

FINAL EXAMINATION

GROUP III

(SYLLABUS 2008)

SUGGESTED ANSWERS TO QUESTIONS

JUNE 2011

Paper- 12 : FINANCIAL MANAGEMENT & INTERNATIONAL FINANCE

Answer Question No. 1 from Part A which is compulsory and any five questions from Part B.

PART - A (25 Marks)

Q. 1. (a) In each of the cases given below, one out of four answers is correct. Indicate the correct answer (= 1 mark) and give workings/reasons briefly in support of your answer (= 1 mark) :

(i) A company issues a new 15 per cent debentures of ₹ 1,000 face value to be redeemed after 10 years. The debenture is expected to be sold at 5 per cent discount. It will involve floatation costs of 2.5 per cent of face value. The company's tax rate is 35 per cent. The cost of debt using short-cut method would be

A. 10.9%; B. 10.21%; C. 10.44%; D. 10.76%.

(ii) The capital structure of a company is as under :

3,00,000 Equity Shares of ₹ 10 each,

32,000, 12% Preference Shares of ₹ 100 each,

General Reserve ₹ 15,00,000,

Securities Premium Account ₹ 5,00,000,

25,000, 14% Fully Secured Debentures of ₹ 100 each,

Term Loan of ₹ 13,00,000.

Based on these, the leverage of the company is

A. 60.22%; B. 58.33%; C. 55.21%; D. 62.10%.

- (iii) The standard deviation of Greaves Ltd. stock is 24% and its correlation coefficient with market portfolio is 0.5. The expected return on the market is 16% with the standard deviation of 20%. If the risk-free return is 6%, what will be the required rate of return on Greaves Ltd. script?

A. 12%; B. 11%; C. 13%; D. 11.5%.

- (iv) Cactus Limited paid a dividend of ₹ 5 per share for 2009-10. The company follows a fixed dividend payout ratio of 60%. The company earns a return of 20% on its investment. The cost of capital to the company is 14%. What would be the expected market price of its share, using the Walter Model?

A. ₹ 69.69; B. ₹ 50.50; C. ₹ 60.69; D. ₹ 70.10.

- (v) The Sterling is trading at \$ 1.6100 today. Inflation in U.K. is 4% and that in U.S.A. is 3%. What could be the spot rate (\$/£) after 2 years?

A. 1.5792; B. 1.5892; C. 1.5992; D. 1.5939.

- (vi) Your customer requests you to book a sale forward exchange contract for US \$ 2 million delivery 3rd month. The quotes are :

Spot US \$ 1 = ₹ 48-050/060

1 month margin = 0-0850/0900

2 month margin = 0-2650/2700

3 month margin = 0-5300/5350

You are required to make an exchange profit of 0.125%. Ignore telex charges and brokerage. What will be your profit?

A. ₹ 1,20,000; B. ₹ 2,30,000; C. ₹ 75,000; D. ₹ 1,00,000.

[2×6=12]

- (b) State if each of the following sentences is T (= true) or F (= false) :

(i) Treasury management includes risk management.

(ii) In the CAPM model 'systematic risk' is the risk that cannot be eliminated by diversification, it being common to all firms.

(iii) An yield gap refers to a situation where yield on shares is lower this year as compared to last year's.

(iv) Profitability Index is the profit expected in capital budgeting.

(v) In futures trading, the margin is to be deposited by both the parties to the contract. [1×5=5]

- (c) Match the sources of fund (i, ii, or iii) with the relevant characteristics stated in letters (a, b, or c) :

Sources of Fund

(i) Global Depository Receipts (GDRs)

(ii) American Depository Receipts (ADRs)

(iii) Euro-bonds

Characteristics

(a) These instruments do not confer voting rights on the investors.

- (b) Only entities enjoying very good to excellent credit ratings gain access to this source.
 (c) Besides periodical receipts of income promptly, there is an assurance of protection of ownership right. [1×3=3]

Note: Write your answer simply by the numerical followed by chosen letter.

