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FINANCIAL MANAGEMENT CURRENT PAPERS 2010 SUBJECTIVE

Operating lease

Operating Lease offers Financing AND MAINTENANCE: often the Lessor is the Supplier / Vendor of the Asset i.e. IBM

– Operating Lease is NOT FULLY AMORTIZED AND IS CANCELLABLE

EXAMPLE

IBM for Computer Hardware, Boeing for Airplanes

FINANCIAL LEASE

Financial Lease is fully amortized: Lessor recovers BOTH the full Value of Asset (Principal amount) AND the Profit (in form of interest or mark-up). BOTH are built Into the Lease Rental amount collected by the Lessor over the lifespan of the Lease. Recall AMORTIZATION TABLE for Bank Loan where Principal and Interest are recovered in equal regular installments. Fully Amortized Lease means the lessor recovers the principal amount plus interest amount.

– Financial Lease is NOT Cancelable: If Lessee MUST Cancel or Terminate the Lease Prematurely then pays heavy penalty to Lessor

SIGNALING THEORY

Raising New Debt carries Positive signal to market. Fresh Equity carries Negative Signal

And

Issuing New Debt (or taking new loan) gives positive signal to Investors. Issuing Fresh Stock / Equity in Stock Market gives negative signal.

BIRD IN HAND THEORY (developed by Gordon and lintner)

This theory is more practical. Shareholder wealth (and Firm's Value) is maximized by a HIGH Dividend Payout because Investors think that Dividend Income is more immediate, regular, and less risky than Capital Gains Income which is uncertain. So firm should pay as high dividend payout as possible.

STOCK DIVIDEND (when the cash position is inadequate)

___ A stock dividend is the issuance of additional shares of stock to stock holder. A stock dividend is may be declared when cash position is inadequate and when the firm wishes to prompt more trading of to its stock by reducing its market price

IN OTHERS WORDS

If stockholder has 2% interest in the company before a stock dividend , he or she will continue to have a 2% interest after stock dividend

STOCK SPLIT

_____A stock split involves issuing a substantial amount of additional share and reducing the par value of the stock on promotional basis. A stock split is often prompted by a desire to reduce the market price per share, which will make it easier for small investor to purchase shares.

TAX SHIELD

Tax Shield = corporate tax rate * value of debt = Tc * D

Q1) MANAGEMENT BUYOUT IS A FORM OF BUYOUT EXPLAIN IN YOUR OWN WORDS ?

Management Buyouts & "Going Private": A type of LBO. Management buys all or most of publicly held shares of their own firm and effectively converts public firm into a privately held one.

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3) HOW ARE DIVIDENDS PAID AND HOW DO COMPANIES DECIDES ON DIVEDEN PAYMENT?

ANS:

Dividend are paid in the following ways

1) **Declaration date**
   - **Dividend Declare in two ways**
     - **A) Stable dividend per share policy**
     - **b) Constant dividend payout ratio**
2) **Date of record**
3) **Ex –dividend date**
4) **Date of payment**

Decision on dividend payment

1) **Cash dividend: if funds are available with the company then dividend paid in cash**
2) **Stock dividend : if the funds are not available with the company then stock dividend is paid to shareholders in the form of additional shares**

Q: WHAT IS ASSET STRIPPING AND WHAT IS THE IDEA BEHIND IT? 3 MARKS

separate out the non-profitable and sell its assets individually to generate cash and restore profitability

4. If a firm decides to maintain a large amount of current assets or small amount.What will be the benefits that the firm will enjoy in both cases

IN CASE OF LARGE AMOUNT OF CURRENT ASSETS

It requires Large Amount of Current Assets not to loose any sales i.e. when a customer places order for a large amount, there is no shortage of inventory
– Occurs when High sales driven by lot of credit facility to buyers
– Good Credit Rating because High Liquidity and good Current Ratio

IN CASE OF SMALL AMOUNT OF CURRENT ASSETS

Small Current Assets means Lower Opportunity Cost of Capital. Firms have raised Capital from Investors (Debt Holders and Shareholders) which comes at a Cost (the WACC includes Interest paid to Debt Holders and Dividends paid to Shareholders). Firms must mobilize the capital in high-return investments in order to repay their investors

.

