

**INSTITUTE OF COST AND MANAGEMENT ACCOUNTANTS
OF PAKISTAN**

PROFESSIONAL-IV (NEW/EXISTING) EXAMINATION—SUMMER 2003

Tuesday, the 27th May, 2003

STRATEGIC FINANCIAL MANAGEMENT/FINANCIAL MANAGEMENT

Time Allowed—2 Hours 40 Minutes

Maximum Marks—90

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- (i) Attempt ALL questions.
- (ii) Answer must be neat, relevant and brief.
- (iii) In marking paper, the examiners take into account clarity of exposition, logic of arguments, presentation and use of clear diagram/chart where appropriate.
- (iv) Read the instructions printed on the top cover of answer script CAREFULLY before attempting the paper.
- (v) Use of non-programmable scientific calculators of: O Casio fx-82 LB, O Casio fx-82 Super, O Casio fx-350 D, O Casio fx-350 HA models is allowed.
- (vi) DO NOT write your Name, Reg. No. or Roll No., anywhere inside the answer script.
- (vii) Question No. 1 "Multiple Choice Question" of 10 marks printed separately, is an integral part of this paper.
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Marks

- Q. 2 (a) The credit manager of Ahmed and Co. feels that the credit policy of the company, needs to be tightened. In support of his argument, the credit manager presented a study to the company's president, comparing the existing credit period of 90 days allowed by the company with that of the 30 days credit terms, prevailing in the Industry. The credit manager based on his experience and survey of customers, expects annual sales as under:

<u>Credit Terms (days)</u>	<u>Annual Sales (Rs.)</u>
90	1,600,000
75	1,575,000
60	1,550,000
45	1,500,000
30	1,425,000
15	1,300,000

The variable cost is 85% of sales, whereas the fixed cost remains at Rs. 100,000.

Required :

- If the opportunity cost of funds is 15%, which credit terms will be most suitable to remain close to the credit period prevailing in the Industry (Assume 360 days in a year). 15
- (b) What principal factors should be kept in mind while setting a credit policy? Discuss in detail. 7

P.T.O.

- Q.3 (a) EM Corporation is considering to purchase a small business computer costing Rs. 70,000. The purchase of this machine is expected to save annually Rs. 20,000 because of reduction in salary expenses. The computer has a useful life of seven years, and a 10% investment tax credit is available at the time the computer is placed in service. The company's marginal tax rate is 40% and the after-tax required rate of return on the project is 13%.

Required :

- (i) Using straight-line depreciation, what is the project's net present value? 5
- (ii) If sum of the year's digit depreciation is used, what is its net present value? 8
- (iii) Explain why answer of (ii) above differs from answer of (i) above? 2
- (b) Compare the internal rate of return with the net present value. Why these two time-value approaches to asset selection might give conflicting decision rules? 8

- Q.4 TP and Light Company currently has the following long term capitalisation:

	<u>Rs (in million)</u>
Debt	80 at 9.5% (Av. before tax cost)
Preferred shares	10 at 8.0% (Av. before tax cost)
Ordinary shares (1 million share)	5
Unappropriated profit	<u>65</u>
	<u>160</u>

Earnings before interest and taxes (EBIT) are presently Rs. 16 million. Because TP and Light Company provides service to a recreational area, therefore, its revenues are more volatile than those of most public utilities.

The company needs to undertake a Rs. 20 million plant expansion programme in order to keep up with the growing demand. Management estimates the following EBIT possibilities for the near future, if the expansion programme is undertaken:

<u>EBIT (Rs. in million)</u>	<u>Probability of Occurrence</u>
17	5%
18	5%
19	10%
20	20%
21	25%
22	20%
23	10%
24	5%

The Credit rating of company's bonds is "A" while tax rate is 50 percent.

To finance the expansion programme, ordinary shares can be sold at a price which would result in net proceeds to the company of Rs. 33-1/3 per share. If debt financing were used, the company's debt rating would be lowered to "B" and the interest rate would be 10-1/2% on the new debt.

Required :

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|-------|--|---|
| (i) | What are the present earnings per share? | 4 |
| (ii) | What will be the earnings per share for the various possible levels of EBIT, if common shares are used to finance the expansion programme? | 7 |
| (iii) | What will be the earning per share if debt financing is used? | 7 |
| (iv) | Does the use of debt financing affect the value of existing debt and equity? Give your recommendations. | 5 |
- Q. 5 (a) The B.T. Company, which has a 40 percent tax rate, wishes to acquire a stamping machine for Rs. 100,000. This machine would be depreciated on straight line basis with an eight year life and no salvage value. An investment tax credit of 10 percent is available to the company at the time the machine is placed into service. The company can obtain the machine on lease rental of Rs. 14,500 per year, payable in advance. Alternatively, it can purchase the machine and borrow Rs. 100,000 less the tax credit @ 10% or Rs. 90,000 at 10 percent. This would require repayment of debt at Rs. 16,870 annually.

Required :

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| (a) | Based on your working, which is the preferred method of financing, if the discount rate is 5 %. | 15 |
| (b) | In your opinion, would the following factors tend to favour borrowing or leasing as a financing alternative and why? | 7 |
| | (i) Increased corporate tax rate. | |
| | (ii) Accelerated depreciation. | |
| | (iii) Rising price level. | |
| | (iv) Increased residual value of the asset. | |
| | (v) An increase in the risk free interest rate. | |

THE END