INSTITUTE OF COST AND MANAGEMENT ACCOUNTANTS OF PAKISTAN

Summer (May) 2011 Examinations

Monday, the 23rd May 2011

STRATEGIC FINANCIAL MANAGEMENT – (S-601)

STAGE-6

Extra Reading Time:	**15 Minutes**	**Maximum Marks: 90**	**Roll No.:**
Writing Time:	**02 Hours 45 Minutes**		

(i) Attempt all questions.
(ii) Answers must be neat, relevant and brief.
(iii) In marking the question paper, the examiners take into account clarity of exposition, logic of arguments, effective presentation, language and use of clear diagram/ chart, where appropriate.
(iv) Read the instructions printed inside the top cover of answer script CAREFULLY before attempting the paper.
(v) Use of non-programmable scientific calculators of any model 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" printed separately, is an integral part of this question paper.
(viii) **Question Paper must be returned to invigilator after finishing/ writing the exam.**

Answer Script will be provided after lapse of 15 minutes Extra Reading Time (9:30 a.m or 2:30 p.m [PST] as the case may be).

Marks

Q.2 Stylish Garments Limited is new name in the garments industry. However, the company has captured the market share very rapidly due to its stylish garments at comparatively competitive prices. The company has just applied for working capital finance from a commercial bank. You are requested by the bank to prepare an estimate of the working capital requirements of the company. You may add 10% to your estimated figure to account for contingencies. The following is the firm's projected profit and loss account:

		Rs.
Sales		4,200,000
Cost of goods sold		3,060,000
Gross profit		1,140,000
Administrative expenses	280,000	
Selling expenses	260,000	540,000
Profit before tax		600,000
Tax 35%		210,000
Profit after tax		390,000

The cost of goods sold has been calculated as follow:

	Rs.
Materials used	1,680,000
Wages and other manufacturing expenses	1,250,000
Depreciation	470,000
	3,400,000
Less: Stock of finished goods (10% product not yet sold)	340,000
Cost of goods sold	3,060,000

The figures given above relate only to the goods that have been finished and not to work in progress; goods equal to 15% of the year's production (in terms of physical units) are in progress on an average requiring full material but only 40% of other expenses. The firm has a policy of keeping two months consumption of material in stock. Desired cash at bank is Rs. 80,000.

All expenses are paid one month in arrear. Suppliers of material grant one and a half month credit; sales are 20% cash while remaining sold on two (2) months credit.

Required:

Prepare an estimate of the requirements of the working capital for the Stylish Garments Limited. 12

PTO

Marks

Q.3 **(a)** The ABC Limited has received a large order for export of bride garments and planning to acquire a short-term loan from bank which increases its borrowings. For this purpose ABC has to forecast the cash requirements for January, February and March. It is company's policy to collect 20% of its sales in the month of sale, 70 % in the following month and 10 % in the second month after the sale. All sales are credit sales. The balance sheet of ABC Limited as on 31st December 2010 is as under:-

			Rs. '000'
Cash	150	Accounts payable	1,080
Accounts receivable	1,590	Bank loan	1,200
Inventories	1,635	Accruals	636
Current assets	3,375	Current liabilities	2,916
Net fixed assets	5,508	Long-term debt	1,350
		Share capital	300
		Retained earnings	4,317
Total assets	8,883	Total liabilities and equity	8,883

Purchases of raw materials equal to 60% of sales to produce bride garments are made in the month prior to the sale. Payments for these purchases are made in the month after the purchase. Labour costs, including overtime, are expected to be Rs.450,000 in January, Rs.600,000 in February and Rs.480,000 in March. Operating expenses and taxes are expected to be Rs.300,000 per month for January through March. Ignore depreciation. Actual sales in November and December and projected sales for January through May are as follows:

					Rs. '000'
November	1,500	January	1,800	March	1,950
December	1,800	February	3,000	April & May	2,250

Required:

(i) Prepare a cash budget for the months of January, February and March. 06

(ii) Determine the amount of additional bank borrowings necessary to maintain a cash balance of Rs.150,000 at all times. 01

