Roll No.

Total No. of Questions-6] [Total No. of Printed Pages-3]

Time Allowed-3 Hours Maximum Marks-100

NOC

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi medium. If a candidate who has not opted for Hindi medium, answers in Hindi; his answers in Hindi will not be valued.

Question No. 1 is compulsory. Answer any four questions from the rest.
Figures in the margin indicate marks allotted to each question.

Working notes should form part of the answer.

1.

(a) Shivam Ltd. is considering two mutually exclusive projects A and B. Project A costs Rs. 30,000 and project B Rs. 30,000. You have been given below the net present value probability distribution for each project.

Project A		Project B	
NPV estimates (Rs.)	Probability	NPV estimates (Rs.)	Probability
15,000	0.2	15,000	0.1
12,000	0.3	12,000	0.4
6,000	0.3	6,000	0.4
3,000	0.2	3,000	0.1

1. Compute the expected net present values of projects A and B.
2. Compute the risk attached to each project i.e. standard deviation of each probability distribution.
3. Compute the profitability index of each project.
4. Which project do you recommend? State with reasons.

(14 Marks)

(b) Presently a company is working with an earning before interest and taxes (EBIT) of Rs.90 lakhs. Its present borrowings are as follows:

(Rs. in lakhs)

12% term loan	300
Working capital borrowings:	
Borrowing from bank at 13%	200
Fixed deposits at 11%	90

CA. L. Muralidharan FCA, AICWA
Cell: 094440 45990, 09849 54207, 044 - 2814 2616, 2489 3030
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The sales of the Company are growing and to support this, the company proposes to obtain additional borrowing of Rs. 100 lakhs at a cost of 16%. The increase in EBIT is expected to be 16%. Calculate the present and the revised interest coverage ratio and comment.

(6 Marks)

Solution to Question No. 1 (a)

(i) Expected NPV

	A			B	
NPV Estimate	Probability	Expected NPV	NPV Estimate	Probability	Expected NPV
15,000	0.2	3,000	15,000	0.1	1,500
12,000	0.3	3,600	12,000	0.4	4,800
6,000	0.3	1,800	6,000	0.4	2,400
3,000	0.2	600	3,000	0.1	300
		9,000			9,000

(ii) Risk of each project

	A			B	
Variance	Probability	Expected Variance	Variance	Probability	Expected Variance
(15-9)²	0.2	7.2	(15-9)²	0.1	3.6
(12-9)²	0.3	2.7	(12-9)²	0.4	3.6
(6-9)²	0.3	2.7	(6-9)²	0.4	3.6
(3-9)²	0.2	7.2	(3-9)²	0.1	3.6
		19.8x 1,000²			14.4 x 1,000²
	SD	4,450		SD	3,795

(iii)

Project	NPV	DISCCO	DISCCI	PI	Rank
A	9,000	36,000	45,000	1.25	II
B	9,000	30,000	39,000	1.30	I

(iv) Project B is better than project A for the following reasons.

a) Lesser risk (Lower SD)

b) Higher PI (Productivity in terms of greater return for Re. 1 investment)

c) Lower outlay (covered in PI)

Solution to Question No. 1 (b)

Source of Borrowing	Amount (Rs. In lacs)	Rate	Interest (Rs. In lacs)
Term Loan	300	12%	36.0
Working Capital Borrowings	200	15%	30.0

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Cell: 094440 45990, 09409 54207, 044 - 2814 2616, 2469 3830
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Fixed Deposit	90	11%	9.9
	390		75.9
Additional Borrowings	100	16%	16.0
	490		91.9

Stage	EBIT	I	Interest coverage ratio
Before	90	75.9	1.19
After	108.2	91.9	1.18

2.

(a) Following information is provided relating to the acquiring company Mani Ltd. and the target company Ratnam Ltd.:

	Mani Ltd.	Ratnam Ltd.
Earnings after tax (Rs. lakhs)	2,000	4,000
No. of shares outstanding (lakhs)	200	1,000
P/E ratio (No. of times)	10	5

Required:

(i) What is the swap ratio based on current market prices?

(ii) What is the EPS of Mani Ltd. after the acquisition?

