

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

PROFESSIONAL-IV EXAMINATION-SPRING (SUMMER), 2005

Sunday, the 29th May, 2005

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STRATEGIC FINANCIAL MANAGEMENT

Time Allowed—2 Hours 45 Minutes

Maximum Marks - 90

- (i) Attempt ALL questions
- (ii) Answers must be neat, relevant and brief
- (iii) In marking 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 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" printed separately, is an integral part of this paper.

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- Marks
- Q. 2 (a) Discuss utility of CVP (Cost-Volume-Profit) Analysis. 8
- (b) A multi-product company has the following costs and output data for the last year :

Particulars	Product			Total
	X	Y	Z	
Sales mix (%)	40	35	25	
Selling price (Rs.)	40	50	60	
Variable cost per unit (Rs)	20	30	36	
Total fixed costs (Rs)				300,000
Total sales (Rs)				1,000,000

The company proposes to replace product Z by product S. Estimated cost and output data are :

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Particulars	Product			Total
	X	Y	S	
Sales mix (%)	50	30	20	
Selling price (Rs.)	40	50	56	
Variable cost per unit (Rs)	20	30	28	
Total fixed costs (Rs)				300,000
Total sales (Rs)				1,000,000

Required :

Should the company replace product Z by S ? Support your answer with all computations/workings. 15

Q. 3 (a) Define Commercial Paper. Discuss its merits and demerits. 6

(b) (i) The earnings per share of a company is Rs 10. It has an internal rate of return of 15 percent and the capitalization rate of its risk class is 12.5 per cent.

Required : If Walter's model is used :

(1) What should be the optimum payout ratio of the firm ? 3

(2) What would be the price of the share at this payout ? 3

(3) How shall the price of the share will be affected if a different pay out is employed ? 2

(ii) A company has a total investment of Rs. 500,000 in assets, and 50,000 ordinary shares of Rs 10 per share (par value) are outstanding. It earns a rate of 15 percent on its investment, and has a policy of retaining 50 percent of the earnings

Required :

(1) Determine the price of its shares using Gordon's Model, if the appropriate discount rate of the firm is 10 percent : 3

(2) What will happen to the price of the shares, if the company has a payout of 80 percent ? 3

(3) What will happen to the price of the shares, if the company has a payout of 20 per cent 2

Q. 4 (a) Discuss limitation(s) of CAPM (Capital Assets Pricing Model).

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- (b) Plastic Ltd. is considering whether to accept one of the two major new investment opportunities, project 1 and project 2. Each project would require an immediate outlay of Rs. 150,000 and Plastic Ltd expects to have available enough resources to undertake only one of them.

The Directors of Plastic Ltd. believe that return from existing activities and from the new project will depend on which of the three economic environments (A, B or C) prevails during the coming year. Their estimate for return for the coming year (that is cash flows to be received at the end of the year plus project value at that time), and the probabilities of the three possible environments is as follows :

Particulars	Environment		
	A	B	C
Probability of environment	0.3	0.4	0.3
	<u>Rs.</u>	<u>Rs.</u>	<u>Rs.</u>
Return from project 1	187,500	187,500	142,500
Return from project 2	150,000	176,250	195,000
Aggregate return from existing Portfolio of Project(s)	1,350,000	1,800,000	1,950,000

The company has a current market value of Rs. 1,500,000. The directors of Plastic Ltd. believe that the risk and return per Re. of market value of their existing activities are similar to those for the stock market as a whole including their dependence on whichever economic environment prevails. The current rate of interest on short-dated government securities and on bank deposit accounts is 10% per annum.

Required :

Prepare a schedule for the directors of Plastic Ltd showing which, of the two proposed projects should be accepted.

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Q. 5 (a) What are secured Premium Notes ? Discuss.

2

- (b) The Goodluck Company currently has a centralized billing system. All customers make payments to the central billing location. It requires, on the average, 4 days for the customers' mailed payments

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to reach the central location. Additional 1-1/2 days are required to process payments before a deposit can be made. The firm has a daily average collection of Rs. 500,000. The company has recently investigated the possibility of initiating a lockbox system. It has estimated that with such a system, customers' mailed payments would reach the receipt location, 2-1/2 days sooner. Further, the processing time could be reduced by 1 additional day, because each lockbox bank would pick mailed deposits twice daily.

Required :

- (i) Determine the reduction in cash balances that can be achieved through the use of a lockbox system. 3
- (ii) Determine the opportunity cost of the present system, assuming a 5% return on short-term instruments. 3
- (ii) If the annual cost of the lockbox system were Rs. 75,000, should such a system be initiated? 3
- (c) The Beta Company has made an after tax profit of Rs. 300m for the year 2004. The balance sheet incorporating the after tax profit before declaration of dividend is summarized below :

Liabilities & Equity	Amount (Rs. in Million)	Assets	Amount (Rs. in Million)
Current liabilities	500	Fixed assets	2,700
Long term debt	1,600	Current assets	600
Equity	1,200		
Total liabilities & equity	3,300	Total assets	3,300

In terms of Prudential Regulations the prescribed debt equity ratio is 60 : 40 and the current ratio is 1:1. The board of directors is scheduled to meet to decide on a dividend declaration and, as Chief Financial Officer, you have been asked to recommend a dividend. Beta Company has historically paid out at least 1/3 of its profits after tax as dividend and lower dividend declaration may adversely affect its share price.

Required :

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|---|---|
| (i) What is the maximum dividend that Beta Company can declare without breaking the Debt/Equity ceiling imposed by the Prudential Regulations ? | 5 |
| (ii) Based on the historical trend, what dividend should the company declare to meet shareholders' expectations ? | 2 |
| (iii) As CFO what dividend would you suggest, taking into account the situations (i) & (ii) above as well as the current ratio requirements ? | 4 |

THE END