QUESTION 2012

GROUP – A
(Multiple Choice Type Questions)

1. Choose the correct alternatives for any ten of the following:

i) Which of the following is not considered to be a financial decision?
- a) Recruitment of 100 sales people in five zones
- b) Launching a new detergent with a marketing budget of Rs.1 crore
- c) Implementing SAP, ERP to connect 450 offices in India and abroad
- ✓d) Lunch time is deferred by half an hour.

ii) Higher operating leverage is related to the use of additional
- ✓a) fixed costs
- b) variable costs
- c) debt financing
- d) common equity financing

iii) Calculate the degree of financial leverage (DFL) for a firm when its EBIT is Rs. 2,000,000. The firm has Rs. 3,000,000 in debt that costs 10% annually. The firm also has a 9%, Rs. 1,000,000 preferred share issue outstanding. The tax rate is 40%.
- a) 0.78
- b) 0.80
- c) 1.24
- ✓d) 1.29

iv) Modigliani and Miller argue that the divided decision
- ✓a) is irrelevant as the value of the firm is based on the earning power of its assets
- b) is relevant as the value of the firm is not based just on the earning power of its assets
- c) is irrelevant as dividends represent cash leaving the firm to shareholders, who own the firm any way
- d) is relevant as cash outflow always influences other firm decision

v) Spontaneous financing includes
- a) Accounts receivable
- ✓ (b) Accounts payable
- c) Short-term loans
- (d) A line of credit

vi) As per Baumol's Model, minimum cash balance is ascertained by
- ✓a) $\sqrt{2BT/i}$
- b) $\sqrt{3BT/i}$
- c) $\sqrt{4BT/i}$
- d) $\sqrt{5BT/i}$

vii) In deciding the appropriate level of current assets for the firm, management is confronted with
- ✓a) A trade-off between profitability and risk
- b) A trade-off between liquidity and marketability
- c) A trade-off between equity and debt
- d) A trade-off between short-term versus long-term borrowing.

viii) The common stock of a company must provide a higher expected return than the debt of the same company because
- a) There is less demand for stock than for bonds
- b) There is greater demand for stock than for bonds

✓c) There is more systematic risk involved for the common stock
d) There is a market premium required for bonds

ix) Financing a long lived asset with short-term financing would
a) An example of "moderate risk-moderate (potential) profitability" asset financing
b) An example of "low risk – low (potential) profitability" asset financing
✓c) An example for "high risk – high (potential) profitability" asset financing
d) Include accounts payable

x) In calculating the costs of the individual components of a firm's financing, the corporate tax rate is important to which of the following component cost formulae?
a) Common stock
✓b) Debt
c) Preferred stock
d) None of these

xi) The cost of procuring additional capital is known as
✓a) Marginal cost of capital
b) Variable cost of capital
c) Overall cost of capital
d) Average cost of capital

xii) Degree of financial leverage refers to
✓a) % change in EPS/% change in EBIT
b) % change in EBIT /% change in EPS
c) % change in EPS X/% change in EBIT
d) None of these

GROUP – B
(Short Answer Type Questions)

2. Discuss the condition that should be satisfied for using a firm's WACC for evaluating new investment.
See Topic: COST OF CAPITAL, Short Answer Type Question No. 5.

3. What are the fundamental principles of Finance? Describe the key activities of financial management.
See Topic: FINANCIAL MANGEMENT, Short Answer Type Question No. 3.

4. Calculate DFL from the following information:

Particulars	
10% Preference share capital	20000
15% debentures	30000
EBIT	40000
Tax Rate	50%

See Topic: OPERATING & FINANCIAL LEVERAGE, Short Answer Type Question No. 5.

5. "Accruals are a free source of finance". Explain your viewpoint with an example.
See Topic: CAPITAL STRUCTURE, Short Answer Type Question No. 4.

6. Define the relationship between Real rate and Inflation rate.
See Topic: COST OF CAPITAL, Short Answer Type Question No. 6.