(iii) What is the expected market price per share of Mani Ltd. after the acquisition, assuming its P/E ratio is adversely affected by 10%?

(iv) Determine the market value of the merged Co.

(v) Calculate gain/loss for the shareholders of the two independent entities, due to the merger.

(10 Marks)

(b) X Ltd. reported a profit of Rs. 63 lakhs after 35% tax for the financial year 2007-08. An analysis of the accounts revealed that the income included extraordinary items Rs. 10 lakhs and an extraordinary loss Rs. 3 lakhs. The existing operations, except for the extraordinary items, are expected to continue in the future; in addition, the result of the launch of a new product are expected to be as follows:

	Rs. in lakhs
Sales	60
Material costs	15
Labour costs	10
Fixed costs	8

You are required to:

(a) Compute the value of the business, given that the capitalization rate is 15%

CA. L. Muralidharan FCA, AICWA.
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(b) Determine the market price per equity share, with X Ltd.'s share capital being comprised of 1,00,000 11% preference shares of Rs. 100 each and 40,00,000 equity shares of Rs. 10 each and the P/E ratio being 8 times.

(10 Marks)

Solution to Question No. 2 (a)

	Mani	Ratnam
Earning After Tax	2,000	4,000
No. of Equity Shares	200	1,000
Earning Per Share	10	4
Price Earning Ratio	10	5
Market price per share Rs.	100	20

i) $$\text{Exchange ratio} = \frac{\text{Value per share of vendor Company}}{\text{Value per share of purchasing Company}}$$

$$= \frac{20}{100} = 0.20 \text{ i.e. } \frac{1}{5}$$

ii) Number of shares to be issued to Ratnam = 200 (1,000 × 1/5)
Total Number of shares in Mani (after acquisition) = 400 (200 + 200)

Earnings of merged entity = 6,000 (Rs. In lacs)

Number of Equity Shares (in merged entity) = 400 (Numbers in lacs)

iii) Adversely effected Price earning ratio shall be 9 times (10 - 10% on 10)
Market Price per share = Earnings per share × Price earning ratio
= 15 × 9 = Rs. 135

iv)

	Same PE Ratio	Adversely effected PE Ratio
Price Earning Ratio	10	7
Earnings per share	15	15
Market price per share	150	135
Number of Shares	400	400
Market value	60,000	54,000

	Share of Mani		Share of Ratnam	
	Same Price Earning Ratio	Adverse Profit Earning ratio	Same Price Earning Ratio	Adverse Profit earning ratio
Before Merger	100	100	20	20
After Merger	150	135	30	27

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			(130 × 0.2)	(135 × 0.2)
Gain	30	35	10	7

Note: For the sub-questions (iv) & (v) it is not clear as what price earning ratio shall be taken. Hence the old Profit earning ratio as well as "Adversely effected" Price earning ratio is taken as two alternatives

Solution to Question No. 2 (b)

(a)

Profit before tax (including Extraordinary)	100L
Less: Extraordinary item (Net gain)	7 L
Profit before tax (excluding extraordinary	93L
Profit after tax 93L × 65%	60.45L
Incremental Profit [60 – 15 – 10 – 8) × 65%]	17.55L
Expected profit	78L
Expected yield	13%
Expected value of business (78L / 13%)	320

(b)

Expected Profit after tax	78L
Preference dividend 11%	11L
Equity earnings	67L
Number of Equity Shares	40L
Earnings per share	Rs. 1.675
Price earning ratio	8 times
Market price per share (1.675 × 8)	13.4

3.

(a) Sundaram Ltd. discounts its cash flows at 16% and is in the tax bracket of 35%. For the acquisition of a machinery worth Rs. 10,00,000, it has two options-either to acquire the asset by taking a bank loan @ 15% p.a. repayable in 5 yearly instalments of Rs. 2,00,000 each plus interest or to lease the asset at yearly rentals of Rs. 3,34,000 for five (5) years. In both the cases, the instalment is payable at the end of the year. Depreciation is to be applied at the rate of 15% using 'written down value' (WDV) method. You are required to advise which of the financing options is to be exercised and why.