5.What will be the impact of the following transactions on the balance sheet.

a) When Mr.Ali issue a bond of 100,000 Rs to increase capital gain.

When you are issuing Bonds (i.e. borrowing money) then the Value of Bonds appears under Liabilities side (as Long Term Debt) of Balance Sheet.
.
b) When Mr.Ali make an investment on bond of Rs. 100,000
– If you are Investing (or buying) Bonds of other companies then their Value

appears under Assets side (as Marketable Securities) of Balance Sheet

1.

WHAT IS OPERATING LEASE? EXPLAIN WITH EXAMPLES? (5 MARKS)

This type of leasing both financing and maintenance services. Operating lease is not fully amortized and is cancelable

Example

The lessee lease property that is owned by lesser. The lessor may be the manufacture of the assets or it may be leasing company that buys assets from the manufacture to lease to other. The lease payment required under the contract is generally not sufficient to recover the full cost of property.

3. TODAY MOST LARGE COMPANIES OFFER DIVIDENT REINVESTMENT PLANS. EXPLAIN THIS PLAN WITH ITS TYPES? (5 MARKS)

Firms give stockholders option to automatically reinvest cash dividends by buying more of the same stock

– Advantage for Firm: no transaction and flotation costs unlike new stock issuance. Cheap way of raising equity.

– Advantage for Investors: no brokerage fee paid to stock broker

FIND NET INCOME

4. EBIT is Rs.50000 fraction of debt in capital structure in 20, returns on debt is 10% amount of debt is 20000 and tax rate is 36%. (3 marks)

SOLUTION

EBIT	**500000**
LESS INTEREST ON DEBT	**2000**
EBT	**48000**
LESS TAX	**17280**
NI	**30720**

·WRITE TWO TAKEOVER DEFENSES TECHNIQUES (3 MARKS)

2 Basic Ways of Hostile Takeovers:

- **Canvassing general public shareholders for their Proxy Votes**
- **Limited-time Share Tender Offer by Raider at share price above the market**

Corporate raiders urge the shareholders to buy their shares.

FIND NET INCOME FROM THE FOLLOWING DATA (3 MARKS)

(EBIT = 50,000, FRACTION OF DEBT IN CAPITAL STRUCTURE = 20, RETURN ON DEBT = 10%, AMOUNT OF DEBT = 20,000 AND TAX RATE = 35%

EBIT	**50000**
LESS INTEREST ON DEBT	**2000**
EBT	**48000**
LESS TAX	**16800**
NI	**31200**

· WRITE A NOTE ON STRUCTURE OF ORGANIZATION AND COST OF CAPITAL (05 MARKS)

STRUCTURE OF ORGANIZATION
Chief Executive Officer)CEO
)Chief Financial Officer)CFO

under Treasurer	**under Controller**
Cash & Investment	**Accounts**
Capital Budgeting	**Audit**
Capital Structure	
Inventory	

COST OF CAPITAL

Conceptually, it refers to the discount rate what would be used in determining the present value of estimated future benefit associated with capital projects
In operational terms, it is define as the weighted average of the cost of each type of capital
1) Cost of debt

2) Cost of preference shares
3) Cost of equity
4) Cost of retained earning

· DIFFERENCE B/W DECLARATION DATE AND EX-DIVIDEND DATE (05 MARKS)

Board announces Dividend amount and dates i.e. Jan 30th 2003. Based on Recommendation of CEO, CFO, and Treasurer
– Declared dividend recorded as actual current liability on the Balance Sheet and Retained Earnings reduced by same amount.
If announced Dividend is higher than before, generally Stock Price rises because Investors take this to be a Positive Signal about future earnings

EX-DIVIDEND DATE

4 Days before Holder-of-record Date. Deadline for new buyers to notify Firm so that Dividend is paid to them and not the previous registered owners i.e. Feb 24th 2003
– Share Price expected to DROP by about the same amount as Dividend on this date.

