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IDEAL ANSWERS

CA Final

(New Syllabus)

Financial Management

Nov, 2010 Exam

Question worth 55 marks directly from NPA notes

Question	Marks	Topic	Notes reference
1(a)	5	Portfolio-1	Similar to Q.19 page 32
1(d)(ii)	2	Portfolio-7	Similar to Q.6 page 69
2(b)	8	Merger & Acquisition	Similar to Q.2 page 172
4(a)	8	Merger & Acquisition	Similar to Q.33 page 185
5(a)	8	Portfolio-2	Similar to Q.24 page 40
5(b)	8	Capital Budgeting	Simpler than Q.1 page 76
6(a)	8	Forex	Similar to Q.61 page 18
6(b)	8	Dividend Policy	Similar to Q.16 page 165
	55		

Prepared by: **CA Tarun Mahajan**,
Address: 161, Tilak Nagar Ext., Indore
email: tarunmahajanca@gmail.com
Mobile: 9893040600

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(Disclaimer: Questions asked in the exam may have wrong/inadequate information and/or ambiguous language. In that case the answers provided by institute may differ from this Ideal Answers. If you find any errors, please email the same.)

Question 1(a) Amal Ltd. has been maintaining a growth rate of 12% in dividends. The company has paid dividend @ Rs. 3 per share. The rate of return on market portfolio is 15% and the risk-free rate of return in the market has been observed as 10% . the beta co-efficient of the company's share is 1.2.

You are required to calculate the expected rate of return on the company's share as per CAPM model and the equilibrium price per share by dividend growth model. **(5 Marks)**

Answer 1(a)

Expected rate of return as per CAPM:

$$E(R_p) = R_f + (R_m - R_f)\beta$$

$$= 10 + (15 - 10)1.2$$

$$= 16\%$$

Equilibrium price as per dividend growth model:

$$P_0 = \frac{D_1}{K_e - g} = \frac{3 \times 1.12}{0.16 - 0.12} = \text{Rs. } 84$$

Question 1(b) From the following particulars, calculate the effective rate of interest p.a. as well as the total cost of funds to Bhaskar Ltd., which is planning a CP issue: **(5 Marks)**

Issue Price of CP	-	Rs. 97,550
Face Value	-	Rs. 1,00,000
Maturity	-	3 Months
Issue Expenses:		
Brokerage	-	0.15% for 3 Months
Rating Charges	-	0.50% p.a.
Stamp Duty	-	0.175% for 3 months

Answer 1(b)

Assumptions: Let us assume that issue expenses are calculated on face value. (question is silent therefore even if a student calculate issue expenses on issue price, he should be awarded marks)

$$\text{Effective Rate of Interest} = \frac{\text{Face Value} - \text{Issue Price}}{\text{Issue Price}} \times 100 \times \frac{12}{\text{Maturity Period}}$$

$$= \frac{100000 - 97550}{97550} \times 100 \times \frac{12}{3} = 10.05\%$$

Calculation of issue expenses:

Brokerage	100000x0.15%	= ₹150
Rating Charges	100000x0.5%x3/12	= ₹125
Stamp Duty	100000x0.175%	= ₹175
Total issue expenses		= ₹450

Total cost of fund = (100000-97550) + 450 = ₹2900

$$\% \text{ cost of fund} = \frac{\text{Face Value} - (\text{Issue Price} - \text{issue expenses})}{(\text{Issue Price} - \text{issue expenses})} \times 100 \times \frac{12}{\text{Maturity Period}}$$

$$= \frac{100000 - (97550 - 450)}{(97550 - 450)} \times 100 \times \frac{12}{3} = 11.95\%$$

Question 1(c) Equity share of PQR Ltd. is presently quoted at Rs.320. The Market Price of the share after 6 months has the following probability distribution: **(5 Marks)**

Market Price	Rs.	180	260	280	320	400
Probability		0.1	0.2	0.5	0.1	0.1

A put option with a strike price of Rs.300 can be written.