Year	1	2	3	4	5
P.V. factor @ 16%	0.862	0.743	0.641	0.552	0.476

(14 Marks)

(b) Briefly explain the term "capital rationing".

(6 Marks)

Solution to Question 3 (a)

Option: Loan

Working Note 1: Interest Computation

(Rs. '000s)

1	2	3	4	5	6	7
Year	Outstanding	@ 15%	Principal	Closing	Interest	CF

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		Interest			After Tax	
1	1,000	150	200	800	97.5	297.5
2	800	120	200	600	78.0	278.0
3	600	90	200	400	58.5	258.5
4	400	60	200	200	39.0	239.0
5	200	30	200	-	19.5	219.5

Working Note 2: Tax savings on Depreciation and Capital Loss

Year	15% Depreciation	Tax Savings on Depreciation
1	1,50,000	32,500
2	1,27,500	44,625
3	1,08,375	37,931
4	92,119	32,242
5	78,301	27,405
	5,56,295	
Capital Loss	4,43,705	1,33,297
	10,00,000	

1	2	3	4	5 = 3-4	6 = 2 x 5
Year	PCF	Principal & Interest (After Tax)	Tax Saving	CF	DISCCF
1	0.862	2,97,500	32,500	2,65,000	2,11,190
2	0.743	2,78,000	44,625	2,33,375	1,73,398
3	0.641	2,58,300	37,931	2,20,369	1,41,383
4	0.552	2,39,000	32,242	2,06,758	1,14,130
5	0.476	2,19,500	1,82,702	36,798	17,516
	3.274				6,57,615

Option: Lease

Lease Rent	3,34,000
Lease Rent (After Tax)(3,34,000 x 65%)	2,17,100
Annuity Factor	3.274
DISCCO	7,10,785

Loan option gives lesser DISCCO than lease option

Solution to Question No. 3 (b)

Capital Rationing:

Generally, firms fix up maximum amount that can be invested in capital projects, during a given period of time, say a year. The firm then attempts to select a combination of investment proposals, that will be within the specific limits providing maximum profitability, and put them in descending order according to their rate of return, such a situation is then considered to be capital rationing. A firm should accept all investment projects with positive NPVs, with an objective to maximize the wealth of shareholders. However, there may be resource constraints due to which a firm may have to select from

CA. L. Muralidharan FCA, AICWA.
Cell: 094440 45990, 09489 54207, 044 - 2814 2616, 2489 3830
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among various projects with positive NPVs. Thus there may arise a situation of capital rationing where there may be internal or external constraints on procurement of necessary funds to invest in all investment proposals with positive NPVs.

Capital rationing can also be experienced due to external factors, mainly imperfections in capital markets which can be attributed to non-availability of market information, investor attitude etc. Internal capital rationing is due to the self-imposed restrictions imposed by management like not to raise additional debt or laying down a specified minimum rate of return on each project.

There are various ways of resorting to capital rationing. For instance, a firm may effect capital rationing through budgets. It may also put up a ceiling when it has been financing investment proposals only by way of retained earnings (ploughing back of profits). Since the amount of capital expenditure in that situation cannot exceed the amount of retained earnings, it is said to be an example of capital rationing.

Capital rationing may also be introduced by following the concept of 'responsibility accounting', whereby management may introduce capital rationing by authorizing a particular department to make investment only upto a specified limit, beyond which the investment decisions are to be taken by higher-ups.

In capital rationing it may also be more desirable to accept several small investment proposals than a few large investment proposals so that there may be full utilization of budgeted amount. They may result in accepting relatively less profitable investment proposals if full utilization of budget is a primary consideration. Similarly, capital rationing may also mean that the firm foregoes the next most profitable investment following after the budget ceiling even though it is estimated to yield a rate of return much higher than the required rate of return. Thus capital rationing does not always lead to optimum results.

4.

(a) The equity share of VCC Ltd. is quoted at Rs. 210. A 3-month call option is available at a premium of Rs. 6 per share and a 3-month put option is available at a premium of Rs. 5 per share.

Ascertain the net payoffs to the option holder of a call option and a put option, given that:

(i) the strike price in both cases is Rs. 220; and

(ii) the share price on the exercise day is Rs. 200, 210, 220, 230, 240.