(d) Fill up the blanks with the appropriate word(s) as given in brackets in each of the following sentences :

- (i) Factoring reduces the working capital _____ by slashing receivables (cycle/need).
 (ii) Collar insulates the investor from the risk of interest rate _____ an agreed rate (falling below/rising above).
 (iii) The longer the loan period, the _____ should be the interest rate (higher/lower).
 (iv) On maturity in an option contract a put right is exercised when market rate is _____ favorable (less/more).
 (v) In foreign exchange quotations the size of spread for a given currency _____ with maturity (decreases/increases). [1×5=5]

Note: In your answer you need not write the full sentence; write only the word(s) as required to fill in the blank.

Answer 1. (a)

(i) A.

$$K_d = \frac{\text{₹ } 150(1 - 0.35) + (\text{₹ } 50 + \text{₹ } 25)/10}{(\text{₹ } 925 + \text{₹ } 1,000)/2} = 10.9 \text{ per cent}$$

$$\therefore K_d = 10.9\%$$

(ii) B.

- a. Fixed Income Funds = ₹ (32,00,000 + 25,00,000 + 13,00,000)
 b. Equity Funds = ₹ (30,00,000 + 15,00,000 + 5,00,000)

$$\text{Leverage} = \frac{a}{a+b} = \frac{\text{₹ } 70,00,000}{\text{₹ } 1,20,00,000} = 58.33\%$$

(iii) A.

From the given,

- R_f (riskfree return) as 6%,
 R_m (market return) as 16%,
 σ_m (standard deviation of market return) as 20%,
 σ_g (standard deviation of Greaves stock) as 24%,
 and ρ_{gm} (correlation coefficient of Greaves with the market) as 0.5,
 we first derive the β (beta of Greaves stock) and then use the CAPM formula for the required return on Greaves stock.

$$\begin{aligned}\text{Beta of Greaves stock} &= \frac{\rho_{gm} \times \sigma_g \times \sigma_m}{(\sigma_m)^2} \\ &= \frac{0.5 \times 0.24 \times 0.20}{(0.20)^2} = 0.6\end{aligned}$$

$$\begin{aligned}\text{The required return} &= R_f + \beta_g (R_m - R_f) \\ &= 6\% + 0.6 (16 - 6)\% \\ &= 12\%\end{aligned}$$

(iv) A

$$\text{EPS} = \frac{\text{Dividend}}{\text{Payout ratio}} = \frac{₹5}{0.6} = ₹8.33$$

$$\begin{aligned}\text{According to Walter model, } P &= \frac{D + (E - D) \times \frac{f}{k}}{K} \\ &= \frac{5 + (8.33 - 5) \times \frac{0.20}{0.14}}{0.14} \\ &= ₹69.69\end{aligned}$$

(v) A

$$\begin{aligned}S (\$/\text{£}) &= F (\$/\text{£}) \times (1 + r\$)^2 / (1 + r\text{£})^2 \\ &= 1.61 \times (1 + 0.03)^2 / (1 + 0.04)^2 \\ &= 1.5792.\end{aligned}$$

(vi) A

$$\begin{aligned}\text{3 month Interbank rate (ask) with margin} &= ₹ (48.0600 + 0.5350) \\ &= ₹48.5950\end{aligned}$$

$$\text{With exchange profit @ 0.125\%, the quote will be } ₹48.5950 \times 1.00125 = ₹48.66$$

$$\text{Profit} = ₹ (48.66 - 48.60) \times 2\text{m USD} = ₹1,20,000.$$

Answer 1. (b)

- (i) True
- (ii) True
- (iii) False
- (iv) False
- (v) True

Answer 1. (c)

- (i) (a); (ii) (c); (iii) (b)

Answer 1. (d)

- (i) Cycle
- (ii) falling below
- (iii) higher
- (iv) less
- (v) increases

PART - B (75 Marks)

Q. 2. (a) Electronics Devices Ltd. sells goods to domestic market on a gross profit of 25% on sales without considering depreciation. Its estimates for the next year are as follows :

	Amount (₹ lakh)
Sales :	
Domestic market at 2 months' credit	1,600
Export selling price 10% below home price (Exports at 3 months' credit)	540
Costs :	
Material used (Supplied extend 2 months' credit)	600
Wages paid ($\frac{1}{2}$ month in arrear)	400
Manufacturing expenses (paid 1 month in arrear)	600
Sales promotion (payable quarterly in advance)	80
Administration expenses (paid 1 month in arrear)	200

The company maintains one month's stock of each of raw material and finished goods. A cash balance of ₹ 20 lakh is also maintained.