You are required to find out expected value of option at maturity (i.e. 6 months)

Answer 1(c)

Expected Market Price	Value of Put (300-MP)	Probability	Put x Probability
180	120	0.1	12
260	40	0.2	8
280	20	0.5	10
320	0	0.1	0
400	0	0.1	0
Expected value of option at maturity			30

Question 1 (d) Calculate Market Price of:

(5 Marks)

- 10% government of India security currently quoted at Rs. 110, but interest rate is expected to go up by 1%.
- A bond its 7.5% Coupon interest, Face Value Rs.10,000 & term to maturity of 2 years, presently yielding 6%. Interest payable half Yearly.

Answer 1(d)

(i) **Assumption: Maturity of bond is not given therefore let us assume that the bonds are perpetual. Also let us assume that the face value is Rs.100.**

Present yield = Coupon/Current market price = $10 / 110 = 9.09\%$

Now if the market rate of interest goes up by 1% then yield will become = $9.09\% + 1\% = 10.09\%$

New Market price = Coupon/yield = $10 / 10.09\% = ₹ 99.10$

(ii) **Assumption: yield of 6% is compounded half yearly.**

Period	Amount	PVF@3%	PV
1	375	0.971	364
2	375	0.943	353
3	375	0.915	343
4	10375	0.888	9218
Current Market price=			10279

Question 2(a) Derivative Bank Entered into a plain vanilla swap through an OIS (Overnight Index Swap) on a principal of Rs.10 crores and agreed to receive MIBOR overnight floating rate for fixed payment on the principal. The swap was entered into on Monday, 2nd August,2010 and was to commence on 3rd August,2010 and run for period of 7 days. **(8 Marks)**

Respective MIBOR rates for Tuesday to Monday were:

7.75%, 8.15%, 8.12%, 7.95%, 7.98%, 8.15%

If Derivative Bank received Rs. 317 net on settlement, Calculate Fixed rate and interest under both legs.

Notes:

- (i) Sunday is Holiday.
- (ii) Work in rounded rupees and avoid decimal working.

Answer 2(a)

Assumptions:

- 1) Question does not specify day count convention, i.e., whether it is 360 or 365. **Let us assume 365 days.**
- 2) **Let us also assume that floating rate portion is compounded daily. Though to keep it simple we can also assume simple daily interest.**
- 3) **Sunday is a Holiday hence let us take rate of Saturday for calculation of interest on Sunday.**

Day	Overnight Mibor	Interest amount	Balance
0			100000000
1	7.75%	21233	100021233
2	8.15%	22334	100043566
3	8.12%	22256	100065823
4	7.95%	21795	100087618
5&6	7.98%	43764	100131382
7	8.15%	22358	100153740

Net receipt = Floating Interest received – Fixed interest paid.

₹ 317 = ₹ 153740 – Fixed interest paid

Fixed interest paid = ₹ 153423

$$\text{Fixed Interest Rate} = \frac{1,53,423}{10,00,00,000} \times 100 \times \frac{365}{7} = 8\%$$

Alternative Presentation:

Average Floating rate:

$$\left[\left(1 + \frac{.0775}{365}\right) \times \left(1 + \frac{.0815}{365}\right) \times \left(1 + \frac{.0812}{365}\right) \times \left(1 + \frac{.0795}{365}\right) \times \left(1 + \frac{.0798 \times 2}{365}\right) \times \left(1 + \frac{.0815}{365}\right) \right] - 1 \times \frac{365}{7} = 8.0165\%$$

Fixed Rate = R%

$$\text{Net Receipt} = (\text{Floating rate} - \text{Fixed rate}) \times \frac{1}{100} \times \frac{7}{365} \times 10,00,00,000$$

$$317 = (8.0165 - \text{Fixed rate}) \times \frac{1}{100} \times \frac{7}{365} \times 10,00,00,000$$

Fixed Rate = 8%

Alternative solution (Assuming simple interest, i.e., no compounding)

Day	Overnight Mibor	Interest amount
1	7.75%	21233
2	8.15%	22329
3	8.12%	22247
4	7.95%	21781
5&6	7.98%	43726
7	8.15%	22329
		153644

Net receipt = Floating Interest received – Fixed interest paid.

