Sr. No.

INSTITUTE OF COST AND MANAGEMENT ACCOUNTANTS OF PAKISTAN

3rd Comprehensive Examination

Sunday, the 17th February, 2008

Time Allowed – 2 Hours **Maximum Marks – 60**

- **(i)** **Attempt both the cases 1 and 2, that carry 30 marks each.**
- **(ii)** **Answers must be neat, relevant and brief.**
- **(iii)** **In marking the question paper , the examiners take into account the clarity of exposition, logic of arguments, effective presentation, language and use of clear diagram or 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 question paper.**

CASE # 1

Marks

Your client, Eshai Ltd., has been negotiating with Bashir Ltd., for the purchase of one of its manufacturing divisions. Profit & loss account of the divisions for the year ended on June 30, 2007, and the balance sheet as at that date, are given below:

Profit and loss account for the year ended June 30, 2007.

Particulars	Rupees in million	
Sales		376
Less: Materials – external	52	
Materials – internal	43	
Manufacturing labour	124	
Depreciation - plant and machinery	15	
Other manufacturing overheads	64	
Administrative cost	38	
Shares of head office cost	24	360
Net Profit		16

Balance Sheet as at June 30, 2007.

Particulars	Rupees in million
Fixed Assets:	
Plant and machinery (net)	34
Stock – value at cost	
• Finished Goods	72
• Raw Materials	26
Accounts Receivable	54
	186
Less: Accounts Payable	32
Capital Employed (Head Office)	154

Based on discussions held, the following information has been ascertained:

1. Materials – internal, represent items transferred from another division. Under Bashir's transfer pricing policy, these items are priced at variable cost plus 30% to cover fixed overheads. Eshai would manufacture the items itself under similar conditions to Bashir as regards cost.

2. Eshai would take over all the assets of the division and discharge the creditors. However, it is believed that plant & machinery is obsolete. Its scrap value will be Rs. 10,000,000 (Rs. 10 million) and replaced by equipment leased on an annual contract for an initial rental of Rs. 25 million per annum.

3. Eshai believes that stock of finished goods could be reduced to one-half of their present level. The reduction would be effected by a special sale, immediately following the acquisition, to realize Rs. 40 million.

4. Share of head office cost represents an allocation of administrative costs on the basis of divisional sales. The acquisition would cause Eshai's cost of general management to increase by Rs. 8 million in the first year.

5. It is hoped that all the items of cost and revenue for the division and all working capital items would increase at 15% per annum. Eshai belives that a rate of return of 21% per annum reflects the systematic risk of the investment in money terms.

<u>Required:</u>

You have been contacted to study the foregoing information and prepare calculations to guide Eshai in deciding on the maximum amount to be paid for the division of Bashir. 30

CASE # 2

You have been appointed finance director of Zeenat Electronics Ltd. The company is considering investing in the production of an electronic security device, with an expected market life of five years.

The previous finance director has undertaken an analysis of the proposed project; the main features of his analysis are shown below. He has recommended that the project should not be undertaken because the estimated annual accounting rate of return is only 12.3%.

Particulars	Year-0 Rs. 000	Year-1 Rs. 000	Year-2 Rs. 000	Year-3 Rs. 000	Year-4 Rs. 000	Year-5 Rs. 000
Investment in depreciable fixed assets	175,500					
Cumulative investment in working capital	11,700	15,600	19,500	23,400	27,300	27,300
Sales		136,500	191,100	207,480	223,860	207,480
Materials		20,865	29,250	35,100	40,950	35,100
Labour		41,730	58,500	70,200	81,900	70,200
Overhead		1,950	3,900	3,900	3,900	3,900
Interest		22,464	22,464	22,464	22,464	22,464
Depreciation		35,100	35,100	35,100	35,100	35,100
		122,109	149,214	166,764	184,314	166,764
Profit before tax		14,391	41,886	40,716	39,546	40,716
Taxation		5,037	14,660	14,251	13,841	14,251
Profit after tax		9,354	27,226	26,465	25,705	26,465

Total initial investment will be Rs. 187,200,000, and average annual after tax profit will be Rs. 23,043,000.

All the above cash flows and profit estimates have been prepared, based on the current prevailing costs and prices, since the previous finance director had assumed, that the sales price could be increased to compensate for any increase in costs.

Following additional information has been made available:

1. Selling prices, working capital requirements and overhead expenses are expected to increase by 5% per year.
2. Material and labour costs are expected to increase by 10% per year.
3. Capital allowance (tax depreciation) are allowable for taxation purposes against profit @ 25% per year on reducing balance basis.
4. Rate of taxation on profit is 35% payable, one year in arrear.
5. Fixed assets will have no salvage value at the end of five years.
6. The company's real after-tax weighted average cost of capital is estimated to be 8% per year and nominal after tax weighted average cost of capital is 15% per year.

Assume that all receipts and payments arise at the end of the year to which they relate, except those in year-0, which occur immediately.

Required:

1. Estimate the net present value of the proposed project. State clearly any assumptions that you have made. 15
2. By how much the discount rate would have to change to result in a net present value of approximately ZERO? (show all computations) 05
3. Describe how sensitivity analysis might be used to assist in assessing this project? What are the weaknesses of sensitivity analysis in capital investment appraisals? Briefly outline alternative techniques of incorporating risk into capital investment appraisal. 10

THE END