You are required to work out the working capital requirement of the company. [10]

(b) Discuss the important factors that determine the dividend policy of a company [5]

Answer 2. (a)**Working Notes :**

(i) Cost of production :	₹ Lakhs
Material used	600
Wages paid	400
Manufacturing expenses	600
Administration expenses	200
	<u>1,800</u>

(ii) Export sales at equivalent domestic price = ₹ 540 L + 0.90 = ₹ 600 L

Statement showing requirement of working capital :

		₹ Lakhs
Current assets :		
Cash balance to be maintained		20.00
Stock of inventories		
Raw material	$600 \times \frac{1}{12}$	50.00
Finished goods	$1,800 \times \frac{1}{12}$	<u>150.00</u>
Debtors		
Domestic Market Sales	$1600 \times 0.75 \times \frac{2}{12}$	200.00
Export market	$600 \times 0.75 \times \frac{3}{12}$	112.00
Requirement of sales production expenses		<u>20.00</u>
		<u>552.00</u> (A)
Current Liabilities :		
for Raw material	$(600 \times \frac{2}{12})$	100.00
for Wages	$(400 \times \frac{1}{24})$	16.66
for Manufacturing expenses	$(600 \times \frac{1}{12})$	50.00
for Administration expenses	$(200 \times \frac{1}{12})$	<u>16.67</u>
		<u>183.33</u> (B)

Working capital required = A – B = ₹ 369.17 L

Answer 2. (b)

Factors determining the Dividend Policy of a company :

- (i) Cash flow situation of the company based on its current and future needs of funds
- (ii) Expectation of shareholders and performance by similar industries
- (iii) Constraints in payment of dividend, legal requirements
- (iv) Investment opportunities available to the company
- (v) Trends in capital market
- (vi) Ownership pattern of the company.

Q. 3. You are provided with the following information for Excellent Ltd. :

Balance Sheet					
Liabilities	As at 31.3.2011 ₹	As at 31.3.2010 ₹	Assets	As at 31.3.2011 ₹	As at 31.3.2010 ₹
Share Capital	5,00,000	5,00,000	Fixed Assets	10,50,000	8,50,000
Profit & Loss A/c	5,00,000	4,25,000	Stock	3,00,000	3,40,000
Long-term Loan	5,50,000	5,00,000	Debtors	3,45,000	3,80,000
Creditors	1,80,000	1,75,000	Cash	35,000	30,000
	<u>17,30,000</u>	<u>16,00,000</u>		<u>17,30,000</u>	<u>16,00,000</u>

Income Statement for the year ended 31.3.2011

	₹
Sales	21,50,000
(Less) Cost of sales	(14,70,000)
	<u>6,80,000</u>
(Less) Operating Expenses :	
Administrative Expenses	(2,40,000)
Depreciation	(1,00,000)
	<u>3,40,000</u>
Add : Dividend Received	25,000
	<u>3,65,000</u>
(Less) Interest Paid	(70,000)
	<u>2,95,000</u>
(Less) Income Tax	(1,30,000)
Profit after Tax	<u>1,65,000</u>

Excellent Ltd. paid Dividend of ₹ 90,000 during the year ended 31.3.2011.

Prepare a Cash Flow Statement of Excellent Ltd. for the year ended 31.3.2011 using Indirect Method and disclosing cash flows from Operating, Investing and Financing activities and the opening and closing cash balances.

[15]

Answer 3.

**Cash Flow Statement of Excellent Ltd. for the year ended
31.3.2011 (Indirect Method)**

	₹
A. Cash Flow from operating activities	2,95,000
Add : Depreciation	1,00,000
Interest paid	70,000
Less : Dividend received (non-operation)	<u>(25,000)</u>
Operating Profit	4,40,000
Add : Decrease in stock	40,000
Decrease in debtors	35,000
Increase in creditors	5,000
	<u>5,20,000</u>
Less : Tax paid	<u>(1,30,000)</u>
Total cash provided by operation activity	3,90,000
B. Cash Flow from Investing activities	
Purchase of Fixed assets (₹ 10,50,000 + 1,00,000 – 8,50,000)	
= ₹ 3,00,000	
(Less) Dividend received on Investments <u>(25,000)</u>	
Cash used in Investing activities	(2,75,000)
C. Cash Flow from Financing activities	₹
Long-term Loan taken	50,000
Interest paid	(70,000)
Dividend paid	<u>(90,000)</u>
Net Cash outflow from financing activities	<u>(1,10,000)</u>
Operating cash	₹
Add : Net increase in cash during year (A+B+C)	30,000
Closing cash	<u>5,000</u>
	<u>35,000</u>

