

PAPER 2- MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS
MAY, 2001

Answer all Questions
 Working notes should form part of the answer.

Question 1

Ze- Te Fashions is a high- fashion women's garments manufacturer. It is planning to introduce a new fashion garment in the market in the forthcoming Diwali season. Four metres of cloth (material) are required to layout the dress pattern. After, cutting some material remains that can be sold as a cut-piece. The left-over material can also be used to manufacture a matching cap & handbag.

Ze- Te expects to sell 2,500 dresses, if matching caps & handbags are not provided and 20% more, if matching caps and handbags are made available. The market research indicates that the cap and/or handbag cannot be sold independently, but only as accessories with the dress.

The following combination of sales is expected:

Complete sets of dress, cap and handbag	68%
Dress and Cap only	12%
Dress and handbag only	9%
Dress only	11%
	<u>100%</u>

The material used in the dress costs Rs.60 per metre. The cost of cutting the dress, if the cap and handbag are not manufactured, is estimated at Rs.20 a dress and the resulting remnants can be sold for Rs.5 for each dress cut out.

If the cap and the handbag are to be manufactured, it requires a more delicate and skillful cutting and hence cutting cost will increase by Rs.8 per dress.

The selling prices and the other costs to complete the three items, once they are cut, are as follows:

	Selling Price Per Unit (Rs.)	Other Costs Per Unit (Rs.)
Dress	400.00	48.00
Cap	29.00	6.50
Handbag	18.00	3.00

Other costs per unit exclude the cost of material and cutting.

You are required to prepare a statement showing:

- Should the company go in for caps & handbags along with dresses? Substantiate your answer. (16 Marks)
- What are the non-quantitative factors that could influence the company's decision to manufacture caps and handbags that match the dress? (4 Marks)

Question 2

- Many companies calculate the internal rate of return of the incremental after-tax cash-flows from financial bases.

What problems do you think this may give rise to? To what rate should internal rate of return be compared? Discuss.

- The HLL has Rs. 8.00 crore of 10% mortgage bonds outstanding under an open-end scheme. The scheme allows additional bonds to be issued as long as all of the following conditions are met:

- Pre-tax interest coverage $\left[\frac{(\text{Income before taxes} + \text{Bond Interest})}{\text{Bond Interest}} \right]$ remains greater than 4.
- Net depreciated value of mortgage assets remains twice the amount of the mortgage debt.
- Debt-to-equity ratio remains below 5.

The HLL has net income after taxes of Rs.2 crore and a 40% tax-rate, Rs.40 crore in equity and Rs. 30 crore in depreciated assets, covered by the mortgage.

Assuming that 50% of the proceeds of a new issue would be added to the base of mortgaged assets and that the company has no Sinking Fund payments until next year, how much more 10% debt could be sold under each of the three conditions? Which protective covenant is binding? **(12 Marks)**

Question 3

- (a) Shoe Company sells to a wholesaler in Germany. The purchases price of a shipment is 50,000 Deutsche Marks with term of 90 days. Upon payment, Shoe Company will convert the DM to dollars. The present spot rate for DM per dollar is 1.71, whereas the 90-day forward rate is 1.70.

You are required to calculate and explain:

- (i) If Shoe Company were to hedge its foreign-exchange risk, what would it do? What transactions are necessary?
- (ii) Is the Deutsche Mark at a forward premium or at a forward discount?
- (iii) What is the implied differential in interest rates between the two countries? (Use interest-rate parity assumption). **(10 Marks)**

- (b) JPL has two dates when it receives its cash inflows. i.e. Feb.15, and Aug.15. On each of these dates, it expects to receive Rs.15 crore. Cash expenditure are expected to be steady throughout the subsequent 6 month period. Presently, the ROI in marketable securities is 8% per annum, and the cost of transfer from securities to cash is Rs.125 each time a transfer occurs.