· ADVANTAGES OF FINANCIAL LEASE FROM POINT VIEW OF LESSEE (05 MARKS)

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Advantage of Financial Lease for Lessee:
• If factory needs to buy new machine urgently and does NOT have enough Finances.
• Leased Assets (and lease liabilities) can sometimes be treated OFF THE BALANCE SHEET ITEMS. Accounting Standards (i.e. FASB USA) in some Countries restrict this so generally speaking, Lease DOES affect DEBT RATIO & Capital Structure in similar way as Loan on Balance Sheet.
• If Company can NOT justify an increase in Assets on the Balance Sheet based On historical earnings. Capital expenditure in Leased Asset can be "Expensed" Out gradually.
• Lease Rental is a TAX-DEDUCTIBLE EXPENSE just like interest payments.
• As long as IRR from leased equipment is higher than cost of lease financing

WHAT IS DIFFERENCE B/W BID RATE AND ASK RATE. MARKS 5

bid rate is buying rate of currency and ask rate is selling rate of currency
Ask rate is greater than bid rate (selling price is greater than buying price)

Q3 LONG TERM FINANCING POLICY AND SHORT TERM FINANCE POLICY? MARKS 5

If a firm uses long term financing it has higher cost of financing comparatively due to high interest cost of long term loans. Despite of this high cost you have low risk here due to surety of access to money for a longer period.

Using Short-term Finance or Loan to buy extra inventory can be Risky
Because if you can't sell it, you will be forced to sell at a Deep Discount. So sell at a loss. Cash trickling in BUT Retained Earnings being wiped out. Not enough cash to pay interest on the loan. Possibly default and bankruptcy

Q4 Define the capital structure? Marks 5

Break even point?
If sale=10 per unit and VC=5 per unit
Fixed cost=2500

Part B
If VC=6 then break even point

Break even point = fixed cost/ Contribution margin to sale ratio
Fixed cost = 2500
Contribution margin = sale – variable cost
10-5
5
Contribribution margin ratio. = Contribution margin/ sales
= 5/10
0.5
Putting values
Break even sale = 2500/0.5
50000 Answer

B)

Break even sale = 2500/0.5
50000 Answer

If variable cost is 6 then
C.M= 10-6=4
C.M ratio 10/4=2.5
Break even sale = fixed cost / CM ratio
2500/2.5
1000

Q: what is meant by 5/10 and n/30 term in credit sale and purchase. (3 marks)
5% paid with in 10 day , net is 30 day

"LEASE IS JUST LIKE COLLATERALIZED LOAN". EXPLAIN THIS STATEMENT.

It is just like a Collateralized Loan (where the leased asset is the collateral). Lease Contract is just as serious as a loan agreement. Failure to pay lease rental is just like failure to pay interest. Can bankrupt the Lessee (Borrower). Lessor (Lender or Leasing Company) can seize the leased asset and, if the claim is larger, also demand up to 1 year lease rental.

– The two parties of lease agreement are:
- **Lessor (Leasing Company)**
- **Lessee**

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WHAT PROBLEMS A FIRM CAN FACE IF IT FACES A SHORTFALL OR SURPLUS OF INVENTORIES.

- **Shortfall** in Inventories: interruptions in production and loss or sales orders
- **Surplus** Inventories: high carrying costs, wastage, and depreciation

COMPARE AGGRESSIVE WORKING CAPITAL FINANCING WITH CONSERVATIVE WORKING CAPITAL FINANCING.

Aggressive
- Maximum Short-term financing at low cost (but risk of non-renewal)
- Use short-term financing for Temporary Current Assets and even partly to buy Permanent Current Inventory

– Conservative
- Maximum Long-term financing. Safe but higher interest costs.
- Use long-term financing for Fixed Assets, entire Permanent Assets, and even part of Temporary Current Assets

Q :Ahmad Corporation, a small business man, provided the following information about the production level:
Fixed operating cost = Rs. 2,500, Sale price per unit is Rs.10 and its operating variable cost per unit is Rs. 5.

- **You are required to calculate the breakeven quantity from the above information.**

- **If variable cost has changed and it is increased up to Rs. 6 then what will be the effect of this change on Break even quantity.**

CM = 10 – 5
= 5
C/S RATIO = 5 / 10
=.5

BREAK EVEN POINT = 2500 / .5
=5000
in units = 5000 / 10 =500
B) CM = 10 – 6
= 4

c/s ratio = 4 / 10
=.4
BE = 2500 / .4
=6250
in units = 6250 / 10 = 625

Q :ABC Corporation expects to have the following data during the coming year.