₹ 317 = ₹ 153644 – Fixed interest paid

Fixed interest paid = ₹ 153327

$$\text{Fixed Interest Rate} = \frac{1,53,327}{10,00,00,000} \times 100 \times \frac{365}{7} = 7.99\%$$

Question 2 (b) MK Ltd. is considering acquiring NN Ltd. the following information is Available:

Company	Earnings after Tax Rs.	No. of Equity Shares	Market Value Per Share (Rs.)
MK Ltd.	60,00,000	12,00,000	200.00
NN Ltd.	18,00,000	3,00,000	160.00

Exchange of Equity Share for acquisition is based on current market value as above. There is no synergy advantage available.

- Find the earning per share for company MK Ltd. after merger, and
- Find the exchange ratio so that shareholders of NN Ltd. would not be at a loss.

(8 Marks)

Answer 2(b)

1) Exchange Ratio = $160/200 = 0.8$ (0.8 shares of MK Ltd. for one share of NN Ltd.)

2) Post merger EPS

$$\frac{\text{Earning of MK} + \text{Earning of NN}}{\text{Shares of MK} + \text{Shares to be issued to NN}} = \frac{60,00,000 + 18,00,000}{12,00,000 + 3,00,000 \times 0.8} = 5.417$$

$$\begin{aligned} \text{Change in EPS for NN} &= \text{Pre merger EPS} - \text{Post merger EPS} \times \text{Exchange Ratio} \\ &= 6 - 5.417 \times 0.8 \\ &= 1.67 \text{ (loss)} \end{aligned}$$

3) Exchange ratio at which there is no loss of NN Ltd.:

- Shortcut method: if the shares are exchanged in the ratio of EPS then there will be no loss of EPS to either party. Hence the exchange ratio should be = $\text{EPS of NN} / \text{EPS of MK} = 6/5 = 1.2$
- Proper method: Let us assume that the exchange ratio is "E".
Change in EPS = Pre merger EPS – Post merger EPS x Exchange Ratio

$$0 = 6 - \frac{60,00,000 + 18,00,000}{12,00,000 + 3,00,000 \times E} \times E$$

$$E = 1.2$$

Question3 (a) Delta Ltd.'s current financial year's income statement reports its net income as Rs.15,00,000. Delta's marginal tax rate is 40% and its interest expenses for the year was Rs.15,00,000. The Company has 1,00,00,000 of invested capital, of which 60% is debt. In addition, Delta Ltd. tries to maintain a Weighted average cost of Capital (WACC) of 12.6%. **(8 Marks)**

- (i) Compute the operating income of EBIT earned by Delta Ltd. in the current year.
- (ii) What is Delta Ltd's Economic Value Added (AVA) for the current Year?
- (iii) Delta Ltd. has 2,50,000 equity shares outstanding. According to the EVA you computed in (ii), how much can Delta pay in dividend per share before the value of the company would start to decrease? If Delta does not pay any dividends, what would you expected to happen to the value of the company?

Answer 3(a)

(i) Computation of EBIT

$$PBT = PAT / (1 - t) = 15,00,000 / 0.6 = \text{Rs.} 25,00,000$$

$$EBIT = PBT + \text{Int.} = 25,00,000 + 15,00,000 = 40,00,000$$

- (ii) $EVA = \text{Capital employed} (ROI \times (1 - t) - K_o)$
 $= 100,00,000 (40\% \times 0.6 - 12.6\%)$
 $= 11,40,000$

$$\text{Note: } ROI = EBIT / \text{Capital Employed} = 40,00,000 / 1,00,00,000 = 40\%$$

(iii) Language of this part of question is really confusing. I am sure that ICAI will provide a strange solution for this part. To my mind this situation can be analyzed as follows:

If we make reverse calculation we can find out cost of equity, given the Weighted Average cost of capital. After tax cost of debt is 15% ($25\% \times 0.6$) and WACC is 12% hence Cost of equity here is 9%. Also if we calculate Return on equity it is 37.5%. Now all the dividend theories say that if the company is able to earn more than the expectations of equity shareholders than it is better to give a lower dividend or even better not to give any dividend.

In this question EPS is Rs.6. Therefore maximum dividend can be Rs.6. But if company gives any amount of dividend then its market value will decrease. And if it does not give any dividend its market value will be at the highest level.

