

Financial Treasury and Forex Management

Solved Paper Dec-2013



Free of Cost

ISBN: 978-93-5034-601-3

Solved SCANNER™ Appendix

CS Professional Programme Module-II
(Solution upto June - 2013 & Questions of Dec - 2013 Included)

Paper - 3: Financial, Treasury and Forex Management

Chapter - 1: Nature and Scope of Financial Management

2013 - June [1] {C} (i)

- ⇒ The term 'liquidity' refers to the firm's ability to honour its future obligation.
- ⇒ It calls for striking a proper balance between the receivables and payables.
- ⇒ Liquidity management requires arrangement of receivables in such a manner that they are realised before the maturity of payables.
- ⇒ A finance manager should determine the need of liquid assets, well in advance, and should arrange them in such a way that there is no scarcity of funds.
- ⇒ On the other hand the term 'profitability' means effective utilisation of funds in such a manner that they yield the highest return.
- ⇒ Thus, the two prime goal which every finance manager has in priority being 'liquidity' and 'profitability' often seem to be competitive in nature. Their contradictory nature is on account of the fact that for survival of business it is essential to have adequate amount of cash. But at the same time having excess cash may result in blocking of cash and there by acting as a hindrance in the path of profitability.
- ⇒ To conclude, a finance manager needs to strike out a proper balance between the goals of liquidity and profitability.

2013 - June [4] (i)

Profit maximisation:-

Profit maximisation is one of the objective of financial management since profit acts as a reward for taking risk and is also an icon of business performance.

Evaluation of profit maximisation as one of the objectives of financial management:-

Advantages of Profit Maximisation:

- ⇒ The ultimate objective of each business is profit maximisation.
- ⇒ Profit acts as a reward for taking risk.
- ⇒ It helps to counteract with the future uncertainties.
- ⇒ Profit is also an icon of business performance.
- ⇒ Last but not the least, profit is the measuring rod which measures the financial soundness of any organisation.

Disadvantages of profit Maximisation:

Reasons as to why profit maximisation is not an objective of financial management:-

- ⇒ Profit maximisation is a narrow approach.
- ⇒ Profit is a vague term since different persons have different perspective for the very same term.
- ⇒ It ignores the timing of return.
- ⇒ Does not take into account the risk factor.
- ⇒ Lastly, it is a short term concept only.

Wealth Maximisation:

It is a long term objectives of financial management whereby the business strives to increase the wealth of the shareholders i.e. the stockholding of individual shareholder by maximising the market price per share.

Advantages of Wealth Maximisation:

- ⇒ As against the profit maximisation, the approach of wealth maximisation is long term in nature.
- ⇒ It does consider the timing impact.
- ⇒ It takes into account the concept of risk and uncertainty.

Disadvantages of Wealth Maximisation:

- ⇒ Lack of direct relationship between financial decisions and prices of shares.
- ⇒ Merely an increase in shareholder's wealth does not lead to wealth maximisation since there exist a large number of other stake holders also.

Chapter - 2: Capital Budgeting Decisions

2013 - June [1] {C} (ii)

- ⇒ Net Present Value (NPV) measures the difference between the present value of future cash inflows and present value of future cash outflow. Internal rate of return on the other hand, is the discount rate at which N.P.V. is zero i.e. present value of cash inflows is equal to the value of investment made.
- ⇒ While in the IRR method, the intermediate cash flows will be reinvested at IRR itself, in case of NPV method the investment is made at cut off rate which proves out to be a better presumption.

Chapter - 3: Capital Structure Decision

2013 - June [1] {C} (iv)

- ⇒ It is apt to state that company employs cost of capital as a minimum benchmark for its yield.
- ⇒ Cost of capital refers to the cost of raising funds, which includes both debt and equity.
- ⇒ Thus, this is the minimum return that investors seek from the company in return of funds provided by them.
- ⇒ Hence forth, it sets a benchmark / threshold for the company to earn that minimum return to satisfy its investors.
- ⇒ To conclude, cost of capital is the minimum benchmark for yield, however the company should try to maximize its yield over and above the cost of capital to increase market value and enable wealth maximization, which is the ultimate objective of business.