Assets	**Rs. 200,000**	**Interest rate**	**8%**
Debt/Assets, book value	**65%**	**Tax rate**	**40%**
EBIT	**Rs. 25,000**		

Required:
What is the firm's expected ROE?
Answer:
ROE=NI/Equity
NI=EBIT-Tax=25,000-10,000=15,000
Assets=(200,000*65%)=130,000
130,000*8%=10,400
Profit after interest=25,000-10,400=14,600
14,600*40%=5840

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Net profit after tax=8,760
ROE=(8,760/70,000)*100=12.51%

What are the real markets effects of leverage on WAAC? (Answer the question in bulleted form only).

Answer: Real Markets Effects of leverage on WACC:

- **Increase in leverage causes a large increase in cost of equity**
- **Increase in leverage causes relatively small increase in cost of debt as compared to cost of equity**
- **As leverage increases WACC 1st falls because of tax saving shield.**
- **With further increase in leverage WACC fall to its minimum point which is the optimal point for capital structure**
- **Further increase in leverage causes increase in WACC because of bankruptcy risk**

Suppose a Firm ABC has Total Assets of Rs.1000 and is 100% Equity based (i.e. Un-levered). There were 10 equal Owners and 5 of them want to leave. So the Firm takes a Bank Loan of Rs.500 (at 10%pa Mark-up) and pays back the Equity Capital to the 5 Owners who are leaving. Now, half of the Equity Capital has been replaced with a Loan from a Bank (i.e. Debt). What impact does this have on ROE?

Answer: As the firm replaces equity with debt it is increasing financial leverage which is a cause of financial risk. The impact of debt on ROE is that ROE will increase but with the greater uncertainty hence greater will be the risk.

Question (Marks: 3)

If interest tax shields are valuable, why don't all taxpaying firms borrow as much as possible?

A. Tax shield give us benefit up to certain level but as leverage increases Firm becomes more Risky so Lenders and Banks Charge Higher Interest Rates and Greater Chance of Bankruptcy.

Question (Marks: 5)

There are different methods to raise capital within the organization. Briefly explain the advantages of equity financing into the business.

A. Equity financing gives the flexibility we don't need to pay fix amount. In case of bond or debt we need to pay fixed interest in case of failure there is threat of Defaulter. Mostly the advantages of equity finance are reaped by the small business enterprises. In some case debt rate is too high that time equity help you to get cheaper capital financing.

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Question (Marks: 5)

What is long-term financing? Explain the factors that can affect the decision of a manager while deciding about long term financing?

ANSWER

Long term financing is a kind of financing which is provided for a period of more than one year.

Permanent Financing comes in two forms:

• Long-term Loans - Bonds It has Low Risk for Firm but has High Cost normally more than one year.

• Common Equity or Stock its Less Risk for Firm but Highest Cost.

If a company is using long-term financing it has higher cost of financing due high interest cost of long term loans despite high cost we have low risk, due to surety of access to money for a longer period. Current liabilities as a source of financing are not

reliable as you have no surety whether you will have same amount of money available next month for financing or not.

TODAY MOST IMPORTANT QUESTIONS

Q1 Define any two Defensive techniques? Marks3

Q2 leverage effect on company? Marks 3

Q3 Effect of financial leverage on ROE? (5)

Q4 Effect of leverage on cost of capital? (5)

Q: What is meant by merger? (5 marks)
Merge effect on acquiring firm?
Merge effect on target firm?

what is difference b/w marks 3

Firm c wnat to maintain hight Current aseets and low. comments on it which if finicial for for both situation.3 last year company sweet stuff cand corporation earned 172000 before interst and taxes. co. paid interest 22000 and 48000 divident. this corporation fall in the tax bracket of 20% caculate taxpayable by company this year calcualte interest liability (5)

2) what are some simple strategies to protect the form against exchange rate of risk ?

2. d/d methods to raise capital within the organization. briefly explain the advantages of equity financing into the bussiness? (5 marks)