- (i) What is the optimal transfer size using the EOQ model? What is the average cash balance?
- (ii) What would be your answer to part (i), if the ROI were 12% per annum and the transfer costs were Rs.75? Why do they differ from those in part (i)? **(10 Marks)**

EITHER

Question 4

- (a) Piyush Loonker and Associates presently pay a dividend of Re.1.00 per share and has a share price of Rs.20.00. **(8 Marks)**

- (i) If this dividend were expected to grow at a rate of 12% per annum forever, what is the firm's expected or required return on equity using a dividend-discount model approach?
- (ii) Instead of this situation in part (i), suppose that the dividends were expected to grow at a rate of 20% per annum for 5 years and 10% per annum year thereafter. Now what is the firm's expected, or required, return on equity?

- (b) The credit manager of XYZ Ltd. is reappraising the company's credit policy. The company sells its products on terms of net 30. Cost of goods sold is 85% of sales and fixed costs are further 5% of sales. XYZ classifies its customers on a scale of 1 to 4. During the past five years, the experience was as under:

Classification	Default as a percentage of sales	Average Collection period- in days for non-defaulting accounts
1	0	45
2	2	42
3	10	40
4	20	80

The average rate of interest is 15%. What conclusions do you draw about the Company's Credit Policy? What other factors should be taken into account before changing the present policy? Discuss **(6 Marks)**

- (c) Corporate financial plans are often used as a basis for judging the subsequent performance.

What do you think can be learned from such comparisons? What problems are likely to arise and how would you cope with those? Discuss. **(6 Marks)**

Or

Alcobex Metal Company (AMC) does business in three products- P1, P2, P3. Products P1 and P2 are manufactured in the company, while product P3 is procured from outside and resold as a combination with either product P1 or P2. The sales volume budgeted for the three products for the year 2000-2001 (April-March) are as under:

Product	Rs. Lakhs	
P1	1,200	
P2	500	
P3	400	[Dec. 1999 to March 2000 Rs. 20.00 Lakh P.M. April 2000 to July 2000 Rs. 25.00 lakh P.M. August 2000 to Nov. 2000 Rs. 30.00 Lakh P.M. Dec. 2000 to March 2001 Rs. 45.00 Lakh P.M.]

Based on the budgeted Sales value, the cash flow forecast for the company is prepared based on the following assumptions:

- Sales realizations is considered at:
 - 50% Current Month
 - 25% Second Month
 - 25% Third Month
 - Production Programme for each month is based on the sales value of the next month.
 - Raw material consumption of the company is kept at 59% of the month's production.
 - 81% of the raw materials consumed are components.
 - Raw material and components to the extent, at 25% are procured through import.
 - The purchases budget is as follows:
 - Indigenous raw materials are purchased two months before the actual consumption.
 - Components are procured in the month of consumption
 - Imported raw materials and components are bought three months prior to the dates of purchases.
 - The company avails of the following credit terms from suppliers:
 - Raw materials are paid for in the month of purchases;
 - Company gets one month's credit for its components;
 - For imported raw material and components payments are made one month prior to the date of purchase.
 - Currently the company has a cash credit facility of Rs.140.88 lakhs.
 - Expenses are given below and are expected to be constant throughout the year:

Wages and salaries	Rs. 312 lakhs
Administrative Expenses	Rs. 322 lakhs
Selling and Distribution Expenses	Rs.53 lakhs
 - Dividend of Rs.58.03 lakhs is to be paid in October.
 - Tax of Rs. 23.92 lakhs will be paid in equal instalments in four-quarters: i.e. January, April, July, October.
 - The term-loan of Rs.237.32 lakhs is repayable in two equal instalments half-yearly, i.e. June/December.
 - Capital Expenditure of Rs.292.44 lakhs for the year is expected to be spread equally during the 12 month period.
- You are required to prepare a Cashflow statement (Cash Budget) for the period of June-November 2000.

(20 Marks)

Question 5

Write short notes on any four of the following:

- Causes of Industrial Sickness in India;
- Effect of Inflation in Inventory Management;

- (c) Role of a Financial Adviser in a Public Sector Undertaking;
- (d) Book-building;
- (e) Advantages of Debt-Securitisation.

(4×5 = 20 Marks)