**

<Answer>

16. VG India Ltd., is considering to invest in a printing machine the details of which are as follows:

Cost of machine Rs.25,00,000.
Annual cost of operations Rs. 2,00,000.
Useful life 9 years.

The annual capital charge of the machine at a cost of capital of 12% is

(a) Rs.4,69,219
(b) Rs.4,77,778
(c) Rs.5,49,113
(d) Rs.6,69,219
(e) Rs.8,07,057. **(3marks)**

<Answer>

17. The beta of stock of Akhil Computers Ltd., is 1.5 and is currently in equilibrium. The required return on the stock is 19% and the expected return on the market is 15%. Suddenly due to a change in economic conditions, the expected return on the market increases to 17%. Other things remaining the same what would be new required rate of return on the stock?

(a) 17.5%
(b) 20.0%
(c) 22.0%
(d) 25.0%
(e) 28.5%. **(2marks)**

<Answer>

18. Given below is the Balance Sheet of Sagar Industries Ltd., for the years ended 31.03.06 and 31.03.07:

Liabilities	31.03.06 Rs.	31.03.07 Rs.	Assets	31.03.06 Rs.	31.03.07 Rs.
Capital	4,00,000	4,00,000	Machinery	1,20,000	1,40,000
Creditors for goods	80,000	70,000	Furniture	20,000	30,000
Outstanding expenses (expenses for goods)	8,000	10,000	Stock	95,000	70,000
			Debtors	1,75,000	2,00,000
			Cash	20,000	10,000
			Bank	58,000	30,000
Total	**4,88,000**	**4,80,000**	**Total**	**4,88,000**	**4,80,000**

Net increase/decrease in the working capital for the year 2006-07 was

(a) Increase of Rs.16,000
(b) Increase of Rs.20,000
(c) No change in Working capital
(d) Decrease of Rs.20,000
(e) Decrease of Rs.30,000. **(2marks)**

<Answer>

19. If the slope of the Security Market Line is zero, which of the following is/are **true**?

I. Risk-free return equals to Market return.
II. Market return equals to Expected return.
III. Expected return equals to Risk-free return.

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

<Answer>

20. Which of the following types of factoring **does not** carry the service elements of factoring?

(a) Recourse Factoring
(b) Full Factoring
(c) Maturity Factoring
(d) Invoice Discounting
(e) Non-Recourse Factoring. **(1mark)**

<Answer>

21. Divya Motors Ltd., is evaluating five independent projects for executing the production of its new car model. The finance manager feels that all the five projects are useful for the company, but the company has limited resources and so Mr. Kushal is interested in ranking the projects according to the Profitability index and dividing his budget accordingly. The table below shows the initial investment and cash inflows related to the five projects.

Rs.000's

Year	I	II	III	IV	V
Initial investment	1,000	1,200	1,250	800	750
1	400	625	600	250	200
2	450	675	600	350	200
3	475	700	600	500	200
4	500	725	600	400	200
5	575	675	600	200	200

Which of the following represents the descending order of the projects based on the profitability index if the required rate of return is 14%?

(a) I, II, III, IV and V
(b) II, III, I, IV and V
(c) III, II, I, IV and V
(d) IV, I, II, III and V
(e) V, IV, I, II and III. **(2marks)**

<Answer>

22. Pranjli Heavy Machines Ltd., (PHML) has estimated that a proposed project's 8-year annual net cash benefit, to be received at the end of each year, will be Rs.3,000 with an additional terminal benefit of Rs.5,000 at the end of the 8th year. Assuming that these cash inflows satisfy exactly PHML's required rate of return of 11 percent, what is the initial cash outlay?

(a) Rs.17,608
(b) Rs.19,091
(c) Rs.25,001
(d) Rs.27,090
(e) Rs.30,098. **(1mark)**

<Answer>

23. Jay Industries Ltd., is interested in the purchase of a machine that costs Rs.10,00,000. The machine has an economic life of 4 years, which can be depreciated on the WDV basis at the rate of 30%. However, the company expects to sell the machine after 3 years at a salvage value of Rs.4,00,000. The machine requires Rs.70,000 for installation. The initial investment on the machine and the book value of the machine at the end of 3^{rd} year is

(a) Rs. 6,70,000; Rs.2,56,907
(b) Rs. 6,70,000; Rs.3,67,010
(c) Rs.10,00,000; Rs.3,43,000
(d) Rs.10,70,000; Rs.3,67,010
(e) Rs.10,70,000; Rs.2,56,907. **(1mark)**

<Answer>

24. Cyndrilla Machines Ltd., is considering an investment opportunity that requires an initial outlay equal to Rs.75,000. The company expects cash inflows of Rs.20,000, 28,000 and Rs.42,000 in years 1, 2 and 3 respectively from that investment. The internal rate of return (IRR) of the project is

(a) 7.45%
(b) 8.57%
(c) 9.27%
(d) 9.89%
(e) 10.07%. **(1mark)**

<Answer>

25. Super Industries Ltd., recently paid Rs.4.00 per share as dividend for the last year. Its dividend is expected to grow by 15 percent every year for the next three years, thereafter it will continue a normal growth rate of 6 percent per annum. If the required rate of return is 16 percent, what is the intrinsic value of the equity share of Supersonic Industries Ltd.?

(a) Rs.35
(b) Rs.41
(c) Rs.47
(d) Rs.53
(e) Rs.59. **(3 marks)**

<Answer>

26. If the risk-free rate of return is 6 percent, the beta of a share is 1.25 and the difference between the return on market portfolio and the risk free rate is 8 percent, then according to the CAPM approach, the required rate of return on the share is

(a) 8 percent
(b) 10 percent
(c) 15 percent
(d) 16 percent
(e) 20 percent. **(1 mark)**

<Answer>

27. The initial outlay for a project is Rs.20 crore. The project manager projected the following annual cash flows that is expected to be generated uniformly over the years:

Year	0	1	2	3	4	5	6
Cash flow (in Rs. crore)	(20)	4	5	5	5	4	7

The pay-back period for this project will be

(a) 4.00 years
(b) 4.25 years
(c) 4.50 years
(d) 4.75 years
(e) 5.00 years. **(2 marks)**

<Answer>

28. The following figures are taken from the current Balance sheet of Punam Software Ltd.:

	(Rs.)
Share capital	10,00,000
Share premium	2,00,000
Reserves	6,00,000
Shareholders' funds (Face value = Rs.10)	18,00,000
15% Irredeemable debentures (Face value = Rs.100)	4,00,000

