INSTITUTE OF COST AND MANAGEMENT ACCOUNTANTS OF PAKISTAN

PROFESSIONAL-IV EXAMINATION-SPRING (SUMMER), 2006

Sunday, the 28th May, 2006 1294

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 the use of clear disgram/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 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 paper.*

Q. 2 ABC chemicals have approached your bank to seek financial assistance in connection with its expansion programme. To support the request, the company has provided last audited accounts which are reproduced below :

Balance Sheet

Assets		**(Rs. in million)**
Cash		7.4
Short term Investments		1.2
Accounts receivable		43.6
Inventories		112.9
Land		3.7
Buildings & equipment	171.5	
Accumulated depreciation	58.4	113.1
Investment in subsidiary		11.3
		293.2

P.T.O

Marks

Liabilities and equity	(Rs. in million)
Accounts payable	45.2
Notes payable 8%	3.5
Taxes payable	12.7
Mortgage bonds 7%	30.0
Debentures (8%) (10 years)	40.0
* Common share (Par Rs. 2)	21.4
Retained earnings	140.4
	293.2

* Market price Rs. 32.5 per share.

Income Statement

		Rs. in million
Net sales		390.2
Cost of goods sold		284.3
Gross profit		105.9
Selling and administration expenses	38.8	
Depreciation-selling and administration	7.8	46.6
Operating income		59.3
Financial charges		5.6
Income before taxes		53.7
Income tax @ 46%		24.7
Net income		29.0
Common dividend		11.7
Transfer to retained earnings		17.3

Chemical Industry Median (Financial Ratios)

Current ratio	2.62
Time interest earned	10.8 times
Average collection period	47 days
Inventory turnover	4.5 times
Total asset turnover	1.45 times
Return on total assets	7.18%
Return on net worth	13.14%
Price/earning ratio	7

Marks

Required :

Analyse the data and submit your findings in comparison with that of industry median. You are also required to write a summary report based on your findings to the higher management for it's approval or rejection. 10

Q. 3 A company has applied for working capital finance from a commercial bank. The projected profit and loss account of the company is as follows :

		Rs.
Sales		22,47,000
Cost of goods sold		16,37,100
Gross profit		6,09,900
Admin. expenses	149,800	
Selling expenses	139,100	288,900
Profit before tax		321,000
Income tax		107,000
Profit after tax		214,000

The details of cost of goods sold are as under :

	Rs.
Material used	898,800
Wages & other manufacturing expenses	668,750
Depreciation	251,450
Cost of goods finished	1,819,000
Less : closing stock of finished goods (10%)	181,900
Cost of goods sold	1,637,10

It is, however, expected that work-in-process inventory equal to 15% of year's production (in terms of units) are in process on an average, requiring full meterial but only 40 per cent of other expenses. The company also has a policy of keeping two months' consumption of material in stock.

All expenses are paid one month in arrear. Suppliers of material grant one and a half months' credit. Sales are 20 per cent in cash, while remaining are on two months' credit. 70 per cent of the income tax has to be paid in advance in quarterly instalments out of income and not from working capital. You are also required to make provision for exigencies equivalent to 10% of working capital requirements.

Required :

Prepare an estimate of the working capital requirements of the company. 15

Marks

Q. 4 (a) Under corporate restructuring programme, why would a company want to divest itself of a business unit ? 5

(b) Winter Limited is a highly successful and profitable publicly traded company. Out of fear for a hostile take over, the management is considering going private through leveraged buy-out by the management. The management presently owns 22% of the 5 million shares outstanding. Market price is Rs. 30 per share and it is felt that a 50% premium over the current market price will be required to entice the public shareholders to tender their shares in a cash offer.

Management intends to keep their shares and obtain senior debt equal to 75% of the funds necessary to consummate the buy-out. The remaining 25% will come from junior subordinated debentures. Terms on the senior debt are 3% above the one year KIBOR, with principal reduction of 20% of the initial loan at the end of each of the next five years. The junior subordinated debentures bear a 15% interest rate and must be retired at the end of year 6 with a single balloon payment. The debentures have warrants attached that enable the holders to purchase 30% of the shares at the end of year 6. The management estimates that earnings before interest and taxes will be Rs. 47 million per year. Because of tax loss carry forwards, the company expects to pay no taxes over the next five years. The company will make capital expenditure in amounts equal to its depreciation.

Required :

You are required to work out the following :

(i) If the one year KIBOR is expected to average 10% over the next five years, is the leveraged buy-out feasible ? 10

(ii) What, if KIBOR averages only 7% ? 4

(iii) What minimal EBIT is necessary to service the debts ? 3

Q. 5 (a) M/s PQR have obtained financing from a leading non-banking financial institution (NBFI) for a project. Because of a number of genuine difficulties experienced by the project, repayment of loan could not be started inspite of lapse of over three years' period. The NBFI accordingly obtained a decree from the court against the company amounting to Rs. 20,100,000 at a mark-up of 15%, till it is fully

Marks

paid. One of the promising buyers has offered to pay decreetal amount with the condition to pay 25% as down payment and balance after six months.

The borrower, to avert this situation, approached the NBFI to provide the relief on the outstanding amount in accordnace with the spirit of circular 29 issued by State Bank of Pakistan (SBP). The NBFI under prudential regulations has also placed the loan under loss category and has made provision of Rs. 8,250,000 in the books.

In accordance with the circular of SBP, NBFI can freeze the outstanding amount including principal, mark-up and other charges and would recover 75% of the total outstanding by way of 10% down payment in cash and balance over a period of 3 years in 12 quarterly installments.

One of the interested directors additionally offered to pay 4% mark up compounded quarterly on the installment amounts agreed under SBP circular 29.

On the date of request following dues were outstanding against M/s PQR :

	Rs.
Principal	22,800,000
Mark-up	9,400,000
Other charges	1,300,000

Required :

Compute net profit/loss to NBFI and give recommendations considering all the three proposals, viz :

(i) if the offer of promising buyer to pay decreetal amount is accepted. 6

(ii) if company's proposal is accepted under SBP circular 29. 5

(iii) if company director's proposal is accepted under SBP circular 29, besides additional payment of mark-up on installment. 6

Q. 5 (b) What are zero-coupon bonds ? Discuss. 3

P.T.O

Marks

Q. 6 (a) TPL company currently has the following long-term capitalization :

Capitalization	Amount (Rs. in million)	Average cost before tax
Debt	80	9.5%
Preferred shares	10	8.0%
Common shares (Rs. 5)	5	
Retained earnings	65	
	160	

Earnings before interest and taxes (EBIT) are presently Rs. 16 million. The company needs to undertake a Rs. 20 million plant expansion programme in order to meet growing demand. Management estimates the following possibilities for the near future, if the expansion programme is undertaken :

EBIT (Rs. in million)	Probability of occurrence (%)
17	5
18	5
19	10
20	20
21	25
22	20
23	10
24	5

The company is in tax bracket of 50 per cent. To finance the expansion programme, 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 is used, the company has to pay interest at the rate of 10 ½% on the new debt.

Required :

(i) What are present earnings per share ? 4

(ii) What will be earnings per share for the various possible levels of EBIT, if common shares are used to finance the expansion programme ? 4

Marks

(iii) What will be earnings per share, if debt is used ? 4

(iv) Which method of financing would you recommend and why ? 5

Q. 6 (b) Differentiate between the net-operating income approach and the Modigliani-Miller approach to the theory of the capital structure. 6

THE END