

PAPER 2 MANAGEMENT ACCOUNTING AND FINANCIAL ANALYSIS
MAY 2002

Answer any five questions.

Question 1

- (a) Discuss briefly the impact of taxation on Corporate Financial Management.
- (b) XYZ Limited pays no taxes and is entirely financed by equity shares. The equity share has a beta of 0.6 a price earning ratio of 12.5 and is priced to offer an expected return of 20 per cent. XYZ Ltd., Now decides to buy back half of the equity shares by borrowing an equal amount. If the debt yields a risk free return of 10% calculate.
- The beta of the equity shares after the buyback
 - The required return and risk premium on the equity shares before the buyback.
 - The required return and risk premium on the equity shares after the buyback.
 - The required return on debt.
 - The percentage increase in expected earnings per share.
 - The new price earning multiple.
- Assume that the operating profit of the firm is expected to remain constant in perpetuity.

- (c) Briefly explain the meaning and importance of "Credit – rating" **(4+12+4=20Marks)**

Question 2

- (a) Distinguish between
- Factoring and bill discounting
 - Forwards and Futures.
 - Net present value and Internal Rate of Return
 - Caps and collars.
- (b) A customer with whom the Bank had entered into 3 months' forward purchase contracts for Swiss Francs 10,0000 at the rate of 27.25 comes to the Bank after 2 months and requests cancellation of the contract. On this date, the rates, prevailing are:

Sport	CHF 1 = Rs.27.30	27.35
One month forward	Rs.27.45	27.50

What is the loss / gain to the customer on cancellation?

- (c) A company has a book value per share of Rs.137.80. Its return on equity as 15% and it follows a policy of retaining 60% of its earnings. If the Opportunity Cost of Capital is 18%, what is the price of the share today? **(8+6+6=20 Marks)**

Question 3

- (a) A Ltd., has an expected return of 22% and Standard Deviation of 40%. B Ltd., has an expected return of 24% and Standard Deviation of 38%. A Ltd., has a beta of 0.86 and B Ltd., a beta of 1.24. The correlation coefficient between the return of A Ltd., and B Ltd., is 0.72. The Standard deviation of the market return is 20% Suggest.
- Is investing in B Ltd., better than investing in A Ltd., ?
 - If you invest 30% in B Ltd., and 70% in A Ltd., what is your expected rate of return and portfolio standard deviation. ?
 - What is the market portfolios expected rate of return and how much is the risk free rate?
 - What is the beta of portfolio if A Ltd.'s weight is 70% and B Ltd., 's weight is 30%
- (b) A project had an equity beta of 1.2 and was going to be financed by a combination of 30% debt and 70% equity. Assuming debt – beta to be zero, calculate the project beta taking risk free rate of return to be 10% and return on market portfolio at 18%.

- (c) A Ltd., has a total sales of Rs.3.2 crores and its average collection period is 90 days. The past experience indicates that bad debt losses are 1.5% on sales. The expenditure incurred by the firm in administering its receivable collection efforts are Rs.5,00,000. A factor is prepared to buy the firm's receivables by charging 2% Commission. The factor will pay advance on receivables to the firm at an interest rate of 18% p.a. after withholding 10% as reserve. Calculate the effective cost of factoring to the firm.

(10+4+6=20 Marls)

Question 4

EITHER

- (a) X Ltd., an existing profit making company, is planning to introduce a new product with a projected life of 8 years. Initial equipment cost will be Rs.120 lakhs and additional equipment costing Rs.10 lakhs will be needed at the beginning of third year. At the end of the 8 year, the original equipment will have resale value equivalent to the cost of removal, but the additional equipment would be sold for Rs.1 lakh. Working capital of Rs.15 lakhs will be needed. The 100% capacity of the plant is of 4,00,000 units per annum, but the production and sales volume expected are as under

Year	Capacity in percentage
1	20
2	30
3-5	75
6-8	50

A sale price of Rs.100 per unit with a profit –volume ratio of 60% is likely to be obtained Fixed Operating cash cost are likely to Rs.16 lakhs per annum. In addition to this the advertisement expenditure will have to be incurred as under:

Year	1	2	3-5	6-8
Expenditure in Rs. Lakhs each year	30	15	10	4

The company is subject to 50% to a straight line method of depreciation, (permissible for tax purpose also) and taking 12% as appropriate after tax cost of capital, should the project be accepted?

- (b) A Ltd., is an all equity Financed company. The current market price of share is Rs.180. It has just paid a dividend of Rs.15 per share and expected future growth in dividend is 12% currently, it is evaluating a proposal requiring funds of Rs.20 lakhs, with annual inflows of Rs.10 lakhs for 3 years. Find out the net present value of the proposal, if (i) it is financial from retained earnings; and (ii) it is financed by issuing fresh equity at market price with a flotation cost of 5% of issue price.

(14+6=20 Marks)

OR

Question 4

- (a) The net sales of A Ltd., is Rs.30 crores. Earnings before interest and tax of the company as a percentage of net sales is 12%. The capital employed comprises Rs.10 crores of equity. Rs 2 crores of 13% cumulative preference shares capital and 15% Debentures of Rs.6 crores. Income Tax rate is 40%.
- Calculate the return on equity for the company and indicates segments due to the presence of preference share capital and borrowing (Debentures).
 - Calculate the operating leverage of the company given that combined leverage is 3.
- (b) A Ltd., uses inventory turnover as one performance measure to evaluate its production manager. Currently, its inventory turnover (based on cost of good sold/ inventory) is 10 times per annum, as compared with industry average of 4. average sales are Rs.4,50,000 p.a. variable costs of inventory have consistently remained at 70% of sales with fixed costs of Rs.10,000. carrying costs if inventory (excluding financing costs) are 5% per annum. Sales force complained that low inventory levels are resulting in lost sales due to stock outs. Sales manager has made an estimate based on stock out reports as under.

Inventory policy inventory turnover Sales in Rs.

Current	10	4,50,000
A	8	5,00,000
B	6	5,40,000
C	4	5,65,000

On the basis of above estimates, assuming a 40% tax rate and an after tax required return of 20% on investment in inventory, which policy would you recommend? **(6+4+10=20Marks)**

Question 5

Write short notes on any five of the following:

- (i) Certainty Equivalent Approach.
- (ii) Asset securitization
- (iii) Curvilinear break even analysis
- (iv) Financial intermediation
- (v) Financial engineering
- (vi) Shareholder value analysis
- (vii) Sustainable growth rate
- (viii) Strategic financial planning in public sector.

(5×4=20Marks)