An annual ordinary dividend of Rs.2 per share has been paid during the recently ended financial year. The dividends are expected to grow at a rate of 8% per annum. Annual interest has been recently paid on the debentures. The company falls in the tax bracket of 40%. The ordinary shares are currently quoted at Rs.22 and the debentures are selling at Rs.90. The weighted average cost of capital for the company (based on market values) is

(a) 15.04%
(b) 16.72%
(c) 17.04%
(d) 18.12%
(e) 18.76%. **(2 marks)**

<Answer>

29. The expected EBIT of Surya Technologies Ltd., is Rs.2,50,000. The firm has recently issued 8% debentures of Rs.6,25,000. The shareholders' required rate of return is 10%. Value of the firm and the overall cost of capital as per Net Income Approach is

(a) Rs.18.25 lakh; 8.00%
(b) Rs.18.75 lakh; 8.52%
(c) Rs.21.25 lakh; 9.00%
(d) Rs.21.75 lakh; 9.35%
(e) Rs.26.25 lakh; 9.52%. **(2 marks)**

<Answer>

30. For Tubes and Cap Ltd., the total current asset is Rs.6 lakh and the current ratio is 1.5. The company repaid its outstanding debentures worth of Rs.30 lakh prematurely after making a rights issue and sold its products on credit for an amount of Rs.2.50 lakh. What is the impact on its net working capital?

(a) Rs.2.00 lakh
(b) Rs.2.50 lakh
(c) Rs.5.00 lakh
(d) Rs.6.00 lakh
(e) No Change. **(2 marks)**

<Answer>

31. Consider the following data for Kiwi Industries Ltd.:

Earnings Per Share (EPS)	Rs.12
Dividend Payout Ratio	30%
Equity Capitalization Rate	12%
Rate of Return on Investments	14%

If the number of shares outstanding for the firm is 2,00,000 the market value of equity of the firm as per Walter's model for dividend policy is

(a) Rs.203.3 lakh
(b) Rs.214.3 lakh
(c) Rs.223.3 lakh
(d) Rs.258.3 lakh
(e) Rs.274.3 lakh. **(2 marks)**

<Answer>

32. The cum-rights price per share is Rs.48 and the theoretical value of the right is Rs.4. The subscription price at which the rights are issued is Rs.36 per share. The number of existing shares required for a rights share is

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

<Answer>

33. Mudra Textiles has furnished the following details for the current financial year:

Sales	Rs.200 lakh
Average collection period	45 days
Bad debt losses	5% of sales
Collection expenses	Rs.1 lakh
Cost of funds	15%
Variable cost to sales ratio	60%

The company is contemplating to enhance the collection effort by reducing the amount of receivables and the incidence of bad debt losses. In view of the above, the company has undertaken a new program which is likely to reduce the average collection period to 30 days, decrease bad debt losses to 3% of sales but increase the collection expenses by Rs.2 lakh. Assuming that the sales remain constant, the change in profits would be

(a) Rs.1,72,500
(b) Rs.2,15,500
(c) Rs.3,25,000
(d) Rs.3,65,000
(e) Rs.4,72,500. **(3 marks)**

<Answer>

34. Which of the following is **not** a source of long term finance?

(a) Reserves and surplus
(b) Equity capital
(c) Cash credit
(d) Deferred credit
(e) Debenture capital. **(1 mark)**

<Answer>

35. Priya Industries had bank balance of Rs.1,00,000 on 1st January, 2008 according to both the company's account and bank pass book. From that day, it issues daily cheques for Rs.25,000 that are cleared on the 2nd working day and deposits daily cheques of Rs.18,000 which are realized on the 4th working day. The amount of net float on 4th January was

(a) Rs.57,000
(b) Rs.50,000
(c) Rs.32,000
(d) – Rs.29,000
(e) – Rs.32,000. **(2 marks)**

<Answer>

36. Other things remaining the same, which of the following will decrease the cost of trade credit?

I. Decrease in the rate of discount.

II. Decrease in the credit period.

III. Decrease in the discount period.

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

<Answer>

37. Consider the following data regarding Rucha Ltd., for the year 2006-07:

Cost of goods sold	:	Rs.39,00,000
Gross profit margin	:	25%
Average receivables turnover ratio	:	52 : 15
Quick assets	:	Rs.18,00,000

The cash balance was

(a) Rs.2,75,000
(b) Rs.3,00,000
(c) Rs.6,00,000
(d) Rs.9,00,000
(e) Rs.9,56,250. **(2 marks)**

<Answer>

38. Firms generally choose to finance temporary working capital with short-term debt because

I. It is easier to match the maturities of short-term assets and short-term liabilities.

II. Short-term interest rates have traditionally been more stable than long-term interest rates.

III. A firm that borrows heavily long-term is more apt to be unable to repay the debt than a firm that borrows heavily short-term.

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

<Answer>

39. Which of the following statements is **false** under currency board system?

(a) Currency board maintains reserves of the anchor currency upto 100% or more of the domestic currency in circulation
(b) The interest rate in the economy is determined by the market forces
(c) Government spending is funded by deficit financing leading to increase in money supply and inflationary pressure on the economy
(d) A high domestic interest rate acts as incentive for international trade and international investment
(e) The board does not lend even to the domestic bank and can not act as the lender of the last resort. **(1 mark)**

<Answer>

40. Consider the following rates:

Rs/£	Spot	79.76/78
Forward 3 months		67/69

The annualized premium on pound sterling is

(a) 2.25%
(b) 3.15%
(c) 3.41%
(d) 4.25%
(e) 4.53%. **(1 mark)**

<Answer>

41. Singapore Dollar is quoted in New Delhi inter-bank market at Rs./S$ 27.28/32. If a bank agrees to quote the rate by charging an exchange margin of 0.10% to an importer, then the rate quoted is

(a) Rs.27.25/S$
(b) Rs.27.29/S$
(c) Rs.27.31/S$
(d) Rs.27.35/S$
(e) Rs.27.42/S$. **(1 mark)**

<Answer>

42. Consider the following:

6 months euro interest rate is 3% p.a. (compounded quarterly)

6 months dollar interest rate is 4% p.a. (compounded quarterly)

The forward six months exchange rate is $1.4872/€

According to interest rate parity, the spot exchange rate is

(a) $1.4878 /€
(b) $1.4896 /€
(c) $1.4912 /€
(d) $1.4946 /€
(e) $1.4974 /€. **(1 mark)**

<Answer>

43. Which of the following is **not** a current account item in India's balance of payment?

(a) Repatriation of profit earned by the branch of a foreign company in India to its parent company
(b) Receipts in foreign currency through travelers cheques/currency notes from tourists on a visit to India
(c) Freight charges/passenger fares collected and remitted by Air India, New York
(d) Remittances by Government of India in connection with maintenance of high commission office in London
(e) Remittances received for depositing in NRI/FCNR deposits from non-resident Indians. **(1mark)**

<Answer>

44. A Foreign Institutional Investor (FII), New York made a portfolio investment at the Bombay Stock Exchange when the exchange rate was Rs.44.00. The exchange rate at the end of one year becomes Rs.39.00.