Q. 4. (a) You are provided with the following estimates of cost of debt and cost of equity capital (after tax) of an organisation at various levels of debt/equity mix employed in its capital structure :

Debt as % of total capital employed	0	10	20	30	40	50	60
Cost of debt (%)	5.0	5.0	5.0	5.5	6.0	6.5	7.0
Cost of equity (%)	12.0	12.0	12.5	13.0	14.0	16.0	20.0

Determine the optimal debt equity mix on the basis of composite cost of capital.

[10]

(b) Describe the role of Hedging as foreign exchange risk management.

[5]

Answer 4. (a)

$K_d(\%)$	$K_e(\%)$	$W_d(B/V)$	$W_e(S/V) = (1-B/V)$	$K_d(W_d) + K_e(W_e) = K_o(\%)$
5.0	12.0	0.0	1.0	12.00
5.0	12.0	0.1	0.9	11.30
5.0	12.5	0.2	0.8	11.00
5.5	13.0	0.3	0.7	10.75
6.0	14.0	0.4	0.6	10.80
6.5	16.0	0.5	0.5	11.25
7.0	20.0	0.6	0.4	12.20

Optimal debt-equity mix for the organisation is at a point where the composite cost of capital is minimum. When debt is 30% of the total capital employed, the K_o is minimum. Therefore, 30% debt and 70% equity mix would be an optimal debt-equity mix for the company.

Answer 4. (b)

In international finance, hedging means a transaction undertaken to offset some exposure arising from a firm's usual operation. In order to reduce or eliminate currency exposure, internal strategies such as currency invoicing, netting and offsetting, leading and lagging, indexation clause in contract, switching the base of manufacture are resorted to.

A money market hedge involves taking a money market position to cover future foreign currency payable and receivables position.

Hedging is a risk management technique, primarily done to protect the foreign exchange exposures against the volatility of exchange rates, by using derivatives like Currency Options, Currency Futures, Forward Contracts, Currency Swaps, Money Markets etc. by taking off-setting positions against the underlying asset. Hedging refers to process, whereby one can protect the price of financial instrument at a date in the future by taking an opposite position in the present by using derivatives like Currency Options, Currency Futures, Forward Contracts, Currency Swaps, Money Markets, etc. It refers to technique of protecting the financial exposures in the underlying asset or liability due to volatility in the exchange rates by taking offsetting positions through derivatives to offset the losses in the cash market by a corresponding gain in the derivatives market.

Hedging involves

1. Foreign exchange exposure identification
2. Value of exposure
3. Creation of offsetting positions through derivatives.
4. Measurement of Hedge ratio.

In order to reduce or eliminate currency exposure, internal strategies such as currency invoicing, netting and offsetting, leading and lagging, indexation clause in contract, switching the base of manufacturer etc are resorted to.

Q. 5. (a) You are given the middle rates as under :

₹ 80/£ 1 in London,

₹ 47 /US \$ in Delhi; and

US \$ 1.58/£ 1 in New York.

Compute the Arbitrage gain on ₹ 8,00,000

[5]

(b) Explain briefly why Purchasing Power Parity Theory does not always work in practice.

[5]

(c) An extract from exchange rate list of a Kolkata based bank is given below :

₹/¥ : 0.3992 : 0.4002

(i) How many Yen will it cost for a Japanese tourist visiting India to purchase ₹ 2,500 worth of jackfruit? [2½]

(ii) How much will Mr. Basu in Kolkata have to spend in rupees, to purchase a Sony Camcorder worth Yen 1,25,000? [2½]

Answer 5. (a)

The following sequential transactions will serve the purpose :

(i) Buy US \$ in Delhi and get 17,021.277 US \$ for ₹ 8L;

(ii) Sell the above US \$ in N.Y for £ and get (£ 17,021.277 ÷ 1.58) = £ 10,772.96

(iii) Sell the £ obtained in (ii) for INR in London

⇒ £ 10,772.96 × 80 = ₹ 8,61,836.80.