2013 - June [2] (a), (c)

(a) (i) To find Alfa Ltd's cost of equity :-

$$\text{cost of equity} = K(e) = \frac{D_1}{P_0} + g$$

Where;

D_1 - Dividend paid at the end of year 1

P_0 - Current market price of share

g - Growth rate

$$\text{Total Earnings} = \frac{6}{37.5\%} = 16$$

EPS = ₹ 16

DPS = 62.5% × 16 = 10

Retained Earnings = 37.5% × 16 = 6

$$P/E = \frac{MPS}{EPS}$$

Where;

MPS = Market Price per share

EPS = Earning per Share

$$\text{Since } P/E = 7.5 = \frac{MPS}{16}$$

MPS = 7.5 × 16 = 120

Thus, $D_1 = D_0 + g = 10 + 8\% = 10.8$

$$\text{So } \frac{D_1}{P_0} + g = \frac{10.8}{120} + 8\% = 17\%$$

(ii) If growth rate is 10% p a, Compute MPS

$$K(e) = 17\%$$

$$D_1 = 10.0 + 10\% = 11$$

$$P_0 = ?$$

$$g = 10\%$$

So,

$$P_0 = \frac{D_1}{k_e - g} = \frac{10.0 + 10\%}{.17 - .10} = \frac{11}{0.07} = 157.14$$

Hence, market price of the share is ₹ 157.14

(iii) $k/e = 15\%$

$$g = 11\%$$

$$MPS = ?$$

$$D_1 = 10.0 + 11\% = 11.10$$

$$P_0 = \frac{D_1}{k_e - g} = \frac{11.10}{0.15 - 0.11} = \frac{11}{.04} = 277.50$$

(c)(i) Following is the balance sheet of Honey well Ltd as on...

$$\text{Operating Leverage} = \frac{\text{Contribution}}{\text{EBIT}}$$

$$\text{Finance Leverage} = \frac{\text{EBIT}}{\text{EBT}}$$

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBT}}$$

or

operating leverage × finance leverage

Total Asset Turnover Ratio = 2.5

$$\frac{\text{Turnover}}{\text{Total Asset}} = 2.5$$

Given,

$$\text{Total Asset} = 6,00,000$$

So,

$$\begin{aligned} \text{Turnover} &= 2.5 \times 6,00,000 \\ &= 15,00,000 \end{aligned}$$

Sales	15,00,000
Less:- Variable Cost (40%)	6,00,000
Contribution	9,00,000

Less:- Fixed Cost	2,00,000
EBIT	7,00,000
Less:- Interest	24,000
EBT	6,76,000
Less:- Tax @30%	2,02,800
PAT	4,73,200

→ Operating Leverage (OL) = $\frac{9,00,000}{7,00,000} = 1.29$

→ Financial Leverage (FL) = $\frac{7,00,000}{6,76,000} = 1.04$

→ Combined Leverage (CL) = O L × FL
 = 1.29 × 1.04
 = 1.33

(ii) If EPS = 6, EBIT- ?

Total Earnings for shareholders
 = No. of shares × EPS
 = 18,000 × 6
 = 1,08,000
 Let us assume EBT be x
 Tax Rate @ 30% = 0.30 x

Hence,

$x - 0.30 x = 1,08,000$
 $.70 x = 1,08,000$
 $x = 15,42,86$

So, EBIT = 1,54,286 + 20,000 = 1,78,286

2013 - June [3](b) (i), (ii)

(i)

Particulars	Issue of Shares	Issue of Debt @ 15%	Issue of Preference Shares @ 12%
EBIT	15,00,00,000	15,00,00,000	15,00,00,000
Less: Int. @ 15%	-	4,50,00,000	-
EBT	15,00,00,000	10,50,00,000	15,00,00,000
Less, tax @ 30%	4,50,00,000	3,15,00,000	4,50,00,000
PAT	10,50,00,000	7,35,00,000	10,50,00,000

Less:- Preference Dividend	-	-	3,60,00,000 [12% of 30 Crores]
Profit available to equity Shareholders	10,50,00,000	7,35,00,000	6,90,00,000
Number of equity shares	90,00,000	60,00,000	60,00,000
EPS	11.667	12.25	11.50

Since, EPS is highest (₹ 12.25 per share) in case of debt issue, the company should go in for that Option.