The return earned on the portfolio in rupee term is 15%.

The return to the Foreign Institutional Investor in dollar term is

(a) 18.06%
(b) 19.45%
(c) 20.55%
(d) 23.43%
(e) 29.74%. **(1mark)**

<Answer>

45. Consider the information given below:

Country	Labour Hours required	
	Car(Units)	Steel (Tons)
U.S.A.	55	110
France	70	105

If 2310 hrs are available, then the opportunity cost of one ton of steel in France is

(a) 0.50 unit of car
(b) 0.67 unit of car
(c) 1.25 units of car
(d) 1.50 units of car
(e) 2.00 units of car. **(1mark)**

<Answer>

46. Which of the following statements is **true**, in case of a direct quote?

(a) Exchange margin is to be added to the bid rate and ask rate
(b) Exchange margin is to be added to the bid rate and deducted from the ask rate
(c) Exchange margin is to be deducted from the bid rate and the ask rate
(d) Exchange margin is to be deducted from the bid rate and added to the ask rate
(e) Exchange margin is to be added to the bid rate only. **(1mark)**

<Answer>

47. According to the Monetary Approach of exchange rate forecasting, inflation is the outcome of

(a) Increase in wages in the economy
(b) Increase in real output growth
(c) Increase in government spending
(d) Increase in money supply in excess of real output growth
(e) Adverse effect of political factors on the economy. **(1mark)**

<Answer>

48. A current account surplus implies that

I. The country is a net lender to the rest of the world.

II. The country is running a net capital account surplus.

III. Foreign investment in domestic securities is at very low levels.

IV. Foreign investment in domestic securities is at very high levels.

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

<Answer>

49. Which of the following statements is/are **true** with respect to an optimal capital structure?

I. The company should make maximum use of leverage at minimum cost.

II. The capital structure should involve maximum dilution of control of the company.

III. The capital structure should be flexible enough to meet the changing conditions.

(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. **(1 mark)**

<Answer>

50. The international exchange value of the U.S. dollar is determined by:

(a) The rate of inflation in the United States
(b) The number of dollars printed by the U.S. Government
(c) The international demand and supply for dollars
(d) The monetary value of gold held at Fort Knox, Kentucky
(e) The value of SDRs held with IMF. **(1 mark)**

<Answer>

51. You are given the following information:

Spot rate : Rs.38.75/$

3 month forward rate: Rs.38.94/$

The inflation rate in India is 5%, calculate the inflation rate in the USA assuming that the Purchasing Power Parity holds good even for the short run

(a) 2.98%
(b) 4.82%
(c) 4.52%
(d) 4.88%
(e) 5.88%. **(1 mark)**

<Answer>

52. If a country is following a system of floating exchange rates, falling income in the country would trigger an

(a) Increase in the demand for imports and an increase in the demand for foreign currency
(b) Increase in the demand for imports and a decrease in the demand for foreign currency
(c) Decrease in the demand for imports and an increase in the demand for foreign currency
(d) Decrease in the demand for imports and a decrease in the demand for foreign currency
(e) Increase in the demand for foreign currency only. **(1 mark)**

<Answer>

53. Which of the following statement is **true** as per the Theory of Comparative Advantage?

(a) A country can be benefited if its exports exceeds imports
(b) The larger country always benefits from free trade and the smaller country always loses
(c) Small countries enjoy a "free rider" effect when they trade with other nations and therefore, they are always the beneficiaries of free trade
(d) Not everyone benefits from free trade, but theoretically, the winners could compensate the losers
(e) Everyone in all trading nations benefits from free trade. **(1 mark)**

<Answer>

54. Under the gold standard, the loss of gold and reduction in the money supply in the deficit country may lead to

(a) An increase in its interest rate and a capital inflow
(b) An increase in its interest rate and a capital outflow
(c) A decrease in its interest rate and a capital inflow
(d) A decrease in its interest rate and a capital outflow
(e) An increase in capital outflow only. **(1 mark)**

<Answer>

55. A crawling peg system is a

(a) Fixed exchange rate system
(b) Floating exchange rate system
(c) Hybrid of fixed and flexible exchange rate system
(d) Currency board system
(e) Free float system. **(1 mark)**

<Answer>

56. A country may be able to correct its persistent (long-term) Balance of Payments deficit by

(a) Reducing the barriers on imported goods
(b) Reducing its official reserves
(c) Expanding its national income
(d) Reducing the international value of its currency
(e) Increasing the international value of its currency. **(1 mark)**

<Answer>

57. Which of the following is/are **not** (an) underlying assumption(s) of purchasing power parity?

(a) Goods can move freely across the globe
(b) Capital can move freely across the globe
(c) There are no tariff on goods
(d) There are no transaction costs involved in the buying and selling of goods
(e) There are no transportation costs. **(1 mark)**

<Answer>

58. The relationship between the spot and forward exchange rates between a pair of currencies is brought about principally through

(a) The Fisher effect
(b) Purchasing power parity
(c) Covered interest rate arbitrage
(d) Uncovered interest rate arbitrage
(e) The law of one price. **(1 mark)**

<Answer>

59. Which of the following measures is **not** a preventive anti-takeover measure?

(a) Golden parachute
(b) Poison pill
(c) Corporate charter amendment
(d) Dual Capitalization
(e) Standstill agreement. **(1 mark)**

<Answer>

60. Which of the following forms of financing that emerged in the fourth merger wave has strengthened the credibility of small companies as raiders?