Arbitrage gain will be ₹ (8,61,836.80 – 8,00,000) = ₹ 61,836.80

Answer 5. (b)

The limits to free trade of goods are many. The larger limits are :

1. **Import and Export Restrictions** viz., quotas, tariffs, laws imposed by different countries make free trade difficult or impossible at times.
2. **Travel costs.** Expensive freight costs from one market to another market may cause a difference in the two market prices.
3. **Perishable Goods.** These goods may not keep for long without extra care or cost being borne for them to sell in another market.
4. **Location.** Utility of two real estates is not the same. Neither can two pieces of land qualify for exchange.

The above are the reasons for the anomaly noted in the Purchasing Power Parity Theory in practice. As a practical matter, a relative version of PPP has evolved, which states that the changes in the exchange rate over time is determined by the difference in the inflation rates of the two countries.

Ans

(i)

(ii)

Q. 6.

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Answer 5. (c)

- (i) The Japanese will have to pay
(₹ 2500/0.3992 or) ¥ 6263 for the jackfruit.
- (ii) Mr. Basu will have to pay
(¥ 125000 × 0.4002) or ₹ 50,000 for the Camcorder.

Q. 6. A company is faced with the problem of choosing between two mutually exclusive projects. Project A requires a cash outlay of ₹ 1,00,000 and cash running expenses of ₹ 35,000 per year. On the other hand, Project B will cost ₹ 1,50,000 and require cash running expenses of ₹ 20,000 per year. Both the machines have an eight-year life. Project A has a salvage value of ₹ 4,000 and Project B has a salvage value of ₹ 14,000. The company's tax rate is 50% and it has a 10% required rate of return.

Assuming depreciation on straight line basis and that there is no funds constraint for the company, ascertain which project should be accepted. Present value of an annuity of ₹ 1 for 8 years = 5.335 and present value of ₹ 1 at the end of 8 years = 0.467, both at the discount rate of 10%.

Please solve the problem by an incremental cash flow approach.

[15]

Answer 6.

A Company
Financial Evaluation of Project A & Project B

	Project A	Project B	Incremental Cash flows
	₹	₹	₹
Cash outflows	1,00,000	1,50,000	50,000
Cash running expenses (for 8 years)	35,000	20,000	15,000
Depreciation (for 8 years)	12,000	17,000	(5,000)
Total saving			10,000
Less : Tax @ 50%			(5,000)
Saving after tax			5,000
Add : Depreciation (not being cash outflow)			5,000
Net Saving			10,000
Salvage value at the end of year 8	4,000	14,000	10,000
Present value of annual saving for 8 years = PV of annuity × Net savings for 8 years = 10,000 × 5.335			53,350
Present value of Incremental salvage value at end of year 8 = 0.467 × 10,000			4,670
Total			58,020
Less : Cash outflow (incremental)			(50,000)
Net Present value (Incremental)			8,020

Recommendation :

Since Project B has positive NPV over and above the NPV of Project A at 10% Discount rate, Project B is recommended for acceptance.

Note : Working for depreciation :

Project A	$(₹ 1,00,000 - 4,000) / 8 \text{ years} = ₹ 12,000$
Project B	$(₹ 1,50,000 - 14,000) / 8 \text{ years} = ₹ 17,000$

Q. 7. A firm's sales, variable costs and fixed cost amount to ₹ 75,00,000, ₹ 42,00,000 and ₹ 6,00,000 respectively. It has borrowed ₹ 45,00,000 at 9 per cent and its equity capital totals ₹ 55,00,000.

- What is the firm's ROI?
- Does it have favourable 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 ₹ 50,00,000, what will the new EBIT be?
- At what level will the EBT of the firm equal to zero? [2½ × 6 = 15]

Answer 7.

(a) $\text{ROI} = \text{EBIT} / \text{Investment}$

$$\text{EBIT} = \text{Sales} - \text{VC} - \text{FC} = ₹ 75 - ₹ 42 - ₹ 6 \text{ lakh} = ₹ 27 \text{ lakh}$$

$$\text{ROI} = ₹ 27 \text{ lakh} / ₹ 100 \text{ lakh} = 27\%$$

(b) Yes, the firm has favourable financial leverage as its ROI is higher than the interest on debt.