Question 3(b) A dealer quotes "All-in-Cost" for a generic swap at 8% against six months labor flat. If the notional principal amount of swap is Rs. 6,00,000,- **(8 Marks)**

- (i) Calculate semi-annual fixed payment.
- (ii) Find the first floating rate payment for (i) above, if the six-months period from the effective date of swap to the settlement date comprises 181 days and that the corresponding labor was 6% on the effective date of swap.
- (iii) In (ii) above, if the settlement is on 'NET' basis, how much the fixed rate payer would pay to the floating rate payer? Generic swap is based on 30/360 days.

Answer 3(b)

(i) Semi Annual fixed payment = $6,00,000 \times 8\% \times 180/360 = ₹ 24,000$

(ii) floating rate payment = $6,00,000 \times 6\% \times 181/360 = ₹ 18,100$

(iii) NET = $24,000 - 18,100 = ₹ 5,900$. Fixed rate payer would pay ₹ 5,900 to the floating rate payer.

Question 4(a) A valuation done of an established company by a well-know analyst has estimated a value of Rs.500 lakhs, based on the expected free cash flow for next year of Rs.20 lakhs and an expected growth rate of 5%. **(8 Marks)**

While going through the valuation procedure, you found that the analyst has made the mistake of using the book values of debt and equity in his calculation. While you do not know the book value weights he used, you had been provided with the following information:

- (i) Company has a cost of equity of 12%,
- (ii) After tax cost debt is 6%,
- (iii) The market value of equity is three times the book value of equity , while the market value of debt is equal to the book value of debt.

You are required to estimate the correct value of the company.

Answer 4(a)

1) Calculation of Overall cost (based on book value weights)

$$\text{Value of firm} = \frac{\text{Free cash flow for the next year}}{\text{WACC} - \text{Growth Rate}}$$

$$500 = \frac{20}{\text{WACC} - 0.05}$$

$$\text{WACC} = 9\%$$

2) Calculation of book value weights

Let us assume that equity has a weight of "E" hence weight of debt is "1-E"

$$12\% \times E + 6\% \times (1-E) = 9\%$$

$$E = 0.5 \text{ and } (1-E) = 0.5$$

3) Calculation of market value weights

$$\text{Market value of equity} = 0.5 \times 3 = 1.5$$

$$\text{Market value of debt} = 0.5$$

4) Calculation of WACC based on market value

$$\text{WACC} = (12 \times 1.5 + 6 \times 0.5) / (1.5 + 0.5) = 10.5\%$$

5) Calculation of correct market value of the company:

$$\text{Value of firm} = \frac{\text{Free cash flow for the next year}}{\text{WACC} - \text{Growth Rate}}$$

$$= \frac{20}{0.105 - 0.05} = \text{Rs.}363.64 \text{ lakhs}$$

Question 4(b) Rahul Ltd. has surplus cash of Rs.100 lakhs and wants to distribute 27% of it to the shareholder. The company decides to buy back shares. The Finance Manager of the company estimates that its share price after re-purchase is likely to be 10% above the buyback price-if the buyback route is taken. The number of shares outstanding at present is 10 lakhs and the current EPS is Rs.3. **(8 Marks)**

You are required to determine:

- (i) The price at which the share can be re-purchased, if the market capitalization of the company should be Rs.210 lakhs after buyback,
- (ii) The number of share that can be re-purchased, and
- (iii) The impact of share re-purchase on the EPS, assuming that net income is the same.

Answer 4(b)

(i) Let us assume that buy back price is "BP".

Market Capitalization after buy back = Post buy back market price x No. of shares

$$210 = (1.1 \times BP) \times \left(10 - \frac{27}{BP}\right)$$

$$BP = ₹ 21.79$$

(ii) No. of shares that can be repurchased = $27,00,000 / 21.79 = 1,23,910$

(iii) Post buy back EPS = net income / post buy back no. of shares

$$= 3 \times 10,00,000 / 10,00,000 - 1,23,910$$

$$= 30,00,000 / 8,76,090$$

$$= ₹ 3.42$$

Question 5(a) Consider the following information on two stocks X and Y:

(8 Marks)

Year	Return on X (%)	Return on Y (%)
2008	12	10
2009	18	16

You are required to determine:

- The expected return on a portfolio containing X and y in the proportion of 60% and 40% respectively.
- The standard deviation of return from each of the two stocks.
- The covariance of returns from the two stocks.
- Correlation co-efficient between the returns of the two stocks.
- The risk of portfolio containing X and Y in the proportion of 60% and 40%.