(a) Mezzanine financing
(b) Junk bond financing
(c) Bridge loan financing
(d) Seller financing
(e) Syndicate loan financing. **(1 mark)**

<Answer>

61. Which of the following are **true** with respect to poison pill strategies?

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)**

<Answer>

62. Adarsh Industries Ltd., which has a value of Rs.8.5 crore merged with Quick Solution Ltd., whose value before merger was Rs.46 crore. The merger brings in cost savings whose present value is Rs.3.64 crore. If the NPV of the merger from the point of view of Quick solution Ltd., is Rs.2.5 crore. The amount offered by Quick Solution Ltd., as cash compensation to Adarsh Industries Ltd., is

(a) Rs. 0.75 crores
(b) Rs. 1.60 crores
(c) Rs. 9.64 crores
(d) Rs.10.35 crores
(e) Rs.11.35 crores. **(1 mark)**

<Answer>

63. Consider the following data for Floak Ltd.:

Year	1	2	3	4	5
Earnings Per Share (Rs.)	4.80	4.00	3.00	5.00	4.50
Payout (%)	63	75	67	60	67
Price per share at the end (Rs.)	42.00	45.00	33.00	38.00	36.00

If the price at the beginning of year 1 is Rs.40, the realized yield over the five year period would be

(a) 4.75%
(b) 5.06%
(c) 5.25%
(d) 6.25%
(e) 7.00%. **(2 marks)**

<Answer>

64. The total capital employed by Junior Ltd., is Rs.18,00,000. The firm has debt-equity ratio of 5:4. The ratio of owner's equity to fixed assets is 8:15. The amount of fixed assets in the company is

(a) Rs.15,00,000
(b) Rs.18,00,000
(c) Rs.20,00,000
(d) Rs.21,00,000
(e) Rs.25,00,000. **(3 marks)**

<Answer>

65. The least expensive form of financing for the firm is

(a) Existing common stock
(b) Preferred stock
(c) Debenture capital
(d) New common stock
(e) Retained earnings. **(1 mark)**

<Answer>

66. A financial services company is considering offering credit to Mr. Sharath. The probability that he pays is 0.8. If cost of sales is 70% of sales, net profit or loss to the firm, if it offers credit, is

(a) A loss of 20% on sales
(b) A loss of 10% on sales
(c) No profit and no loss
(d) A profit of 10% on sales
(e) A profit of 20% on sales. **(2 marks)**

<Answer>

67. Which of the following statements is/are **correct** for a project with a positive net present value?

I. Internal rate of return exceeds the cost of capital.
II. Net benefit cost ratio is less than zero.
III. Benefit cost ratio is greater than 1.

(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)**

<Answer>

68. Which of the following is **false** with regard to the net present value (NPV) as an appraisal criterion for projects?

(a) It gives more weight to the earlier cashflows than the later cashflows
(b) NPVs of multiple projects can be added to give a combined NPV
(c) It considers the cashflows over the entire life of the project
(d) It represents the contribution of the project to the wealth of the lenders of the firm
(e) It considers the time value of money.

(1 mark)

<Answer>

69. A single, overall cost of capital is often used to evaluate projects because

(a) It avoids the problem of computing the required rate of return for each investment proposal
(b) It is the only way to measure a firm's required return
(c) It acknowledges that most new investment projects have about the lower degree of risk
(d) It acknowledges that most new investment projects offer about the same expected return
(e) It considers agency and bankruptcy costs. **(1 mark)**

<Answer>

70. An investment project is expected to generate earnings before taxes (EBT) of Rs.60,000 per year. Annual depreciation from the project is Rs.30,000 and the firms' tax rate is 40 percent. The project's annual net cash flows are

(a) Rs.36,000
(b) Rs.40,000
(c) Rs.48,000
(d) Rs.54,000
(e) Rs.66,000.

(2 marks)

<Answer>

71. Consider the following information related to Prakasha Ltd.:

Net sales	=	Rs.240 lakh
Net profit margin	=	12.50 percent
Outstanding Preference shares	=	Rs.100 lakh @ 12 percent per annum
Number of equity shares	=	4,50,000
Cost of equity shares	=	12 percent
Retention ratio	=	40 percent
Return on investment	=	16 percent.

What should be the approximate share price as per Gordon's model? (Round off your answer to the nearest integer)

(a) Rs.100
(b) Rs.43
(c) Rs.39
(d) Rs.36
(e) Rs.21.

(3 marks)

<Answer>

72. Which of the following measures would prevent a situation of overtrading in a company?

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

(1 mark)

<Answer>

73. Following details are given about Kashi Ltd.:

Opening balance of accounts receivable	Rs.16,000
Closing balance of accounts receivable	Rs.22,000
Average collection period	185 days

(Assume 1 year = 360 days)

The annual credit sales for the company are approximately

(a) Rs.35,000
(b) Rs.36,972
(c) Rs.40,000
(d) Rs.42,186
(e) Rs.45,000.

(2 marks)

<Answer>

74. Which of the following statements is **true** with respect to Bought out Deals?

(a) Immediate finance may not be available to the companies
(b) These are known as Angles in UK
(c) The issue price will be current market price prevailing at that time
(d) The timing of the offloading is to be done within a very rigid framework
(e) It is very expensive way of issue.

(1 mark)

END OF QUESTION PAPER

Suggested Answers
Financial Management (CFA540): January 2008

Answer **REASON**

1. C — Alternative (a) is a part of the ‘control’ function of the finance manager. Alternative (b) involves partly the ‘deployment’ function. Alternative (d) is a part of the deployment of funds’ function. Alternative (e) is also related with the ‘deployment of funds’ function. Alternative (c) is related to the ‘mobilization of funds’ function. < TOP >

Hence (c) is the answer.

2. E — The savings function provides the investors with the opportunity to liquidate the investments. < TOP >

The payment function offers a very convenient mode of payment for goods and services.

The liquidity function ensures that the public savings reach the hands of those in production.

The risk function provides immense opportunities for the investors to hedge against the possible risks involved in various investments.

The policy function allows for the exchange of current income for future income and transformation of savings into investments.

Hence (e) is the answer.

3. C — They are issued at a discount to face value, they are freely transferable by endorsement and delivery, they offer higher yields compared to conventional deposits, they are maturity-dated obligations of banks forming a part of time liabilities and are subjected to usual reserve requirements, and they can be issued in demat form and can be transferred as per the procedure applicable to other demat securities. Hence (c) is the answer. < TOP >

4. D — In case of a T-Bill, < TOP >

$$k = \frac{F\text{-}P}{P} \times \frac{365}{d}$$

$$0.0695 = \frac{100 - P}{P} \times \frac{365}{182}$$

$$0.0695P \times 182 = (100 - P)365$$

$$12.65P = 36{,}500 - 365P$$

$$12.65P + 365P = 36{,}500$$

$$P = \text{Rs.}96.65$$

Hence (d) is the answer.

5. E < TOP >

Effective rate of interest, $r = \left(1 + \frac{k}{m}\right)^m - 1$

Where, k = nominal rate of interest and

m = frequency of compounding

Effective interest rate is always higher than the nominal interest rate. The effective rate of interest increases with increase in the frequency of compounding. Both the effective rate of interest and the nominal rate of interest are equal if the frequency of compounding is one. Hence statements (II) and (III) are true and statement (I) is not true. Hence (e) is the answer.