(ii) Let EBIT be x

Under Debt:-

EBIT → x

Less: **Interest** → 4,50,00,000

EBT → x - 4,50,00,000

Less: Tax @ 30% → 0.30 (x - 4,50,00,000)

PAT → 0.70 (x - 4,50,00,000)

No. of Shares → 60,00,000

So, EPS = $\frac{0.70(x-4,50,00,000)}{60,00,000}$ -----(i)

Under Equity :-

EBIT → x

(-) Int → NIL

EBT → x

(-) Tax = 0.3 x

PAT = 0.7 x

No. of share → 90,00,000

So,

EPS = $\frac{0.7x}{90,00,000}$ ----- (2)

Equating (1) & (2) , we get:-

$$\frac{0.7x-3,15,00,000}{60,00,000} = \frac{0.7x}{90,00,000}$$

$$x = 13,50,00,000$$

Thus, at ₹ 13.50 crores EBIT, there will be an equivalency level.

Chapter - 4: Sources of Finance

2013 - June [7] (v)

- The section that deals with sweat equity share is Section 79 A of Companies Act 1956.

- Sweat equity shares are those shares which are issued by the company to employees or directors at a discount or for consideration other than cash, for providing know how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.
- These shares are specially issued to the employees or directors only.
- Sweat equity shares are issued if the following conditions are satisfied:
 - Special resolution is passed
 - Resolution specifies the number of shares, current market price, consideration if any, and the class or classes of directors or employees to whom such equity shares are to be issued.
 - Atleast one year has passed since commencement of business.
 - Issued in accordance with regulation made by SEBI

Chapter - 5: Dividend Policy

2013 - June [5] (a) (i), (ii)

(i) As per Miller-Modigliani dividend Model:-

$$P_0 = \frac{D_1 + P_1}{1 + K(e)}$$

Where:-

P_0 = Current Market Price

D_1 = Dividend in year 1

P_1 = Price at the end of year 1

$K(e)$ = Capitalisation rate

(i) Given,

$$P_0 = 100$$

$$D_1 = \frac{4,00,000}{1,00,000} = 4$$

$$K(e) = 14\%$$

$$100 = \frac{4 + x}{1 + 0.14}$$

$$114 = 4 + x$$

$$x = 110$$

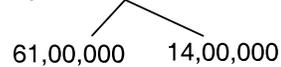
$$\text{So, } P_1 = ₹ 110$$

$$\text{Expected Income} \Rightarrow ₹ 65,00,000$$

$$\text{Less:- Dividend} \Rightarrow \quad \underline{4,00,000}$$

$$\text{Amount available} \Rightarrow \quad 61,00,000$$

Amount required by new project ₹ 75,00,000



$$\text{Number of shares} \Rightarrow \frac{14,00,000}{110} = 12,727.27$$

Thus, 12,728 shares need to be issued

(ii) When no dividend is paid:-

$$P_0 = ₹ 100$$

$$D_1 = 0$$

$$P_1 = ?$$

$$K(e) = 14\%$$

$$P_1 = 100 \times 1.14 = 114$$

$$\text{Less Dividend} = 0$$

$$\text{So, } P_1 = 114$$

$$\text{Expected Income} = 65,00,000$$

$$\text{Less:- Dividend} = \text{Nil}$$

$$\text{Income Available} = 65,00,000$$

$$\text{Amount required for new project} = 75,00,000$$

$$\text{Less:- Income Available} = 65,00,000$$

$$\text{Amount Required} = 10,00,000$$

$$\text{Price at the end of year 1 (or } P_1) = 114$$

$$\text{So, } \frac{10,00,000}{114} = 8,771.93$$

Hence, a total of 8,772 shares need to be issued.

Chapter - 6: Working Capital Management and Control

2013 - June [2] (b)

A company believes that it is possible -

	Current	Proposal	Increment
Sales	10,00,000	12,00,000	2,00,000
(-) Variable cost (70%)	7,00,000	8,40,000	1,40,000
Contribution	3,00,000	3,60,000	60,000
Less:- (-) fixed cost	(50,000)	50,000	-
(-) Bad debts	(10,000)	(24000)	14,000

(-)Cost of investment in debtors 20% of $\left[\frac{7,00,000 + 50,000}{10} \right]$	15,000		
20% of $\left[\frac{8,40,000 + 50,000}{6} \right]$		29,666	14,666
Income	2,25,000	2,56,334	31,334

'The proposed change in policy results in an incremental income of ₹ 31,334 and hence the same should be implemented.