(iii) Prepare a pro forma balance sheet as at 31st March, 2011. 05

(b) The following information has been extracted from the books of XYZ Limited:

Annual interest rate	12%
	Rs.
Fixed cost per transaction	500
Total cash required	1,200,000

Required:

(i) Calculate the target (optimum) cash balance using the Baumol model. 02

(ii) What are the opportunity costs of holding cash, the trading cost (transaction cost) and the total cost? 02

(iii) What would be the total annual cash requirement if the target cash balance is Rs.75,000? 02

Q.4 Comfort Furniture Company is considering to add a new line to its product mix and the capital budgeting analysis is being conducted by Miss Shamsa Ali, a recently qualified CMA. The production line would be set up in unused space in Comfort's main plant. The invoice price of machinery would be approximately Rs.1,300,000. The shipping charges of Rs.40,000 would be required. Cost of Rs.160,000 to install the equipment would also be required. The machinery has an economic life of 5 years with zero salvage value. The company uses straight-line-method for depreciation of machinery.

Marks

The new line would generate incremental sales of 2,500 units per year for 5 years at an incremental variable cost of Rs.900 per unit. The fixed cost of the project excluding depreciation is Rs.350,000. Each unit can be sold for Rs.1,500. The firm's tax rate is 35% and its weighted average cost of capital is 18%.

Required:

(a) Assume that Miss Shamsa Ali thinks that the unit sale, price, variable cost, and fixed cost projections of new line are accurate within the range of ($\pm$) 10%. Work out the operating cash flow (OCF) of each variant i.e., base-case, best-case and worst-case. 10

(b) What is the project's base-case NPV? What are the best-case and worst-case NPVs? Do you suggest that the project should be undertaken under each scenario? 04

(c) What are the cash, accounting and financial break-even sales levels for this project under base-case scenario? Ignore taxes in answering. 06

Q.5 Assume that you have just joined the Novelty Shoes Limited a reputed company as Deputy Director Finance. The balance sheet as at 31st December 2009 of the company is as under:-

Liabilities	Rs.	Assets		Rs.
Share capital:		Fixed assets		360,000
Ordinary shares of Rs.10 each	200,000	Current assets:		
Retained earnings	300,000	Inventory	140,000	
Accounts payable	100,000	Accounts receivable	100,000	240,000
	600,000			600,000

The company in the year 2010, plans to undertake a major capital investment for expansion which would increase the fixed assets by Rs.140,000. Turnover for the year as well as profits before interest and taxes is expected to increase by 50% and it is anticipated that working capital excluding cash would also increase by the same percentage.

The EBIT for the year ended 31st December 2009 was Rs.120,000 and company's tax rate is 35%. Dividends Re.1 per share were paid at the end of the year and the same dividend per share would be paid in the next year. Tax rate is not expected to change.

The finance division of the company is examining the following alternatives to raise the requisite funds for expansion:

(i) Issue of 10% convertible Term Finance Certificates (TFCs) of Rs.400,000; each Rs.1,000 TFC is convertible into 80 equity shares.

(ii) Issue of TFCs for Rs.400,000 with interest warrants attached. Interest rate is to be fixed at 13% per annum and each Rs.1,000 TFC will enable the holder to purchase 50 ordinary shares at Rs.15 each on 31st December 2010.

(iii) Making a rights issue, which would allow shareholders to buy 8 new shares at Rs.12.50 each for every five shares presently held.

Assume that the TFCs with interest warrant and rights issue will be made on 1st January 2010. In the case of convertible TFCs, assume that all the TFCs are converted on 1st July 2010. If funds are raised in excess of the needs of the company under each option, it may be assumed that they will be held in the form of cash.

Required:

(a) Considering each of the above alternatives (i to iii) separately, calculate earnings per share taking into account the number of share that have been issued under alternative (ii) at 31st December 2010. 08

(b) Which alternative's financial plan is offering the highest cash balance? 04

(c) Prepare the balance sheet under each alternative in columnar form and indicate the most viable alternative in your opinion. 08

PTO

Marks

Q.6 (a) Why do companies “go global”? Discuss. 06

(b) The Natural Foods Limited practices a strict residual dividend policy and maintains a capital structure of 60% debt, 40% equity. Earnings for the year are Rs 2,500,000.