6. B — All risks i.e. sector risk, credit risk, management risk are diversifiable i.e. can be diversified away by holding of stocks of more than one company. However, market risk cannot be diversified away. < TOP >

Hence (b) is the answer.

7. D Given the variance on the portfolio and the variances of individual stocks, the correlation coefficient can be found out from the following equation: < TOP >

$$\sigma_p^2 = w_1^2\sigma_1^2 + w_2^2\sigma_2^2 + 2\rho w_1 w_2 \sigma_1 \sigma_2$$

Since the proportion of stocks in the portfolio is given as 1:3, 25% is invested in stock A and 75% is invested in stock B. Therefore $w_1 = 0.25$ and $w_2 = 0.75$.

$144 = (0.25)^2(169) + (0.75)^2(196) + 2 \text{ x } \rho \text{x } (0.25) \text{ x } (0.75) \text{ x } 13 \text{ x } 14$

$144 - 120.81 = 68.25\ \rho$

$\rho = 0.34.$

Hence (d) is the answer.

8. C < TOP >

Holding period return for a bond = $\frac{(P_2 - P_1) + I}{P_1} = \frac{(960 - 950) + 95}{950} = 11.05\%$

Hence (c) is the answer.

9. B Average collection period = Net operating cycle + Average payment period – (RM storage period + Conversion period < TOP >

+ FG storage period)

= 55 + 25 – (40 + 2 + 20) = 18 days.

Hence (b) is the answer.

10. C The orders can be classified into: < TOP >

- Limit Orders: Order limited by a fixed price. It may or may not include brokerage.
- Best Rate Order: To execute the buy/sell order at the best possible price.
- Immediate or Cancel Order: Order shall get cancelled if not executed immediately at the quoted price.
- Limited Discretionary Order: To provide discretion to the broker to execute order at a price, which is almost, approximate to the price fixed by client.
- Stop Loss Order: A particular limit is given for sustenance of loss. If the price falls below that, the broker is authorized to sell immediately to stop further occurrence of losses.
- Open Order: When client does not fix any time or price limit for execution of order.

Therefore (c) is the answer.

11. A In the security market line (SML) the y-intercept is the risk free rate of return(r_f) and the slope is the difference between the rate of return on the market index and the risk free rate of return (r_m - r_f). If the risk free rate of return increases then the y-intercept increases; so the SML shifts up. If the investors become more risk averse then (r_m - r_f) increases i.e., the slope of SML increases. Hence alternative (a) is the answer. < TOP >

12. E < TOP >

β of the security = $\frac{COV(r_s, r_m)}{\sigma_m^2}$, where r_s is return on security and r_m is market return.

β decreases with increase in variance of market returns. Statement I is true.

Beta equal to one indicates an asst of average risk. Beta greater than 1 indicates above-average risk stocks, and beta less than 1 indicates below average risk. Statement II is not true.

Also $\frac{\rho_{sm}\sigma_s\sigma_m}{\sigma_m^2}$, where ρ_{sm} is the correlation coefficient of market return and stock return.

Increase in the value of correlation coefficient between security and market returns will increase the value of β. Decrease in standard deviation of the security's return will decrease the value of β.Hence statement III is correct and statement IV is false.

Hence (e) is the answer.

13. B 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 = $PV(1+r)^n$

45,000 = 25,000 $(1+r)^5$

1.8 = $(1+r)^5$

r = 12.47%

Therefore the company earns a return of 12.47%.

14. E < TOP >

10,00,000 = $A \times PVIFA_{(0.12/12,\ 60)}$

$$A = \frac{10,00,000}{44.955} = 22,244.$$

15. C Average annual income = (30000 + 45,000 + 75,000)/3 = Rs. 50,000 < TOP >

Average net book value of investment = (2,10,000+0)/2 = Rs. 1,05,000.

Accounting rate of return = (50,000/ 1,05,000) x 100 = 47.62%

16. D < TOP >

$$\text{Annual capital charge} = \frac{\text{PV of costs}}{\text{PVIFA}_{k,n}}$$

$$\text{ACC of the machine} = \frac{25,00,000 + 2,00,000\ \text{PVIFA}_{12,9}}{\text{PVIFA}_{12,9}}$$

$$= \frac{25,00,000}{\text{PVIFA}_{12,9}} + 2,00,000 = \text{Rs.}6,69,219$$

Hence, (d) is the answer.

17. C < TOP >

β =1.5

R_e = 19%

R_m = 15%

R_f = ?

Substituting the values in the CAPM equation,

19% = R_f + 1.5 (15% - R_f)

R_f = 7%

Now, if the R_m is increased to 17%,

R_e = 7% + 1.5(17% - 7%)

= 22%.

Therefore the new required return on the stock would be 22%.

Hence (c) is the answer.

18. E **Schedule of change in working capital** < TOP >

	31.03.06	31.03.07	Increase in WC	Decrease in WC
Current Assets:				
Stock	95,000	70,000	-	25,000
Debtors	1,75,000	2,00,000	25,000	-
Cash	20,000	10,000	-	10,000
Bank	58,000	30,000	-	28,000
Current Liabilities:				
Creditors for goods	80,000	70,000	10,000	-
Expenses for goods	8,000	10,000	-	2,000
			35,000	65,000
Net decrease In WC				**30,000**

Therefore (e) is the answer.

19. E The graphical representation of the CAPM models is the SML. The SML equation is given by E (r) = $R_f + \beta_j (k_m - R_f)$. The SML intersects the vertical axis at the risk-free rate of return R_f and $(k_m - R_f)$ is the slope of the SML. When the slope of SML is zero then Risk-free rate = Expected return and risk-free rate = Market return. Hence all the given statements are true. < TOP >

20. D Invoice discounting does not carry the service elements of factoring like sales ledger administration etc. < TOP >

Hence, option (d) is the correct choice.

Recourse factoring, Non-recourse or full factoring and maturity factoring include the service elements of factoring.

21. B < TOP >

$$PI = \frac{\text{PV of cash inflows}}{\text{PV of cash outflows}}$$

Project I:

$$PI = \frac{\frac{400}{(1.14)} + \frac{450}{(1.14)^2} + \frac{475}{(1.14)^3} + \frac{500}{(1.14)^4} + \frac{575}{(1.14)^5}}{1,000} = \frac{1612.43}{1,000} = 1.61$$

Project II:

$$PI = \frac{\frac{625}{(1.14)} + \frac{675}{(1.14)^2} + \frac{700}{(1.14)^3} + \frac{725}{(1.14)^4} + \frac{675}{(1.14)^5}}{1,200} = \frac{2,319.95}{1,200} = 1.93$$

Project III:

$$PI = \frac{600 \text{ x PVIFA}_{(14\%,5)}}{1,250} = \frac{2,059.8}{1,250} = 1.65$$

Project IV:

$$PI = \frac{\frac{250}{(1.14)} + \frac{350}{(1.14)^2} + \frac{500}{(1.14)^3} + \frac{400}{(1.14)^4} + \frac{200}{(1.14)^5}}{800} = \frac{1,166.80}{800} = 1.46$$

Project V:

$$PI = \frac{200 \text{ x PVIFA}_{(14\%,5)}}{750} = \frac{686.6}{750} = 0.92$$

Projects in descending order: II, III, I, IV, and V. Hence (b) is the answer.