Also indicate the price range at which the call and the put options may be gainfully exercised.

(10 Marks)

(b) A mutual fund that had a net asset value of Rs. 16 at the beginning of a month, made income and capital gain distribution of Rs. 0.04 and Rs. 0.03 respectively per unit during the month, and then ended the month with a net asset value of Rs. 16.08. Calculate monthly and annual rate of return.

(4 Marks)

(c) Explain the term "debt securitization".

CA. L. Muralidharan FCA, AICWA.
Cell: 094440 45990, 09489 54207, 044 - 2814 2616, 2489 3830
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(6 Marks)

Solution to Question No. 4 (a)

		Call			Put		
EPS	SK Price	V_c	Premium	Payoff	V_p	Premium	Payoff
210	220	Nil	6	-6	10	5	5
200	220	Nil	6	-6	20	5	15
210	220	Nil	6	-6	10	5	5
220	220	Nil	6	-6	Nil	5	-5
230	220	10	6	4	Nil	5	-5
240	220	20	6	14	Nil	5	-5

If FSP > 220 then the payoff would be +ve incase of call option

If FSP < 215 then the payoff would be +ve incase of put option

Solution to Question No. 4 (b)

Period	Price
M1	16
M2	16.08
Appreciation	0.08
Increase	0.7
Total increase	0.15

Monthly Rate of Return = $\frac{0.15}{16} \times 100 = 0.9375\%$

Annual Rate of Return = $\frac{0.15}{16} \times \frac{12}{1} \times 100 = 11.25\%$

Solution to Question No. 4 (c)

It refers to converting retail loans into wholesale loan and their reconverting into retail loans. For example, a bank lends Rs. 10 lakhs each to 300 borrowers as part of its loan portfolio. The total debt thus on the bank's books will be Rs.30 crores. By way of securitized on, the bank can break the entire portfolio of loan/debt of Rs.30 crores into a paper of Rs.300 each for instance, and market it in secondary market to investor. The philosophy behind the arrangement is that an individual body cannot go on lending sizeable amount for about a longer period continuously but if the loan amount is divided into small pieces and made transferable like negotiable instrument in the secondary market, it becomes easy to finance large projects having long gestation period.

Given the scarcity of resources and to provide flexibility to investors, innovative financing techniques such as debt Securitised Con which will Securiti additional resources through a wider investor base, is a step in the right direction.

In India, HDFC has Securitised its debt by selling a part of its loan to infrastructure leasing and Financial services Ltd. (ILFS)

CA. L. Muralidharan FCA, AICWA
Cell: 094440 45990, 098409 54207, 044 - 2814 2616, 2489 3830
Visit us at : www.sreeramcoachingpoint.com

5.

(a) The following 2-way quotes appear in the foreign exchange market

	Spot	2 Months Forward
RS/US $	Rs. 46.00/Rs. 46.25	Rs. 47.00/Rs. 47.30

Required:

(ii) How many US dollars should a firm sell to get Rs. 25 lakhs after 2 months?

(iii) How many Rupees is the firm required to pay to obtain US $ 2,00,000 in the spot market?

(iv) Assume the firm has US $ 69,000 in current account earning no interest. ROI on Rupee investment is 10 % p. a. Should the firm encash the US $ now or 2 months later?

(6 Marks)

(b) X & Co. is contemplating whether to replace an existing machine or to spend money in overhauling it. X & Co. currently pays no taxes. The replacement machine costs Rs.95,000 and requires maintenance of Rs. 10,000 every year at the year end for eight years. At the end of eight years, it would have a salvage value of Rs. 25,000 and would be sold. The existing machine requires increasing amounts of maintenance each year and its salvage value falls each year as follows:

Year	Maintenance (Rs.)	Salvage (Rs.)
Present	0	40,000
1	10,000	25,000
2	20,000	15,000
3	30,000	10,000
4	40,000	0

The opportunity cost of capital for X& Co. is 15%. You are required to state, when should the firm replace the machine.