Answer 5(a)

X	Y	$(x - \bar{x})$	$(y - \bar{y})$	$(x - \bar{x})^2$	$(y - \bar{y})^2$	$(x - \bar{x}) \times (y - \bar{y})$
12	10	-3	-3	9	9	9
18	16	3	3	9	9	9
30	26			18	18	18

$$\text{Mean of X} = 30/2 = 15$$

$$\text{Mean of Y} = 26/2 = 13$$

Standard Deviation of X:

$$\sigma_x = \sqrt{\frac{\sum(x - \bar{x})^2}{n}} = \sqrt{\frac{18}{2}} = 3$$

Standard Deviation of y:

$$\sigma_y = \sqrt{\frac{\sum(y - \bar{y})^2}{n}} = \sqrt{\frac{18}{2}} = 3$$

Covariance between X and Y:

$$\text{Cov}(x, y) = \frac{\sum(x - \bar{x}) \times (y - \bar{y})}{n} = \frac{18}{2} = 9$$

Correlation between X and Y:

$$r = \frac{Cov(x,y)}{\sigma_x \times \sigma_y} = \frac{9}{3 \times 3} = +1$$

(i) Return on portfolio = $15\% \times 0.6 + 13\% \times 0.4 = 14.2$

(ii) Standard deviation of X and Y are 3 each.

(iii) Covariance between X and Y is 9

(iv) Correlation coefficient is +1.

(v) Risk of portfolio is as under

$$\begin{aligned}\sigma_p &= \sqrt{(\sigma_1 \times w_1)^2 + (\sigma_2 \times w_2)^2 + 2\sigma_1\sigma_2w_1w_2r_{12}} \\ &= \sqrt{(3 \times 0.6)^2 + (3 \times 0.4)^2 + 2 \times 3 \times 3 \times 0.6 \times 0.4 \times 1} = 3\end{aligned}$$

Question 5(b) Shashi Co. Ltd. has projected the following cash flows from a project under evaluation: **(8 Marks)**

Year	0	1	2	3
Rs. (in Lakhs)	(72)	30	40	30

The above cash flows have been made at expected prices after recognizing inflation. The firm's cost of capital is 10%. The expected annual rate of inflation is 5%. Show how the viability of the project is to be evaluated. PVF at 10% for 1-3 years are 0.909, 0.826, and 0.751.

Answer 5(b)

Assumption: Question does not specify that the cost of capital of 10% is a money rate or a real rate. Normally when we use the words "cost of capital" it includes inflation. Therefore let us assume that 10% is the nominal/money rate.

Year	Amount	PVF@10%	PV
0	-72	1	-72
1	30	0.909	27.27
2	40	0.826	33.04
3	30	0.751	22.53
NPV=			10.84

NPV is positive hence we can accept the proposal.

Alternative solution:

If ICAI assumes that 10% is the real rate then the money rate = $(1.10 \times 1.05) - 1 = 15.5\%$. In this case solution will be as follows:

Year	Amount	PVF@15.5%	PV
0	-72	1	-72.00
1	30	0.866	25.97
2	40	0.750	29.98
3	30	0.649	19.47
NPV=			3.43

Question 6(a) Given the following information:

(8 Marks)

Exchange rate – Canadian Dollar 0.666 per DM (spot)

Canadian Dollar 0.671 per DM (3 months)

Interest rate – DM 8% p.a.

Canadian Dollar 10% p.a.

What operations would be carried out to earn the possible arbitrage gains?

Answer 6(a)

Let us assume that Canadian dollar is the home currency and DM is the foreign currency.