22. A We know that IRR is that rate of return, which equates the present value of the cash inflows and the present value of cash outflows. Therefore PV of cash inflows will be the initial cash outlay. < TOP >

PV of cash inflows = 3,000 x $PVIFA_{(11\%, 8)}$ + 5,000 x $PVIF_{(11\%, 8)}$

= 3,000 x 5.146 + 5,000 x 0.4339

= Rs.17,608

Hence the initial outlay is Rs.17,608. Hence (a) is the answer.

23. D Initial investment on the machine = Cost of the machine + installation charges < TOP >

= 10,00,000 + 70,000

= Rs.10,70,000

Depreciation:

Year	Depreciation @ 30% (Rs.)	Book value (Rs.)
1	0.3 x 10,70,000 = 3,21,000	7,49,000
2	0.3 x 7,49,000 = 2,24,700	5,24,300
3	0.3 x 5,24,300 = 1,57,290	3,67,010
4	0.3 x 3,67,010 = 1,10,103	2,56,907

Therefore the book value at the end of year 3 = Rs.3,67,010.

Hence (d) is the answer.

24. B IRR is that rate of return, which equates the present value of the cash inflows and the present value of cash outflows., or where NPV is zero. Let 'r' be the relevant IRR. < TOP >

Present value of cash outflow = Rs.75,000

Present value of cash inflows = $20{,}000/(1+r) + 28{,}000/(1+r)^2 + 42{,}000/(1+r)^3$

$\therefore$ Rs.75,000 = $20{,}000/(1+r) + 28{,}000/(1+r)^2 + 42{,}000/(1+r)^3$

By trial and error,

When r = 8%, Present value of cash inflows = Rs.75,864.96

When r = 9%, Present value of cash inflows = Rs.74,347.37

Therefore r lies between 8% and 9%.

r = 8% + (75,864.96 – 75,000)/(75,864.96 - 74,347.37)

= 8% + 0.57%

= 8.57%

Hence (b) is the answer.

25. D Dividends for the next three years are as follows: < TOP >

Year	1	2	3
Dividend (Rs.)	$4 \times 1.15 = 4.60$	$4 \times 1.15 \times 1.15 = 5.29$	$4 \times (1.15)^3 = 6.084$

So, the required intrinsic value of the share is

$$= \frac{4.60}{1.16} + \frac{5.29}{(1.16)^2} + \frac{6.084}{(1.16)^3} + \frac{6.084 \times 1.06}{0.16 - 0.06} \times \frac{1}{(1.16)^3}$$

$$= 3.97 + 3.93 + 3.90 + 41.32 = 53.12 \approx \text{Rs.53 (approx.)}$$

26. D According to the CAPM approach, the required rate of return on a share is < TOP >

$k_e = R_f + \beta(R_m - R_f) = 6 + 1.25 \times 8 = 6 + 10 = 16$ percent.

27. B The pay back period of a project is defined as the time required generating sufficient cash flows so as to recover the initial investment made in the project, by duly ignoring the time value of money. Here the amount of cash generated for the first four years is Rs.19 crore against an investment of Rs.20 crore. This amount can be recovered by the first quarter of the fifth year as the cash flows occur uniformly. Hence, the pay back period is 4.25 years. < TOP >

28. B In order to calculate the WACC, the specific cost of capital and debt capital are to be calculated as follows: < TOP >

$$k_e = \frac{D_1}{P_0} + g = \frac{2(1.08)}{22} + 0.08 = 0.1782$$

Market value of equity = Rs.22 x 1,00,000 = Rs.22,00,000.

$$k_d = \frac{\text{Interest (1-t)}}{\text{Price of the debentures}} = \frac{15(1-0.4)}{90} = 0.10$$

Market value of debt = Rs.4,000 x 90 = Rs.3,60,000

Total capital = Rs.25,60,000

$$\text{WACC} = \frac{22,00,000}{25,60,000} \text{ x } 0.1782 + \frac{3,60,000}{25,60,000} \text{ x } 0.10 = 16.72\%$$

Hence (b) is the answer.

29. E < TOP >

EBIT	Rs.2,50,000
(–) Interest	Rs.50,000
Net profit	Rs.2,00,000
ke	10%
Value of equity (Net profit/ke) – S	Rs.20,00,000
Value of debt – B	Rs.6,25,000
Value of the firm (S + B)	Rs.26,25,000
ko (EBIT/V)	9.52%

Hence (e) is the answer.

30. E Here, the repayment of the debentures prematurely by using the proceeds of the rights issue does not make any impact on the net working capital as neither of the facts is related to the working capital. Selling products on credit reduces the amount of inventory in the company but also simultaneously increases the volume of debtors in the balance sheet of the company. Therefore, it makes a resultant impact of zero. < TOP >

31. C According to Walter's Model < TOP >

$$P_o = \frac{D}{k} + \frac{{}^{r}\!/_{k}(E-D)}{k}$$, where symbols are in standard use.

Substituting the given values we get

$$= \frac{3.6}{0.12} + \frac{\frac{0.14}{0.12}(12-3.6)}{0.12}$$

$= 30 + 81.67$

$=$ Rs.111.67

Number of shares outstanding = 2,00,000

$\therefore$ Market value of equity $= P_o \times N = 111.67 \times 2,00,000$

= Rs.223.3 lakh.

Hence (c) is the answer.

32. B The theoretical value of a right = $\frac{P_0 - S}{N+1}$ where P_0 is the cum-rights price, S is the subscription and N is the number of shares required for a rights share. Hence, $4 = \frac{48-36}{N+1}$. < TOP >

By solving, N=2. Hence (b) is the answer.