7. (a) What do you mean by cost of capital?
(b) A company has 80,00,000 ordinary shares outstanding. The current market price is ₹25 and the book value is ₹18 per share. The company's earning per shares are ₹3.60 and dividend per share is ₹1.44. What is the growth rate assuming that the past performance will continue? Calculate the cost of equity capital.
See Topic: COST OF CAPITAL, Short Answer Type Question No. 7(a).
See Topic: COST OF CAPITAL, Short Answer Type Question No. 7(b).

GROUP – C
(Long Answer Type Questions)

8. A company has an investment opportunity of ₹40,000. The following is the expected Net Cash Flow (after tax, before depreciation):

Years	1	2	3	4	5	6	7	8	9	10
Cash Flow	7000	7000	7000	7000	7000	8000	10000	15000	10000	4000

Assuming 10% as the cost of capital; determine
Pay Back Period
Net Present Value at 10% discounting factor
Profitability Index at 10% discounting factor
Internal Rate of Return.
See Topic: CAPITAL BUDGETING, Long Answer Type Question No. 6.

9. Corona Electricals Ltd of Siliguri, maintains a majority of electrical installations of hydel power plants located in the districts of Darjeeling and Jalpaiguri of West Bengal. The Capital Structure of the company as on 31st March, 2012 was following:

Equity Share Capital	5,00,000 (with face value of Rs.100 each)
Retained Earnings	2,50,000
14% Debentures	2,50,000
Total	10,00,000

The company wants to undertake an expansion scheme of `6,00,000 which can be financed –
i) entirely by issue of equity shares, or
ii) by 12% debentures of `100 each at par

As a result of expansion, sales and operating fixed costs will increase by 50% and 100% respectively. The present operating details are as follows:

Sales	20,00,000
Variable cost	60% of sales
Operating fixed cost	2,00,000
Corporate tax	40%

Calculate the leverage and EPS before and after expansion and give your recommendations. Assume that there is no change in corporate tax rate.
If EBIT levels are expected to fluctuate widely, state:
The EBIT level above which financing by 12% debentures will be more profitable

The EBIT level below which financing by equity will be more profitable.
See Topic: OPERATING & FINANCIAL LEVERAGE, Long Answer Type Question No. 3.

10. (a) What are the determinants of Capital Structure?
(b) Company X and Company Y have an expected annual net operating Income (EBIT) ₹50,000 each. The X Company has
₹2,00,000 worth of 10% debenture. The equity capitalization rate of both the companies is 12.5% and the tax rate 35%.
Find the value of the firms X and Y under Neat Income Approach.
See Topic: CAPITAL BUDGETING, Short Answer Type Question No. 5.

11. From the following particulars prepare a statement showing the working capital needed to finance a level of activity of 1200 units of output p.a.

Raw Material	₹50 per unit
Labour	₹30 per unit
Overhead	₹20 per unit
Total cost	₹100 per unit
Profit/unit	₹20
Selling Price/unit	₹120

Additional information:
Raw Materials are to remain in store on an average of 2 months.
Materials are processed on an average of 3 months
Finished goods are in stock on an average of 3 months
Credit allowed to debtors is 4 months
Credit availed from supplier for 2 months
Cash in hand is desired to be maintained at Rs. 30,000
See Topic: MANAGEMENT OF WORKING CAPITAL, Long Answer Type Question No. 6.

12. Write short notes on any three of the following.
   a) Inventory holding cost
   b) Preference Shares
   c) Operating cycle
   d) Degree of Combined leverage
   e) Risks in long-term project management

a) See Topic: MANAGEMENT OF WORKING CAPITAL, Long Answer Type Question No. 14.(b).
b) See Topic: COST OF CAPITAL, Long Answer Type Question No. 5(a).
c) See Topic: MANAGEMENT OF WORKING CAPITAL, Long Answer Type Question No. 14.(c).
d) See Topic: OPERATING & FINANCIAL LEVERAGE, Long Answer Type Question No. 6.(b).
e) See Topic: CAPITAL BUDGETING, Long Answer Type Question No. 10.(f).