Formula for interest rate parity is as under:

$$\frac{1 + r^{CD}}{1 + r^{DM}} = \frac{\text{Forward Rate}}{\text{Spot Rate}} \quad \frac{1 + 0.10 \times 3/12}{1 + 0.08 \times 3/12} = \frac{F}{0.666} \quad F = 0.669$$

Ideally the forward rate should be DM1 = CD 0.669. Actual forward rate is 0.671. It means foreign currency is currently overvalued and one can start arbitrage by borrowing home currency.

Steps for arbitrage:

- 1) Borrow Canadian Dollar 1000 @10% p.a.
- 2) Convert into Dm = 1000/0.666 = 1501.50
- 3) Invest @8% DM 1501.50 x 1.02 = DM1531.53
- 4) Reconvert into CD = 1531.53 x 0.671 = 1027.65 CD
- 5) Repay dollar borrowings = 1000 x 1.025 = 1025 CD
- 6) Net profit = 1027.65 - 1025 = 2.65 Canadian Dollar.

Question 6(b) The following information relates to Maya Ltd.:

(8 Marks)

Earning of the company	Rs. 10,00,000
Dividend payout Ratio	60%
No. of shares outstanding	2,00,000
Rate of Return on Investment	15%
Equity capitalization rate	12%

- (i) What would be the market value per share as per walter's model?
- (ii) What is the optimum payout ratio according to walter's model and the market value of company's share at that payout ratio?

Answer 6(b)

(i) Market value as per Walter's Model:

$$P_0 = \frac{DPS + \frac{\text{Rate of return}}{\text{Equity cap. rate}} \times (EPS - DPS)}{\text{Equity Capitalization Rate}} = \frac{3 + \frac{15\%}{12\%} (5 - 3)}{12\%} = \text{Rs. 45.83}$$

(ii) Optimum dividend payout ratio: rate of return is more than cost of equity therefore 0% payout will be the best. Market value at that payout ratio is as under:

$$= \frac{0 + \frac{15\%}{12\%} (5 - 0)}{12\%} = \text{Rs. 52.08}$$

Question 7 Answer any **four** from the following:

(a)

(4 Marks)

- (i) What is the meaning of NBFC?
- (ii) What are different categories of NBFCs?
- (iii) Explain briefly the regulation of NBFCs under RBI Act.

(b) Explain the concept 'Zero date of a Project' in project management.

(4 Marks)

(c) Give the meaning of Caps, Floors and Collars' options.

(4 Marks)

(d) Distinguish between Open-ended and Close-ended Schemes.

(4 Marks)

(e) Explain CAMEL model in credit rating.

(4 Marks)

Answer 7(a)**Definition of NBFC:**

A non-banking financial company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business

NBFCs are doing functions akin to that of banks, however there are a few differences:

- a NBFC cannot accept demand deposits
- it is not a part of the payment and settlement system and as such cannot issue cheques to its customers; and
- deposit insurance facility of DICGC is not available for NBFC depositors unlike in case of banks.

Types of NBFCs

the NBFCs that are registered with RBI are:

- (i) equipment leasing company;
- (ii) hire-purchase company;
- (iii) loan company;
- (iv) investment company.

With effect from December 6, 2006 the above NBFCs registered with RBI have been reclassified as

- (i) Asset Finance Company (AFC)
- (ii) Investment Company (IC)
- (iii) Loan Company (LC)

Regulations for NBFCs under RBI Act:

The NBFCs accepting public deposits should furnish to RBI:

- i. Audited balance sheet of each financial year and an audited profit and loss account in respect of that year as passed in the general meeting together with a copy of the report of the Board of Directors and a copy of the report and the notes on accounts furnished by its Auditors;
- ii. Statutory Annual Return on deposits - NBS 1;
- iii. Certificate from the Auditors that the company is in a position to repay the deposits as and when the claims arise;
- iv. Quarterly Return on liquid assets;
- v. Half-yearly Return on prudential norms;
- vii. Half-yearly ALM Returns by companies having public deposits of Rs 20 crore and above or with assets of Rs 100 crore and above irrespective of the size of deposits ;
- viii. Monthly return on exposure to capital market by companies having public deposits of Rs 50 crore and above; and
- ix. A copy of the Credit Rating obtained once a year along with one of the Half-yearly Returns on prudential norms as at (v) above.