33. C The effect of the new collection program on the profits of the company can be estimated from the following formula: < TOP >

$\Delta P = \Delta S\ (1\text{-}V) - k\ \Delta I - \Delta\ BD - \Delta C$

Where,

ΔP = Change in profits

ΔS = Change in sales

V = Variable cost to sales ratio

k = Cost of capital

ΔI = Increase in investment in receivables

$$= \frac{S_0}{360}\left(ACP_N - ACP_o\right) + \frac{\Delta S}{360} ACP_N \text{ x } V$$

Δ BD = Increase in bad debts cost

$= b_n(S_o + \Delta S) - b_o S_o$

ΔC = Increase in collection expenses

Since there is no change in sales, $\Delta S = 0$

$$\Delta I = \frac{200}{360}(30 - 45) = -\text{Rs.}8.33 \text{ lakh}$$

$\Delta\ BD = b_n(S_o + \Delta S) - b_o S_o = 0.03(200) - 0.05(200) = -$ Rs.4 lakh

ΔC = Rs.2 lakh

$\Delta P = \Delta S\ (1\text{-}V) - k\ \Delta I - \Delta\ BD - \Delta C$

$= 0 - 0.15 \text{ x } (-8.33) - (-4) - (2)$

= Rs.3. 25 lakh = Rs.3,25,000.

Hence (c) is the answer.

34. C Cash credit is not a source of long term finance. It is a type of short term bank finance. Alternative (a), (b), (d), and (e) represent sources of long term finance. < TOP >

35. D < TOP >

Balance as per the cash book:

Day	1st January	2nd January	3rd January	4th January
Opening balance	Rs.100,000	Rs.93,000	Rs.86,000	Rs.79,000
Cheques Deposited	Rs.18,000	Rs.18,000	Rs.18,000	Rs.18,000
Cheques Issued	Rs.25,000	Rs.25,000	Rs.25,000	Rs.25,000
Closing balance	Rs.93,000	Rs.86,000	Rs.79,000	Rs.72,000

Balance as per the pass book:

Day	1st January	2nd January	3rd January	4th January
Opening balance	Rs.100,000	Rs.100,000	Rs.75,000	Rs.50,000
Cheque Deposited				Rs.18,000
Cheque Issued		Rs.25,000	Rs.25,000	Rs.25,000
Closing balance	Rs.100,000	Rs.75,000	Rs.50,000	Rs.43,000

Net float = Rs.43,000 – Rs.72,000 = – Rs.29,000.

36. E < TOP >

$$\text{Cost of trade credit} = \frac{\text{Rate of discount}}{1 - \text{Rate of discount}} \times \frac{360}{\text{Credit Period} - \text{discount period}}$$

Other things remaining the same, following factors will decrease the cost of trade credit:

Decrease in the rate of discount. For example: “1/10 Net 30” will have a lesser cost of trade credit compared to “2/10 Net 30”.

Decrease in the discount period. For Example: “1/10 Net 30” will have a lesser cost of trade credit compared to “1/15 Net 30”.

Increase in the credit period. For example “1/10 Net 30” will have a greater cost of trade credit compared to “1/10 Net 45”.

Hence (e) is the required answer.

37. B Cost of goods sold = Rs. 39,00,000. < TOP >

Gross profit margin is given to be 25%. In other words gross profit is 25% of sales.

Let Sales be x.

Therefore, Cost of goods sold + 0.25 x = x

39,00,000 + 0.25x = x

Hence x (i.e. Sales) = Rs. 52,00,000.

Average receivables turnover ratio is given to be 52:15

i.e. $\frac{\text{Net credit sales}}{\text{Average accounts receivables}} = \frac{52}{15}$ (assume that the entire sales are on a credit basis)

$$\frac{52,00,000}{\text{Average accounts receivables}} = \frac{52}{15}$$

Therefore, Debtors (or average account receivables) = Rs. 15,00,000.

Cash and Bank = Quick assets – debtors = 18,00,000 – 15,00,000 = Rs.3,00,000.

38. A Matching the maturities of assets and liabilities reduces risk. Hence, generally firms choose to finance temporary working capital with short-term debt to match the maturities of assets and liabilities and thereby to reduce risk. < TOP >

39. C Unlike a central bank, a currency board does not even have the power to print unlimited amounts of Money. Due to the requirement of the domestic currency being backed by reserves of anchor currency, the board can print as much currency as can be backed by its existing reserves. This prevents board lending to either the government, or the domestic banks. < TOP >

40. C < TOP >

$$\text{Annualized Premium} = \frac{\text{Forward (A/B)mid - spot (A/B)mid}}{\text{spot (A/B)mid}} \text{ x } \frac{12}{3} \text{x100}$$

$$\frac{80.45 - 79.77}{79.77} \text{x} \frac{12}{3} \text{x100} = 3.41\%$$

41. D < TOP >

		Amount
Rs/ S$	Inter bank ask rate :	27.32
	Add exchange margin of 0.1%	0.03
		27.35

42. D < TOP >

$$S = 1.4872 \times \frac{\left(1 + \frac{0.04}{4}\right)^2}{\left(1 + \frac{0.03}{4}\right)^2} = 1.4946$$

43. E Foreign currency deposits of NRIs are classified under capital account in India's balance of payment. < TOP >

All items under (a), (b), (c) and (d) come under current account. Correct answer is (e).

44. E $1 = Rs.44 < TOP >

$$\frac{44\ (1.15)}{39/1} - 1 = 29.74\%$$

45. D we have 2310 hrs available [< TOP >]

Then, in U.S.A. we can make.

2310/55 = 42 cars

2310/110 = 21 tons of steel

Similarly, in France we can make,

2310/70 = 33 cars

2310/105 = 22 tons of steel

Then opportunity costs:-

	Cars	Steel
U.S.A.	21/42 = 0.50	42/21 = 2
France	22/33 = 0.67	33/22 = 1.50

Therefore, opportunity cost of one ton of steel in France is 1.50 units of Car

46. D Exchange margin is to be deducted from the bid rate and added to the ask rate, in the case of a direct quote. In the case of a direct quote the principle is buy low - sell high. [< TOP >]

Hence, option (d) is the correct answer.

47. D According to the Monetary Approach, an increase in the money supply causes the currency to depreciate. The outcome of the increase in money supply in excess of real output growth is inflation. [< TOP >]

48. E A current account surplus implies that, the country is a net lender to the rest of the world and foreign investment in domestic securities is at very high levels. [< TOP >]

Hence the correct answer is (e).

49. D Features of an optimal capital structure are: [< TOP >]

Profitability: The company should make maximum use of leverage at minimum cost. Statement (I) is true.

Flexibility: The capital structure should be flexible enough to meet the changing conditions. Statement (III) is true.

Control : The capital structure should involve minimum dilution of control of the company. Statement (II) is not true.

Therefore statements (I) and (III) are true and statement (II) is not true. Hence (d) is the answer.