(c) $\text{Asset turnover} = \text{Sales} / \text{Total assets or Total investments}$
 $= ₹ 75 \text{ lakh} / ₹ 100 \text{ lakh} = 0.75$. It is lower than the industry average.

$$\begin{aligned} \text{(d) Operating leverage} &= \frac{\text{Sales} - \text{Variable cost}}{\text{EBIT}} \\ &= \frac{(₹ 75 - ₹ 42) \text{ lakh}}{₹ 27 \text{ lakh}} \\ &= 1.22 \end{aligned}$$

$$\begin{aligned} \text{Financial leverage} &= \frac{\text{EBIT}}{\text{EBIT} - \text{Interest}} = \frac{₹ 27 \text{ lakh}}{(₹ 27 \text{ lakh} - ₹ 4.05 \text{ lakh})} \\ &= 1.18 \end{aligned}$$

(e)

(f)

Q. 8

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$$\text{Combined leverage} = \frac{\text{Sales} - \text{Variable cost}}{\text{EBIT} - \text{Interest}} = \frac{\text{₹ 33 lakh}}{\text{₹ 22,95,000}} = 1.44$$

$$\text{Alternatively} = \text{OL} \times \text{FL} = 1.22 \times 1.18 = 1.44$$

(e) EBIT at sales level of ₹ 50 lakh :

	₹
Sales revenue	50,00,000
Less : Variable costs (50 lakh × 0.56)	28,00,000
Less : Fixed costs	<u>6,00,000</u>
EBIT	<u>16,00,000</u>

(f) Zero EBT implies break-even sales (BESR)

$$= \text{FC/CV ratio, CV ratio} = \text{₹ 33 lakh} / \text{₹ 75 lakh} = 44\%$$

$$\text{BESR} = (\text{₹ 6 lakh} + \text{₹ 4.05 lakh}) / 0.44 = \text{₹ 22,84,091.}$$

Q. 8. Write short notes on (any three) :

[5×3=15]

- Foreign Direct Investment;
- Venture Capital;
- Operating Lease;
- Project Appraisal.

Answer 8. (a)

Foreign Direct Investment is that investment which is made to serve the business interest of the investors in a company, which is in a different country of the investor. FDI flows like the flow in the capital market, have been the fastest growing component of long term flow to developing countries as a whole. FDI is considered to be an essential tool for jump starting economic growth of a country by bolstering domestic capital, productivity and employment. FDI has an impact on country's trade balance as well. In India FDI is guided by certain regulatory norms and investments are allowed in specified percentages.

Answer 8. (b)

Venture Capital : Venture Capital is a type of private equity capital typically provided by professional outside investors to new, high risk, high return and high potential projects. Venture capital investments are generally made in exchange of shares in the invested company. Venture capital funding is generally used for technology projects like I.T., Biotechnology, etc. Venture capitalist undertakes the risk on behalf of the technocrat entrepreneur, who is not able to convert the idea into reality due to lack of finance. The venture capitalist

does this at a premium. Venture capitalist generally exist when the project can stand alone on its own by divesting their stake in a predetermined manner. While initially VC was associated with high technology ventures, over the years the concept has undergone a change and currently it may be pooled investment in an unlisted company.

Answer 8. (c)

Operating Lease : An operating lease normally includes both financing and maintenance services. Normally the lessor agrees to maintain a service — the service, the cost of which are built into the lease payment. Further, as operating lease is one where an asset is leased or hired for a period of time less than its useful life. The lessor expects to recover costs in subsequent renewal payments or on disposal.

Besides the cost of machinery, the lessor also bears insurance, maintenance and repair costs etc. Agreements of operating lease generally provide for an option to the lessee/lessor to terminate the lease after due notice.

Answer 8. (d)

Project Appraisal : Project appraisal is a process of verification of the situation in the field. It will evaluate the financial, economic and social objective of the project report. It will also

- (i) verify the procedures of the project formulation team, and
- (ii) recommend the conditions which will ensure that the project objectives are met.

The basic criteria of project appraisal is to assess the project's viability, profitability, repayment capability, socio-economic factors and above all the promoters' background and their commitment to the success of the project.

PAP

1 (a) I

(ii)

(iii)

(iv)