Other important guidelines:

- Higher CRAR of 15 per cent for NBFCs seeking public deposits without credit rating as against 12 per cent for rated NBFCs.
- The Reserve Bank of India stipulate 25 per cent of reserves of NBFCs to be invested in marketable securities in addition to SLR securities already held by them.
- Liquid asset ratio to be increased from existing 12.5 per cent to 25 per cent of public deposit in a phased manner.

Answer 7(b)

The zero date of a project signals the effective start of the project. It is an important part of the project planning and establishment. The completion of projection will be counted from this point of time. It is important to ensure that all activities that effect project performance like arrangement of finance, infrastructure facilities, formation of new company, division, government and clearance etc. beside time, cost and technical parameters are fully established by this time.

Answer 7(c)**Interest Rate Caps**

CAP is a series of European interest rate call options used to protect against rate moves above a set strike level. It creates a ceiling on floating rate interest costs. When market rates move above the cap rate, the seller pays the purchaser the difference.

A company borrowing on a floating rate basis when 3 month LIBOR is 6% might purchase a 7% cap, for example, to protect against a rate rise above that level. If rates subsequently rise to 9%, the company receives a 2% cap payment to compensate for the rise in market rates. The cap ensures that the borrower's interest rate costs will never exceed the cap rate.

Interest Rate Floors

FLOOR a series of European interest rate put options used to protect against rate moves below a set strike level. A floor is the mirror image of a cap. When market rates fall below the floor rate, the seller pays the difference. A 6% floor triggers a payment to the purchaser whenever market rates drop below 6%. Asset managers buy floors to guarantee a minimum return on floating rate assets.

Interest Rate Collars

COLLAR is the simultaneous purchase of an interest rate cap and sale of an interest rate floor on the same index for the same maturity and notional principal amount. The premium due for the cap is partially offset by the premium received for the floor, making the collar an effective way to hedge rate risk at low cost. In return the hedger gives up the potential benefit of favorable rate movements outside the band defined by the collar.

A borrower who purchases an 8% cap and sells a 6% floor guarantees a 6-8% base rate on a floating rate loan. A costless collar is created when the cap and floor levels are set so that the premiums exactly offset each other.

Answer 7(d)

Open ended funds can issue and redeem units any time during the life of the scheme while close ended funds can not issue new units except in case of bonus or rights issue. Hence, unit capital of open ended funds can fluctuate on daily basis while that is not the case for close ended schemes. Other way of explaining the difference is that new investors can join the scheme by directly applying to the mutual fund at applicable net asset value related prices in case of open ended schemes while that is not the case in case of close ended schemes. New investors can buy the units from secondary market only.

Parameter	Open Ended Fund	Closed Ended Fund
Fund Size	Flexible	Fixed
NAV	Daily	Daily
Liquidity Provider	Fund itself	Stock Market
Sale Price	At NAV plus load, if any	Significant Premium / Discount to NAV
Availability	Fund itself	Through Exchange where listed
Portfolio Disclosure	Monthly	Monthly
Intra-Day Trading	Not possible	Possible but Expensive

Answer 7(e)

CAMEL Stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the Rating Agencies deserves special attention, it focuses on the following aspects:

a) **Capital** – Composition of Retained Earnings and External Funds raised; Fixed dividend component for preference shares and fluctuating dividend component for equity shares and adequacy of long term funds adjusted to gearing levels; ability of issuer to raise further borrowings.

b) **Assets** – Revenue generating capacity of existing / proposed assets, fair values, technological / physical obsolescence, linkage of asset values to turnover, consistency, appropriation of methods of depreciation and adequacy of charge to revenues. Size, ageing and recoverability of monetary assets viz receivables and its linkage with turnover.

c) **Management** – Extent of involvement of management personnel, team-work, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.

d) **Earnings** – Absolute levels, trends, stability, adaptability to cyclical fluctuations ability of the entity to service existing and additional debts proposed.

e) **Liquidity** – Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the pre-dominance of positive / negative aspects under each of these five categories and these are factored in for making the overall rating decision.

**If I find some corrections, I will upload modified solutions.
Therefore it is advised to download this file again after 15 days.**