

Name → Divya Sharma

Class → F.Y BSc ASQP.

Roll No. → 70

classmate

Date

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Business Finance - 2 Assignment - 1

Question 1. (D) IRR is the most reliable means of choosing between mutually exclusive projects

Question 2. (A) Market Price of share / Earnings per share

Question 3. (D) All of the above

Question 4. (c) 900,000

Question 5. (i) Sales - cost - tax = 2500 - 1500 - 400
= Rs 600.

(ii) $NPV = 1000(1 - 20\%) = \underline{Rs 800}$

(iii) $NPV = 2500(1 - 20\%) - 1500(1 - 20\%)^2$
= 1040

The NPV has increased by Rs 240.

Question 6. The ratios used to analyse a company's efficiency are -

- (i) Inventory turnover ratio
- (ii) Asset Turnover ratio
- (iii) Trade receivables turnover ratio
- (iv) Trade Payables turnover ratio

Answer 7 -

Limitations of Ratio Analysis :-

- ① The firm can make some changes (year end changes) to their financial statements, to improve their ratios. Then the ratios end up being nothing but window dressing.
- ② Ratios ignore the price level changes due to inflation.
- ③ Accounting ratios completely ignore the qualitative aspects of the firm.
- ④ There are no standard definitions of the ratios.
- ⑤ Accounting ratios do not resolve any financial problems of the company.

Question 8. (i) The beta of a stock indicates how volatile its price is in comparison to the overall stock market. This volatility relates to the existing activities of the company. It considers factors which are risk involved; the potential of growth of the company, the cyclical nature of the project. The factors are what determine the beta of the stock. Different companies have different risk, growth potential and other factors. Thus, stocks of different companies trade at different betas in the stock market.

$$(ii) \text{ Geared Beta} = \text{ungeared beta} \times \left[1 + \frac{\text{debt:equity ratio}}{1 - \text{tax rate}} \right]$$

$$\begin{aligned} \text{Current geared beta} &= 1.1 \\ \text{Current debt:equity} &= 1:2 \\ \text{tax rate} &= 30\% \end{aligned}$$

$$1.1 = \text{ungeared beta} \times \left[1 + \frac{1:2}{1 - 30\%} \right]$$

$$\text{ungeared beta} = \frac{1.1}{1 + \frac{1}{2}(1 - 0.3)}$$

$$= \frac{1.1}{1.35}$$

$$\text{ungeared beta} = 0.815$$

Question 8. (ii)

$$\text{New debt: equity} = 2:2$$

$$\text{New geared beta} = (0.815) [1 + 2:2 (1 - 30\%)]$$

$$= (0.815) (1 + 0.7)$$

$$= (0.815) (1.7)$$

$$= 1.3855$$

$$\text{New geared beta} = \underline{1.4}$$

Question 9. (D) In general the Market Value of investment trust is not correlated to the NPV.

Question 10.

(i) The shareholder's wealth can be maximised by improving the stock price. The problem with this is that the stock price depends on the beta of the company. The higher the beta the more returns it generates. So the companies would try to improve their beta by either increasing their debt: Equity ratio or by increasing their risk. To increase their debt: Equity ratio they would need to increase their debt. This could be a problem in case of insolvency.

Ques 11: (i) Beta can be regarded as a measure of the systematic risk associated with a particular stock. And we can

(ii) we can compare individual stocks with the overall market by assessing the beta (β) of the stock. For company 'i'.

$$\beta_i = \sigma_{im} / \sigma_m^2$$

where σ_m^2 is the variance of the market index and σ_{im} the covariance between the individual stock's returns and that of the market. An alternative expression for beta is:

$$\beta_i = \rho_{im} \sigma_i / \sigma_m$$

(iii) In my opinion I would invest in a stock with a beta 1.

A beta close to zero would indicate a stock that provided a more stable return than the market as a whole.

A negative beta would signify a stock whose performance was counter cyclical offsetting the overall marketing experience.

Question 12:

$$\begin{aligned}\text{(i) Cost of equity} &= R_F + MRF \times \beta \\ &= 7\% + 5\% \times 1.5 \\ &= 14.5\%\end{aligned}$$

$$\text{Cost of Debt} = \text{gross cost of debt} (1 - E)$$

$$= 9\% (1 - 25\%)$$

$$= 6.75\%$$

$$WACC = \frac{1}{2} (6.75) + \frac{1}{2} (14.5)$$

$$= 10.625\%$$

$$\text{(ii) } \beta_G = \beta_{UG} (1 + D/E (1 - E))$$

$$1.5 = \beta_{UG} (1 + 1 (1 - 25\%))$$

$$1.5 = \beta_{UG} (1.75)$$

$$\beta_{UG} = 0.8571$$

$$\text{New } D/E = 0.1$$

$$\therefore \text{New } \beta_G = 0.8571$$

$$\begin{aligned}RDE &= 7\% + 5\% \times 0.8571 \\ &= 11.2857\%\end{aligned}$$

Question 13.

(i) NPV = 140000 at 5%.

$$= 1,14,199.1345$$

Question 14.

(i) (a) Current Ratio - It is a liquidity ratio which measures company's ability to pay all the short term due which are due within a year.

(b) Debtor Turnover Period - It is average period of time in which company pay back the debt.

(ii) Finance Manager of XYLO Ltd. should track current ratio on 2 regular basis to ascertain whether the company would be able meet its short term liabilities. The current ratio must be 2:1 or higher.