

**PAPER 2 MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS
MAY 1998**

Answer Any Five Question

Question 1

S Engineering Company is considering to replace or repair a particular machine, which has just broken down. Last year this machine costed Rs.20,000 to run and maintain. These costs have been increasing in real terms in recent years with the age of the machine. A further useful life of 5 years is expected, if immediate repairs of Rs.19,000 are carried out. If the machine is not repaired it can be sold immediately to realize about Rs.5,000 (Ignore loss/gain on such disposal).

Alternatively, the company can buy a new machine for Rs.49,000 with an expected life of 10 years with no salvage value after providing depreciation on straight line basis. In this case, running and maintenance costs will reduce to Rs.14,000 each year and are not expected to increase much in real terms for a few years at least. S Engineering Company regard a normal return of 10% p.a. after tax as a minimum requirement on any new investment. Considering capital budgeting technique, which alternative will you choose? Take corporate tax rate of 50% and assume that depreciation on straight line basis will be accepted for tax purposes also.

Given cumulative presents value of Re.1 p.a. at 10% for 5 years Rs.3.791, 10 years Rs.6.145. **(20 Marks)**

Question 2

(a) A limited company operates a lodging house with a restaurant, shops and recreational facilities attached. Its manager has entrusted you with the planning of the coming year's operations, more particularly on the level of profits the company was likely to earn.

The lodging house has 100 double bed rooms, which are likely to be rented at Rs.150 per day. The manager expects an occupancy ratio of 75% for a period of 250 days during the tourist season. It is also anticipated that both the beds in a room will be occupied during the period.

Each person staying in the lodging house is expected to spend, on the basis of past statistics, Rs.30 per day in the shops attached to the lodge and Rs.60 per day in the restaurant. The recreational facilities are not charged to the customer. Some other relevant data available to you is as under:

(i) Variable Cost to volume ratio:

	Shops	Restaurant
Cost of goods sold	40%	30%
Supplies	5%	15%
Others	5%	10%

(ii) For the lodging house, the variable costs are Rs.25 per day per occupied room for leaning, laundry etc.,

(iii) Annual fixed costs for the entire complex are Rs.19,50,000.

From the above, you are required to prepare:

(a) An income statement for the coming year, and

(b) An analysis to indicate whether the manager's suggestion of reducing the room rent to Rs.125 per day to enhance the occupancy ratio to 90% should be accepted.

(b) An investor is seeking the price to pay for a security, whose standard deviation is 3.00 per cent. The correlation coefficient for the security with the market is 0.8 and the market standard deviation is 2.2 per cent. The return from government securities is 5.2 per cent and from the market portfolio is 9.8 per cent. The investor knows that, by calculating the required return, he can then determine the price to pay for the security. What is the required return on the security? **(14+6=20 Marks)**

Question 3

(a) The present credit terms of P Company are 1/10 net 30. Its annual sales are Rs.80 lakhs, its average collection period is 20 days. Its variable costs and average total costs to sales are 0.85 and 0.95 respectively

and its cost of capital is 10 per cent. The proportion of sales on which customers currently take discount is 0.5. P company is considering relaxing its discount terms to 2/10 net 30. such relaxation is expected to increase sales by Rs.5 lakhs, reduce the average collection period to 14 days and increase the proportion of discount sales to 0.8. What will be the effect of relaxing the discount policy on company's profit? Take year as 360 days.

- (b) A company operating in a country having the dollar as its unit of currency has today invoiced sales to an Indian Company, the payment being due three months from the date of invoice. The invoice amount is \$13,750 and at to-days spot rate of \$ 0.0275 per Re.1, is equivalent to Rs.5,00,000. It is anticipated that the exchange rate will decline by 5 % over the three month period and in order to protect the dollar proceeds, the importer proposes to take appropriate action through foreign exchange market. The three month forward rate is quoted as \$0.0273 per Re.1.

You are required to calculate the expected loss and to show, how it can be hedged by forward contract.

- (c) X Co. Ltd., issued commercial paper as per following detail:

Date of issue	17 th January, 1998
Date of maturity	17 th April, 1998
No. of days	90
Interest rate	11.25% p.a.

What was the net amount received by the company on issue of commercial Paper?

(10+6+4=20 Marks)

Question 4

EITHER

- (a) What is Financial Forecasting? Describe in brief, its utility and how it is effected.
 (b) The following figures are made available to you.

	Rs.
Net profit for the year	18,00,000
Less: Interest on secured debentures at 15% p.a (Debentures were issued 3 months after the commencement of the year	1,12,500
	16,87,500
Less : Income tax at 35% and dividend distribution tax	8,43,750
Profit after tax	8,43,750
Number of equity shares (Rs.10 each)	1,00,000
Market quotation of equity share	Rs.109.70

The company has accumulated revenue reserves of Rs.12 lakhs. The company is examining a project calling for an investment obligation of Rs.10 lakhs; this investment is expected to earn the same rate of return as funds already employed.

You are informed that a debt equity ratio (Debt divided by debt plus equity) higher than 60% will cause the price earning ratio to come down by 25% and the interest rate on additional borrowals will cost company 300 basic points more than on their current borrowal on secured debentures.

You are required to advise the company on the probable price of the equity share, if

- (a) the additional investment were to be raised by way of loan ; or
 (b) the additional investment were to be raised by way of equity.

(10+10=20 Marks)

OR

A newly established company manufacturing two products furnishes the Cost Sheets as under:

	Products Rs./ unit
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	L	M
Direct materials	40	20
Direct labour	30	15
Variable overheads	14	7
Selling price	100	50

Fixed overheads excluding bank interest amount to Rs.6,00,000 per annum spread out evenly throughout the year.

Sales forecast is as under:

Product	July	August	September	October	November'98
L (Units)	4,200	4,600	3,600	4,000	4,500
B (Units)	2,100	2,300	1,800	2,000	1,900

Production : 75% of each month's sales will be produced in the month of sale and 25% in the previous month.

Sales pattern:

L :

- one third of sales will be on cash basis on which a cash discount of 2% is allowed.
- one third will be on documents against payment basis.

The documents will be discounted by the bank in the month of sales itself.

- Balance of one –third will be on documents against acceptance basis.

The payment under this scheme will be received in the third month.

For e.g. for sales made in September, payment will be received in November.

B :

80% of the sales will be against cash to be received in the month of sales and the balance 20% will be received next following month.

Direct Materials: 50% of the direct materials required for each month's production will be purchased in the previous month and the balance in the month of production itself. The payment will be made in the month next following the purchase.

Direct wages : 80% of the direct wages will be paid in the month of use of direct labour for production and the balance in the next following month.

Variable overheads : 50% to be paid in the month of incurrence and the balance in the next following month.

Fixed overheads : 40% will be paid in the month of incurrence and the other 40% in the next following month. The balance of 20% represents depreciation.

The bill discounting charges payable to the Bank in the month in which the bills are discounted amount to 50 paise per Rs.100 of bills discounted.

A cash balance of Rs.1,00,000 will be maintained on 1st July, 1998.

Prepare a cash budget month wise for July, August and September, 1998.

(20 Marks)

Question 5

Write short notes on any four of the following :

- (a) Walter's approach to Dividend Policy.
- (b) Different kinds of float with reference to Management of Cash.
- (c) Appraisal of projects under inflationary conditions.
- (d) Euro Convertible bonds
- (e) Functions of Finance Manager.

(4×5=20 Marks)