Required:

(i) What is the maximum amount of capital expenditures possible without selling new equity? 02

(ii) Suppose that planned investment outlays for the coming year are Rs.4,000,000. Will Natural Foods Limited be paying a dividend? If so, how much? 02

(iii) What is the dividend yield ratio if market price of Natural Foods Limited’s share price is Rs.20 and the company has 500,000 shares outstanding? 02

(c) The Raees Corporation, which has an 8% after-tax cost of capital, is considering the acquisition of the Syma Company. As a result of merger, net after tax cash flows would be expected to increase as estimated below:

Rs. in million

	Average for years			
	1–5	6–10	11–15	16–20
Annual net income attributable to Syma	30	45	60	45
New investment required	6	15	30	30
Net after tax cash flow	24	30	30	15

Required:

Calculate maximum price that Raees Corporation should pay for Syma Company. 08

THE END

PRESENT VALUE FACTORS

Years	8%	10%	12%	14%	16%	18%	20%
1	0.926	0.909	0.893	0.877	0.862	0.847	0.83
2	0.857	0.826	0.797	0.769	0.743	0.718	0.69
3	0.794	0.751	0.712	0.675	0.641	0.609	0.58
4	0.735	0.683	0.636	0.592	0.552	0.516	0.48
5	0.681	0.621	0.567	0.519	0.476	0.437	0.402
6	0.630	0.564	0.507	0.456	0.410	0.370	0.335
7	0.583	0.513	0.452	0.400	0.354	0.314	0.279
8	0.540	0.467	0.404	0.351	0.305	0.266	0.233
9	0.500	0.424	0.361	0.308	0.263	0.225	0.194
10	0.463	0.386	0.322	0.270	0.227	0.191	0.162
11	0.429	0.350	0.287	0.237	0.195	0.162	0.135
12	0.397	0.319	0.257	0.208	0.168	0.137	0.112
13	0.368	0.290	0.229	0.182	0.145	0.116	0.093
14	0.340	0.263	0.205	0.160	0.125	0.099	0.078
15	0.315	0.239	0.183	0.140	0.108	0.084	0.065
16	0.292	0.218	0.163	0.123	0.093	0.071	0.054
17	0.270	0.198	0.146	0.108	0.080	0.060	0.045
18	0.250	0.180	0.130	0.095	0.069	0.051	0.038
19	0.232	0.164	0.116	0.083	0.060	0.043	0.031
20	0.215	0.149	0.104	0.073	0.051	0.037	0.026

CUMULATIVE PRESENT VALUE FACTORS

8%	10%	12%	14%	16%	18%	20%
0.926	0.909	0.893	0.877	0.862	0.847	0.833
1.783	1.736	1.690	1.647	1.605	1.566	1.528
2.577	2.487	2.402	2.322	2.246	2.174	2.106
3.312	3.170	3.037	2.914	2.798	2.690	2.589
3.993	3.791	3.605	3.433	3.274	3.127	2.991
4.623	4.355	4.111	3.889	3.685	3.498	3.326
5.206	4.868	4.564	4.288	4.039	3.812	3.605
5.747	5.335	4.968	4.639	4.344	4.078	3.837
6.247	5.759	5.328	4.946	4.607	4.303	4.031
6.710	6.145	5.650	5.216	4.833	4.494	4.192
7.139	6.495	5.938	5.453	5.029	4.656	4.327
7.536	6.814	6.194	5.660	5.197	4.793	4.439
7.904	7.103	6.424	5.842	5.342	4.910	4.533
8.244	7.367	6.628	6.002	5.468	5.008	4.611
8.559	7.606	6.811	6.142	5.575	5.092	4.675
8.851	7.824	6.974	6.265	5.668	5.162	4.730
9.122	8.022	7.120	6.373	5.749	5.222	4.775
9.372	8.201	7.250	6.467	5.818	5.273	4.812
9.604	8.365	7.366	6.550	5.877	5.316	4.843
9.818	8.514	7.469	6.623	5.929	5.353	4.870