2013 - June [3] (a)

Number of boxes required in 3 months ⇒ 125

Hence,

- ⇒ Number of boxes required in 1 year = $125 \times 4 = 500$ boxes
- ⇒ Cost per box = ₹ 125
- ⇒ Ordering cost = ₹ 250 per order
- ⇒ Carrying cost = 20% = ₹ 25

(i) Total Annual Cost = Purchase cost + Ordering cost + Carrying Cost

So,

$$62,500 + [250 \times 4] + \frac{1}{2} \times 125 \times 25 = 65,062.50$$

(ii) If EOQ (Economic order quantity) is placed:-

$$EOQ = \sqrt{\frac{2 \times A \times B}{C}}$$

Where;

A = Annual Requirement/Demand

B = Ordering Cost

C = Carrying Cost

$$= \sqrt{\frac{2 \times 500 \times 250}{25}} = 100 \text{ units}$$

Total cost under EOQ = Purchase price + Ordering cost + Carrying cost

$$= 62,500 + \left[\frac{500}{100} \times 250 \right] + \left[\frac{1}{2} \times 100 \times 25 \right]$$

$$= 65,000$$

Saving on account of EOQ = $65,062.50 - 65,000 = 62.50$

2013 - June [6]

(i) Computation of networking capital:

Raw Material W. No.1	6,40,000
Work in Progress-W. I. P. W. No. 2	5,00,000
Finished Goods W. No. 3	13,60,000
Debtors W. No.4	25,10,769
Cash	25,000
Total current assets	50,35,769
Less:-	
Raw Material Creditors W. No. 5	7,13,846
Wage Creditors W. No. 6	91,731
Net working Capital	42,30,192

Working Notes:

W. No.1

Raw Material:-

$$2,000 \times 4 \times 80 = 6,40,000$$

W. No. 2

Work in Progress:

Raw Material + 50% of wages +50% of Over heads

$$= [4,000 \times 80] + [4,000 \times 30 \times 50\%] + [4,000 \times 60 \times 50\%]$$

$$= 5,00,000$$

W. No. 3

Finished Goods:

$$8000 \times 170 = 13,60,000$$

W. No.4_

Debtors :

$$[1,04,000 - 8,000] \times 170 \times \frac{8}{52}$$

$$= 25,10,769$$

W. No. 5

Raw Material Creditors :-

$$[1,04,000 \times 80 + 4,000 \times 80 + 2,000 \times 4 \times 80] \times \frac{4}{52} = 7,13,846$$

W. No. 6

Wages Creditors:

$$[1,04,000 \times 30 + 4,000 \times 30 \times 50\%] \times \frac{1.5}{52} = 91,731$$

(ii) M P B F - as per Tandon Committee 75 % of Current Asset (-) Current Liabilities
 75 % of 50,35,769 - 8,05,577
 = **29,71,251**

Chapter - 7: Security Analysis and Portfolio Management

2013 - June [4] (iv)

Efficient Portfolio	Optimal Portfolio
1. Efficient portfolio is the one which provides us maximum return at minimum risk level.	Optimal portfolio is that efficient portfolio which suits the requirement of an individual investor
2. It reflects all sets of possible combination as represented by Capital Market Line (CML)	It is a subset selected from those combination by an individual according to his risk- return expectations.

Chapter - 8: Financial Services

2013 - June [1] {C} (v)

- ⇒ It is true to say that depository systems functions quite similar to banks.
- ⇒ The similar features between depository system and banking system are:-
 - Both holds funds / securities for its clients.
 - Provide the service of transfer of funds / securities for its clients.
 - Both provide secured transactions to its clients.

