

PUSASQF203
Business Finance-II

Time: 2 hours
Total Marks: 60 marks

Note:

- 1) The candidate has option to either attempt question 4A or question 4B. Rest all questions are mandatory.
- 2) Numbers to the right indicate full marks.
- 3) The candidates should only write the option alphabet for answers in case of the MCQ based questions.
- 4) Use of approved scientific calculator is allowed.

Q1.

15 Marks

1. Maxwell ltd. Common stock beta is 1.2 and the debt/equity ratio is 0.7. The corporation tax rate is 30 %. If risk free return is 6% and market risk premium is 5% then what is the required rate of return on total assets of the company?
 - a. 12.20%
 - b. 15.73%
 - c. 9.83%
 - d. 9.24%
2. Preference shares are generally considered as being more like debt than equity. Which of the following appropriately explains this?
 - a. The tax treatment of preference dividends
 - b. The marketability of preference shares
 - c. The fixed nature of participation in profits
 - d. The ability to make capital gains or losses
3. Depreciation provided by a company will affect:
 - I Profit and loss account
 - II Balance sheet
 - III Market value of assets
 - a. I only
 - b. I and II only
 - c. all of the above
 - d. none of the above

4. A project has the following cash flow :

Time	0	1	2
Cash Flow	-100	20	230

Certainty equivalent factor for first inflow is 0.75 and for second is 0.50. If the uniform discount rate is 15% then what is the NPV of the project?

- a. 0.00
 - b. 100.00
 - c. 107.61
 - d. 91.30
5. “The preparation of financial statements should avoid presenting an unduly optimistic set of results”. Which of the following statement is the least accurate in the above mentioned context?
- a. The lowest reasonable figure should be stated for profit or for any of the assets.
 - b. The highest reasonable figure should be stated for any liabilities.
 - c. Profits are recognized by inclusion in income statement whether realized in the form of cash or of other assets, or which can be assessed with reasonably certainty or is a best estimate in the light of the available information.
 - d. Provision is made for all known liabilities, expenses and losses, whether the amount is known with certainty or is a best estimate in the light of the information available.
6. What happens to a company’s weighted average cost of capital if the corporate tax rate increases and RBI policies cause an increase in the risk free rate?
(Consider the two events independently)

Tax rate increase

- a. Decrease
- b. Decrease
- c. Increase
- d. Increase

Increase in risk free rate

- Increase
- Decrease
- Increase
- Decrease

7. Dynamic Ltd is investing Rs 4 crores to purchase new industrial equipment. The estimated NPV of future after tax cashflows from the equipment is Rs 7 crores. The company currently has 2 million equity shares, with a current market price of Rs 350. Assuming that this project is new information and independent of other expectations about the company, what is the theoretical effect of public disclosure of the purchase of the new equipment on the stock price?
- Decreases to Rs 330
 - Increases to Rs365
 - Increases to Rs385
 - Remains unchanged
8. Which of the following is a valid relationship in the ratio analysis –
- PE Ratio = Net Dividend Yield/ Payout Ratio.
 - PE Ratio = $1 / (\text{Net dividend yield} \times \text{Payout ratio})$.
 - $(\text{PE ratio} \times \text{Net dividend yield}) / \text{Payout ratio} = 1$.
 - Payout ratio = Dividend cover x Dividend Yield.
9. Which of the following problems is most likely to be overlooked by a ratio analysis of a company's financial statements?
- Contingent Liabilities
 - High gearing
 - Poor efficiency
 - Liquidity problems
10. Which of the following statements list the merits of written down value method depreciation –
- Assets can be completely written off.
 - No undue pressure in later years.
 - Simplicity of calculation.
 - Equality of depreciation burden.

Q2.

A.

5 Marks

- a) Define the following ratios and explain the main limitations of these ratios: -
- i. Income Cover (1.25)
 - ii. Asset Cover (0.75)
- b) The following ratios have been calculated from financial statements of two companies of similar size and same industry: -

	Right LTD	Left LTD
Gross Profit Ratio	40%	20%
Net Profit Ratio	32%	16%
Return on capital employed	10%	14%

Explain which of the two companies is more profitable and why?

B.

5 Marks

A company has experienced volatile earnings in the last 5 years. The underlying business is unpredictable and risky and involves a high proportion of overseas earnings. List the steps the management can take to reduce the volatility in reported earnings for equity share holders.

C.

