

**PAPER 2- MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS
MAY 1997**

Answer five questions

Question 1

Excel Ltd., manufactures a special chemical for sale at Rs.30 per kg. The variable cost of manufacture is Rs.15 per kg. Fixed cost excluding depreciation is Rs.2,50,000. Excel Ltd., is currently operating at 50% capacity. It can produce a maximum of 1,00,000 kgs at full capacity.

The Production Manager suggests that if the existing machines are fully replaced the company can achieve maximum capacity in the next five years gradually increasing the production by 10% per year.

The Finance Manager estimates that for each 10% increase in capacity, the additional increase in fixed cost will be Rs.5,00,000. The existing machines with a current book value of Rs.10,00,000 can be disposed of for Rs.5,00,000. The Vice-President (Finance) is willing to replace the existing machines provided the NPV on replacement is about Rs.4,53,000 at 15% cost of capital after tax.

- (i) You are required to compute the total value of machines necessary for replacement. For your exercise you may assume the following:
- The company follows the block assets concept and all the assets are in the same block. Depreciation will be on straight-line basis and the same basis is allowed for tax purposes.
 - There will be no salvage value for the machine newly purchased. The entire cost of the assets will be depreciated over five year period.
 - Tax rate is at 40%
 - Cash inflows will arise at the end of the year.
 - Replacement outflow will be at the beginning the next year 0
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Year	0	1	2	3	4	5
Discount Factor at 15%	1	0.87	0.76	0.66	0.57	0.49

- (ii) On the basis data given above, the managing director feels that the replacement, if carried out, would at least yield post tax return of 15% in the three years provided the capacity build up is 60%, 80% and 100%; respectively. Do you agree? **(20 Marks)**

Question 2

- (a)
- What are the causes of industrial sickness? **(5 Marks)**
 - Mention a few symptoms which might indicate than industrial sickness lies ahead. **(4 Marks)**
- (b) A firm has sales of Rs.75,00,000 variable cost of Rs.42,00,000 and fixed cost of Rs.6,00,000. it has debt of Rs.45,00,000 at 9% and equity of Rs.55,00,000.
- What is the firm's ROI?
 - Does it have favorable financial leverage ?
 - If the firm belongs to an industry whose asset turnover is 3, does it have a high or low asset leverage?
 - What are the operating, financial and combined leverages of the firm?
 - If the sales drop to Rs.50,00,000, what will be the new EBIT?
 - At what level the EBT of the firm will be equal to zero? **(11 Marks)**

Question 3

- (a) The Balance Sheet of Smart Ltd., as on March, 31, 1997 is as follows:

(Figures in lakhs of rupees)

Liabilities	Rs	Assets	Rs
Share capital	200	Fixed assets	500

Reserves	140	Inventories	300
Long term loans	360	Receivables	240
Short term loans	200	Cash and bank	60
Payables	120		
Provisions	80		
	1100		1100

Sales for the year were 600 lakhs. For the year ending on March, 31, 1998 sales are expected to increase by 20%. The profit margin and dividend pay out ratio are expected to be 4% and 50% respectively.

You are required to:

- (i) Quantify the amount of external funds required.
 - (ii) Determine the mode of raising the funds given the following parameters:
 - a. Ratio of fixed assets to long term loans should be 1.5
 - b. Long term debt to equity ratio should not exceed 1.05.
 - (iii) The funds are to be raised in the order of short term bank borrowings, long term loans and equities. **(14 Marks)**
- (b) The turnover of R Ltd., is Rs.60 lakhs of which 80% is on credit. Debtors are allowed one month to clear off the dues. A factor is willing to advance 90% of the bills raised on credit for a fee of 2% a month plus a commission of 4% on the total amount of debts. R Ltd., as a result of this arrangement is likely to save Rs.21,600 annually in management costs and avoid bad debts at 1% on the credit sales. A scheduled bank has come forward to make an advance equal to 90% of the debts at an interest rate of 18% p.a. However its processing fee will be at 2% on the debts. Would you accept factoring or the offer from the bank? **(6 Marks)**

Question 4

EITHER

- (a) Explain briefly, Modigliani Miller approach on cost of capital. **(10 Marks)**
- (b) The Beta Coefficient of Target Ltd., is 1.4. The company has been maintaining 8% rate of growth in dividends and earnings. The last dividend paid was Rs.4 per share. Return on Government securities is 10%. Return on market portfolio is 15%. The current market price of one share of Target Ltd., is Rs.36.
 - i. What will be the equilibrium price per share of Target Ltd.?
 - ii. Would you advise purchasing the share? **(10 Marks)**

OR

- i. "Promoters' contribution is one of the principal means of financing the project" - Discuss **(10 Marks)**
- ii. Z Ltd., is foreseeing a growth rate of 12% per annum in the next 2 years. The growth rate is likely to all to 10% for the third year and fourth year. After that the growth rate is expected to stabilize at 8% per annum. If the fast dividend paid was Rs.1.50 per share and the investors' required rate of return is 16%, find out the intrinsic value per share of Z Ltd., as of date. You may use the following table:

Years	0	1	2	3	4	5
Discounting Factor at 16%	1	0.86	0.74	0.64	0.55	0.48

Question 5

Write short notes on :

(4×5=20 Marks)

- (a) Cross Currency Roll Over:
- (b) Financial Swaps.
- (c) Fixed Versus Flexible Budget.
- (d) Tools of Financial Forecasting.