50. C The international exchange value of the U.S. dollar is determined by the international demand and supply for dollars. [< TOP >]

Hence, option (c) is the correct answer.

51. A Applying PPP, we can state that Rs. 38.75 and $1 can buy same basket of goods today [< TOP >]

Let the inflation rate in the USA be i

After 3 months, the price of the basket willl be as follows :

in India 38.75 (1+ 0.05/4) = Rs. 39.23

in USA, 1(1+ i/4) = S(1 + i/4)

Expected Spot rate after three months is then 39.23/ (1 + i/4)

But the expected spot rate is nothing but the forward rate

So, we can write 39.23 / (1 + i/4) =38.94

i =2.98%

52. D Given a system of floating exchange rates, falling income in the country would trigger a (an) decrease in the demand for imports and a decrease in the demand for foreign currency. [< TOP >]

53. D The country is the net winner even though certain individuals may lose. [< TOP >]

54. A Under the gold standard, the loss of gold and reduction in the money supply in the deficit country may lead to an increase in its interest rate and a capital inflow [< TOP >]

55. C A crawling peg system is a hybrid of fixed and flexible exchange rate system. Under this system the value of a currency is fixed in terms of a reference currency and this peg itself keeps changing in accordance with the underlying economic fundamentals, by letting the market forces play a role in determining the exchange rate. [< TOP >]

56. D A country may be able to correct its persistent (long term) Balance of Payments deficit by reducing the international value of its currency. This takes place by devaluation. As a result of this exports would be more competitive and imports would be more costlier. By this the Balance of Payments deficit gets corrected. < TOP >

57. B Option (b) is not assumption of purchasing power parity (PPP). < TOP >

58. C The relationship between the spot and forward exchange rates between a pair of currencies is brought about principally through covered interest arbitrage. The fisher effect says that the real interest rates are equal across different countries. Purchasing power parity says that the exchange rate between two countries currencies is determined by the respective price levels in the two countries. Correct answer is (c). < TOP >

59. E Preventive measures are designed before a hostile bid to reduce the likelihood of a financially successful hostile takeover. Standstill agreements are active anti takeover measure generally adopted after the hostile bid has been attempted. < TOP >

60. B Junk bond financing that emerged in the fourth merger wave has strengthened the credibility of small companies as raiders. < TOP >

61. 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 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.

62. C NPV of Merger from the point of view of X will be < TOP >

2.5 = Rs. 46 crore + Rs. 8.5 crore + Rs.3.64 crore –Rs. x crore – Rs. 46 crore

= Rs. 9.64 crore

63. B < TOP >

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

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

The wealth ratios for Beta Ltd will be as follows:

	1	2	3	4	5
Wealth Ratio	1.1256	1.143	0.78	1.242	1.027

Yield = $(1.1256 \times 1.143 \times 0.78 \times 1.242 \times 1.027)^{1/5} - 1$

= 1.0506 – 1

= 0.0506

= 5.06%.

64. A Debt Equity ratio = 5:4 [< TOP >]

Therefore Equity = $\frac{4}{9} \times 18,00,000$ = Rs. 8, 00,000.

Computation of fixed assets:

It is given that ratio of owner's equity to fixed assets is 8:15.

i.e. $\frac{8,00,000}{\text{Fixed Assets}} = \frac{8}{15}$

Therefore, fixed assets = 8 00,000 x $\frac{15}{8}$ = Rs. 15 00,000.

Hence Choice (a) is the correct option.

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

66. D $P_p \times$ (1– Percentage of Cost on Sales) – (1– P_p) × Percentage of Cost on Sales [< TOP >]

0.8 ×0.3 – 0.2 ×0.7 = 0.1 =10% on sales.

67. D 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. [< TOP >]

Hence statement (I) is correct.

A positive NPV indicates that the present value of inflows is greater than the present value of outflows. It does not give any relevant information about the pay back period being more than the cut-off rate.

Hence statement (II) is incorrect.

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

Therefore a positive NPV indicates that the present value of inflows is greater than the initial investment, in other words it implies that BCR > 1.

Hence option (d) is the answer.

68. D NPV gives more weight to earlier cash flows than later cash flows (a). NPVs are additive in nature (b). NPV considers the entire life of the project (c). NPV represents the contribution of the project to the wealth of the equity shareholder. Hence (d) is false. It considers the time value of money (e). [< TOP >]

69. A A single, overall cost of capital is often used to evaluate projects because it avoids the problem of computing the required rate of return for each investment proposal. The other alternatives (b), (c), (d) and (e) are not true. [< TOP >]

70. E Net Cash Flow = Rs.60,000 (1 – 0.40) + Rs.30,000 = Rs.66,000. [< TOP >]

71. B Net profit for the company = Rs.240 lakh × 12.50 percent = Rs.30 lakh [< TOP >]

Profit available for the equity shareholders = Rs.30 lakh – Rs.12 lakh (preference dividend) = Rs.18 lakh and the amount of EPS is Rs.4.00

According to Gordon's dividend capitalization model,

$$P = \frac{E(1-b)}{k_c - br} = \frac{4 \times (1-0.40)}{0.12 - 0.40 \times 0.16}$$

Here, E = Rs.4, b = 40 percent, k_c = 12 percent and r = 16 percent.

Or, P = $\frac{2.4}{0.12 - 0.064} = \frac{2.4}{0.056}$ = Rs.42.857 = Rs.43 (approximately)

Hence, the required market price per share = Rs.43.

72. D 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, an 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 (d) is the answer.

73. B < TOP >

$$\text{Average collection period} = \frac{\text{Average debtors}}{\text{Average daily credit sales}}$$

$$\text{Average debtors} = \frac{\text{Opening stock of debtors + closing stock of debtors}}{2}$$

$$= \frac{16{,}000 + 22{,}000}{2} = \text{Rs.}19{,}000$$

Average daily credit sales = Average debtors/ Average collection period

= 19,000/185 = Rs.102.70

Annual credit sales = 102.70 x 360 = Rs.36,972.

Hence (b) is the answer.

74. B Bout-out deals are known as Angles in U.K. Buy-out is a process whereby an investor or a group of investors buy-out a significant portion of the equity of an unlilsted company with a view to selling the equity to public within an agreed time frame. The company places the equity shares, to be offered to the public, with a sponsor. At the right time, the shares will be off loaded to the public through the OTCEI route or by way of a public issue. An advantage accruing the investor is that the issue price usually reflects the company's intrinsic value. This route is relatively inexpensive and funds accrue without much delay. Hence, alternatives (a),(c),(d) and (e) are false. Alternative (b) is true and is answer. < TOP >

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