5 Marks

The wordings of the standard audit report can be modified if the auditor wishes to highlight areas of uncertainty or is unable to express an unqualified opinion, describe the different categories of auditor's report with different degrees of qualification.

Q3.

A.

5 Marks

a) Define the following terms –

- i. Associated undertaking (1)
- ii. Holding and subsidiary company (1)
- iii. Minority Interest (1)

b) HTC Ltd owns shares in three companies, Aroma Ltd (25% shareholding), Fragrance Ltd (70% shareholding), Fresh Ltd (40% shareholding). HTC Ltd has a contractual right to appoint 65% of the board of Aroma Ltd. W Ltd has appointed 70% directors of Fragrance Ltd using its voting rights. Which companies are associates of HTC Ltd and which are subsidiaries? (2)

B.

5 Marks

Discuss briefly the problems of interpreting company accounts under the following headings:

- i. Subjectivity
- ii. Appropriateness of figures used
- iii. Comparisons between firms
- iv. Accuracy of figures.

C.

5 Marks

a) Define Systematic Risk and Specific Risk.

b) Distinguish between systematic risk and specific risk and explain their relevance to capital project appraisal.

Q4A.

15 Marks

1. From the following trial balance of Healthcare Ltd prepare trading and Profit & Loss Account for the year ended 31st December 2020 and a balance sheet on that date –

Trial Balance –	Dr	Cr
Opening Stock	20,000	
Sales		2, 70,000
Purchases	80,000	
Purchase return		4,000
Sales Return	6,000	
Discount		5,200
Carriage Inward	3,600	
Sundry creditors		25,000
Carriage Outward	800	
Bills Payable		1,800
Wages	42,000	
Share Capital		75,000
Salaries	27,500	
Plant & Machinery	90,000	
Furniture	8,000	
Sundry Debtors	52,000	
Bills receivable	2,500	
Cash in hand	24,300	
Traveling expenses	3,700	
Lighting (factory)	1,400	
Rents and taxes	7,200	
General expenses	10,500	
Insurance	1,500	
	3, 81,000	3, 81,000

Adjustments –

- Stock on 31st December 2020 was valued at ₹ 24,000 (Market Value– 30,000)
- Wages outstanding for December 2020 amounted to ₹ 3,000.
- Salaries outstanding for December 2020 amounted to ₹ 2,500.
- Prepaid insurance amounted to ₹ 300.
- Provide depreciation on plant and machinery at 5% and on furniture at 20%.

4B.

15 Marks

Genius Round (GR) is a venture capital company, financed entirely by equity. The current market capitalization of GR is ₹120 crores and the beta coefficient is 2.2. The directors of GR believe that the high beta coefficient has depressed the market capitalization and so they wish to invest in some new lines of business.

The directors have decided that all major investments will be evaluated in terms of their net present value (NPV) and that NPV will be determined in a relevant and meaningful manner. Unfortunately, they cannot agree on the application of the best way to calculate NPV.

The directors are considering an investment that will reduce the GR's beta. They intend to borrow ₹40 crores at an interest rate of 9%. They intend to invest the whole amount in a new project that is significantly different from the present business. This project is in a business area where companies traditionally have beta coefficients of approximately 1.3, although the directors feel that the business is so different from the existing industry that there is an even greater diversification effect.

The directors are considering evaluating the NPV of the investment in terms of the GR's present cost of equity, although two members of the board believe that this rate is theoretically incorrect. One board member believes that the cost of equity will be affected by the investment and that it should be used in place of the present rate and another believes that the weighted average cost of capital, revised to allow for the fresh investment and the new borrowing, should be used.

The risk free rate of return is 6%. The market risk premium is 8%. GR's effective tax rate is 30%.

- i. Use the Capital Asset Pricing Model (CAPM) to:
 - a. Calculate GR's present cost of equity (1)
 - b. Estimate GR's ungeared beta, assuming that it proceeds with the investment (1)
 - c. Estimate GR's geared beta, assuming it proceeds with the investment (1)
 - d. Determine GR's weighted average cost of capital to proceed with the investment, using the results of your other calculations and estimates. (3)

- ii. Use the Capital Asset Pricing Model (CAPM) to:
- a) Discuss the appropriateness of the directors' decision to determine the NPV of the proposed investment in terms of one or other of the measures of the company's cost of capital. (4)
 - b) State, with reasons, whether there is a more appropriate rate that should be used instead. (1)
- iii. Explain why the directors are mistaken in their belief that their investment in this new project is even more worthwhile to the shareholders because of the additional diversification effect that it carries. (4)