[This question paper contains 5 printed pages.]

419 *Your Roll No.* ....

BBS / IV Sem. – 2012

BUSINESS STUDIES – Paper 404

Financial Management

Time : 3 hours *Maximum Marks : 75*

(Write your Roll No. on the top immediately on receipt of this question paper.)

Attempt **all** *questions.*

1. Royal Industries is considering the replacement of one of its moulding machine. The existing machine is in good operating condition, but is smaller than required if the firm is to expand its operations. It is 4 years old, has a current salvage value of Rs. 2,00,000 and a remaining life of 6 years. The machine was initially purchased for Rs. 10 lakh and is being depreciated at 25% on the WDV basis.

   The new machine will cost Rs. 15 lakh and will be subject to the same method as well as the same rate of depreciation. It is expected to have the useful life of 6 years. The management anticipates that with the expanded operation there will be need of an additional net working capital of Rs. 1,00,000. The new machine will allow the firm to expand the current operation and thereby increase annual revenues by Rs. 5,00,000, variable cost will be 30 percent of sale. Fixed cost are likely to remain same. The corporate tax rate is 35%. Its cost of capital is 10%. The company has several machines in the block of 25% depreciation.

Should the company replace the existing machine ? What course of action will you suggest if the salvage value of the new machine has (i) zero salvage value at the sixth year end (ii) Rs. 1,50,000 salvage value at the sixth year end ? (6+6=12)

2. XYZ Ltd has the following book value capital structure (Rs. Crore)

Equity capital (Rs. 10 each)	Rs. 15
12% preference capital (Rs. 100 each)	1
Retained earnings	20
11.5% Debenture (Rs. 100 each)	10
11% Term loan	12.5

The next expected dividend on equity shares per share is Rs. 3.60; the dividend per share is expected to grow at the rate of 7 percent. The market price per share is Rs. 40.

Preference stock, redeemable after 10 years, is currently selling at Rs. 75 per share.

Debentures redeemable after 6 years, are selling at Rs. 80 per debenture.

The income tax rate for the company is 40 percent.

Calculate the weighted average cost of capital by using the (i) book value weights (ii) market value weights. (6+6=12)

3. (i) A company belongs to a risk class for which the appropriate capitalization rate is 10 percent. It currently has outstanding 25,000 shares selling at Rs. 100 each. The firm is contemplating the declaration of a dividend of Rs. 5 per share at the end of the current financial year. It expects to have a net income of Rs. 2,50,000 and has a proposal for making new investments of Rs. 5,00,000. Show that under the MM assumptions, the payment of dividend does not affect the value of the firm ? (7)

(ii) How the Internal rate of return method is used in capital budgeting decisions ? (5)

4. (i) A firm has a capital structure of ordinary shares amounting to Rs. 10,00,000. The firm wishes to

raise additional Rs. 10,00,000 for expansion. The firm has four alternative financial plans.

A. It can raise the entire amount in the form of equity capital.

B. It can raise 50% as equity capital and 50% as debenture at 5% coupon rate.

C. It can raise the entire as debenture at 6% coupon rate.

D. It can raise 50% as equity capital and 50% as preference at 5% dividend rate.

Further assuming that the existing EBIT are Rs. 1,20,000, the tax rate is 35%, outstanding ordinary share 10,000 and the market price per share is Rs. 100 under the four alternatives. Which financial plan should the firm select? (7)

(ii) What are different sources of systematic and unsystematic risk? Explain. (5)

5. (i) A firm is contemplating an increase in the credit period from 30 days to 60 days. The average collection period which is at present 45 days is expected to increase to 75 days. It is also likely

that the bad debt expenses will increase from the current level of 1 percent to 3 percent of sales. Total credit sales are expected to increase from the level of 30,000 units to 34500 units. The present average cost per unit is Rs. 8, the variable cost and a sale price per unit is Rs. 6 and Rs. 10 per unit respectively. Assume the firm expects a rate of return of 15 percent. Should the firm extend the credit period? (7)

(ii) How American depository receipt (ADR) and foreign bonds are used by domestic firms in raising capital from foreign markets? (5)

6. (i) Why there is need for working capital? Explain the factors which determine the amount of working capital in any business. (8)

(ii) Explain the Net Income Approach and Net Operating Income Approach of Capital Structure. (7)