(Given: Present value of an annuity of Re. 1 per period for 8 years at interest rate of 15 %- 4.4873; present value of Re. 1.00 to be received after 8 years at interest rate of 15%- 0.3269)

(10 Marks)

(c) According to the position taken by Miller and Modigliani, dividend decision does not influence value. Please state briefly any two reasons, why companies should declare dividend and not ignore it

(4 Marks)

Solution to Question No. 5 (a)

(i) Sell $ & AD's; BR (Forward)

1$ = Rs. 47

? = Rs. 25L

Get 53.191$

(ii) Purchase $ & AD's; or (Spot)

CA. L. Muralidharan FCA, AICWA
Call: 094440 45990, 09840954207, 044 - 2814 2616, 2489 3830
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CA. L. Muralidharan FCA, AICWA
Cell: 094440 45990, 98409 54207, 044 - 2814 2616, 2489 3030
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1$ = Rs. 46.23

21.$ = ?

Pay = Rs. 92.5L

(iii) If encashed now, Invoiceable INR for 69,000 $ is:

Step 1: Sell $ @ AD's (Bid rate) spot

1$ = Rs. 46

69,000 $ = ?

= Rs. 31,74,000

Step 2: Invest 31,74,000 for 10% for 2 months

Step 3: Maturity value of Investment 32,27,006

Step 4: Realization at forward 32,43,000 (69,000 x 47)

Conclusion: Realizing 69,000$ two months later is better

Solution to Question No. 5 (b)

Year	Life	Co	PVF	DISCO	Salvage	Net DISCO	Main cost	PV of Main	Cum of PV Main	AF	PV of Mai	All PV of CF	AF	EAC
0	8	55,000	1	55,000	8,173	46,827	0	0	0	4.4873	44,873	91,700	4.4873	20,436
1	9	70,000	0.8696	60,870	7,107	53,763	10,000	8,696	8,696	3.8944	38,944	1,01,403	4.7716	21,251
2	10	80,000	0.7561	60,491	6,180	54,312	20,000	15,123	23,819	3.3931	33,931	1,12,061	5.0188	22,328
3	11	85,000	0.6575	55,889	5,374	50,515	30,000	19,725	43,544	2.9503	29,503	1,23,364	5.2337	23,609
4	12	95,000	0.5718	54,317	4,673	49,644	40,000	22,870	66,414	2.3656	25,656	1,41,714	5.4206	26,144

The lowest EAC occurs at year 0. That is the machine should be replaced immediately

Solution to Question No. 5 (c)

Modigliani and Miller Approach argue that firm's dividend policy has no effect on its value of assets. Through arbitrage process MM hypothesis explains the value of the firm remains the same whether the firm pays dividend or not. It states that the value depends on the earnings of the firm and is unaffected by the pattern of income distribution.

i. Present Value Factor: Under MM approach the wealth of the shareholders remains unchanged whether dividends are paid or not i.e. If dividends are paid the dividends plus terminal price and otherwise the appreciated capital value at the end will be the same. Value of money received today is always higher than that received at a future

CA. L. Muralidharan FCA, AICWA
Cell: 094440 45990, 09409 54207, 044 - 2014 2616, 2489 3830
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date. Hence cash dividends paid now will be preferred by the investors over the capital appreciation that can be encashed in future.

ii. Investors' Preference: Most of the investors go for dividends than capital appreciation given there are no taxes since dividends ensure regular and immediate cash flows.

6. (a) What is sensitivity analysis in Capital budgeting?

(6 Marks)

(b) Z Co. Ltd. issued commercial paper worth Rs. 10 crores as per following details:

Date of issue:	16th January, 2009
Date of maturity:	17th April, 2009
No. of days:	91
Interest rate	12.04% p.a.

What was the net amount received by the company on issue of CP ?(Charges of intermediary may be ignored)

(4 Marks)

(c) Explain briefly the advantages of investing in mutual funds.

(3 Marks)

(d) Write a brief note on the Small Industries Development Bank of India

(3 Marks)

Solution to Question No. 6 (a)

- NPV of a project is based upon the series of cash flows and the discount factor. These determinants depend upon so many variables such as sales revenue, input cost, competition etc., given the level of all these variables, there will be a set series of cash flows and hence there will be a NPV of the proposal. However, if any of these variables changes then the value of the NPV will also change. It means that the value of NPV is sensitive to all these variables. However, in most of the cases, the value of NPV will not change in the same proportion for a given change in anyone of these variables. For some variables the NPV may be less sensitive while for others the NPV may be more sensitive. The Sensitivity Analysis (SA) deals with the consideration of sensitivity of the NPV in relation to different variables contributing to the NPV.
- In general, the SA is a theoretical procedure whereby values of the variable parameters (inputs) are changed to denote different situations/assumptions, and the effect of these changes is measured on the expected value of the outcome (result) When applied to the capital budgeting situations, the SA is a technique to evaluate the effect of changes in factors contributing to cash flows on the value of the NPV of the proposal.
- The 'single point' estimates of cash flows or the expected results are based on the judgment of the analyst and the information available. In fact, these are the averages of the possible outcome, implicitly weighed by their respective probabilities. By introducing a range of high, low and expected levels of cash inflows and outflows, the analyst can use a form of sensitivity analysis to indicate the consequences of expected fluctuations, and thus the degree of risk. At times, the past experience can provide clues to the range of future outcomes, but essentially the projection of future cash flows has to be judgmental and based on specific estimates. The following steps are required to apply the SA to capital budgeting proposals:

CA. L. Muralidharan FCA, AICWA
Cell: 094440 45990, 09840954207, 044 - 2814 2616, 2489 3830
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1. Based on the expectations for the future, the cash flows are estimated in respect of the proposal.
2. To identify the variables which have a bearing on the cash flows of a proposal. For example, some of these variables may be the selling price, cost of inputs, market share, market growth rate etc.,
3. To establish the relationship between these variables and the output value i.e., the effect of these variables on the value of NPV of the proposal.
4. To find out the range of variations and the most likely value of each of these variables, and
5. To find out the effect of change in any of these variables on the value of NPV. This exercise should be performed for all the factors individually. For example, in case of a project involving the product sale, the effect of change in different variables such as number of units sold, selling price, discount rate etc., can be taken up on the NPV or IRR of the project. This information can be used in conjunction with the basic capital budgeting analysis to decide whether or not to take up the project.

Solution to Question No. 6 (b)

$$\text{Interest Cost (in \%)} = \frac{FV - IP}{IP} \times \frac{365}{n} \times 100$$

$$12.04 = \frac{10 - IP}{IP} \times \frac{365}{91} \times 100$$

$$IP = 9.709$$

Solution to Question No. 6 (c)

1. Professional management: Mutual funds employ expert investors' analysis and professional knowledge and expertise for selection and supervision of their investment portfolio.
2. Low cost high value portfolio diversification: An investor gets an opportunity to be a part of owner of a diversified portfolio, which an individual cannot.
3. Reduction/ Diversification of Risk: When an investor invests in a mutual fund, he is actually investing in a pool of funds. These funds will be in turn invested in securities. So, the individual investor will share the losses with other investors.
4. Reduction in transaction cost: A mutual fund offers economies of search and verification due to size and scale of operations.
5. Liquidity: Mutual funds provide liquidity to the investor as he can dispose off his investment in mutual fund whenever he requires the funds.

Solution to Question No. 6 (d)

SIDBI has been set up under the Small Industries Development Bank of India Act, 1990 passed by parliament. It is intended to work as a principal financial institution for the promotion, financing and development of industries in small scale sector. It is also expected to co-ordinate the functions of the financial institutions, viz., State Financial Corporation,

CA. L. Muralidharan FCA, AICWA
Cell: 094440 45990, 098409 54207, 044 - 2814 2816, 2489 3830
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State Small Industrial Development Corporations, Scheduled Banks and State Co-operative Banks, etc., engaged in promotion, financing and developing the small scale industries.

SIDBI has set up a Technology Development and modernization Fund to help SSI units in technology upgradation.

SIDBI will participate in venture capital fund set up by public sector institutions as well as private sector companies up to 30% of the total corpus of the funds, provided such funds are dedicated to the financing of small scale industrial sector.

The measures taken by SIDBI will help a large number of SSI units in obtaining their credit requirement as well as technology upgradation and modernization.