2013 - June [7] (I)

- Factoring refers to an arrangement whereby account receivables arising due to sale of goods and services are sold by the client to a financial intermediary called 'factor' who performs the function of administering and collecting the receivables.
- In return for the services provided, the factor charges a fee based on specific percentage (mutually decided) of the total value of receivables.
- It is an alternate to in house management of receivables.
- Various services provided by the factor:-
 - Administration of sales ledger
 - Arrangement of collection of accounts receivable
- **Mechanics of factoring:-**
 - Client / seller sends invoices to customer
 - Client enters into an arrangement with the factor
 - Client notifies the customers that the invoice is assigned to and must be paid to factor
 - Factor maintains the sales ledger.
 - He follows up with the customer for realisation of payments

- He sends periodic statement to the client and receives his agreed upon share of fees for the services so provided.

Chapter - 9: Project Planning and Control

2013 - June [7] (iv)

- ⇒ While evaluating any project using social cost benefit analysis (SCBA), economic rate of return (ERR) is deployed.
- ⇒ As against this, while making economic appraisal of any project Internal Exchange Rate (IER) is made use of.
- ⇒ Economic rate of return equates real economic cost to its economic benefits during the project life time.
- ⇒ Thus, economic rate of return acts as an important tool to evaluate and select the project.
- ⇒ ERR is based on shadow prices which depicts real cost of inputs & real benefits of output to the society.

Chapter - 10: Derivatives and Commodity Exchanges

2013 - June [4] (iii)

Currency Swap:

- Currency swap are entered in case the parties want to exchange same amount, however in different currencies.
- The concept of currency swap is based on the fact that many a times there is a comparative advantage in borrowing home currency and thus the parties may swap currencies between them so as to avail benefits.

Currency Option:

- Currency option as against currency swap is a derivate financial instrument that gives the owner the right but not the obligation to exchange money denominated in one currency into another currency at pre agreed exchange rate during a specified period of time.

2013 - June [5] (b) (i), (ii)

- (i) Number of future contracts to be sold:-

$$\frac{1200 \times 250 \times 0.5}{4,00,000} = 0.375$$

- (ii) Loss of shares (since spot market has gone down by 10%)

$$= 1200 \times 250 \times 10 \% = 30,000$$

Gain on Nifty in such a case will be twice:-

$$4,000 \times 100 \times 0.375 \times 20\% = 30,000$$

Thus, Mr. X is enjoying a fully hedged position.

Chapter - 11: Treasury Management

2013 - June [1] {C} (iii)

Treasury management is the science of managing treasury operations of a firm. The main function of treasury management is the management of funds. Treasury management has both macro and micro aspects. Treasury management is different from financial management.

Some of the tools of treasury management are as follows:-

- (i) **Zero Base Budgeting:** It is a method of budgeting which requires each cost element to be specifically justified. It requires each budget to be prepared & justified from zero, instead of simply using last year's budget as base.
- (ii) **Financial Statement Analysis:** Financial statement analysis helps to know the soundness & intrinsic worth of the company. It plays an important role in deciding whether to invest in the company or not to invest in the company.
- (iii) **Analytic & planning tools:**
 - Analytic & planning tools are necessary for planning & budgeting.
 - Planning & budgeting are important to achieve the targets of treasury function.

Some of the differences between 'Treasury management' & 'financial management' are as follows:-

- (i) Treasury management is concerned with monitoring the income & expense budgets on a periodic basis while financial management is concerned with the preparation of profit and loss account and the balance sheet.
- (ii) Net current assets of the firm are dealt by the treasury manager whereas the finance manager deals with the creation of fixed assets.
- (iii) Treasury management is mainly short term in nature while financial management is mainly long- term in nature.
- (iv) Treasury management is involved in internal audit but external audit is dealt by financial management.
- (v) Treasury manager is concerned with short term investments but financial manager is concerned with long - term investments.

Chapter - 12: Forex Management

2013 - June [4] (ii), (v)

- (ii) 1. The term 'netting' is used for that general protection measure employed in context of mitigating foreign exchange risk whereby only net amount of receipts and payment between holding and subsidiary should be given effect to.
2. Netting may thus serve as a general protection measure to hedge against foreign exchange risk.
3. Netting can be of two types:
 - (a) Bilateral Netting
 - (b) Multilateral Netting

- (4) Bilateral Netting: As the name suggest, bilateral netting refers to that netting which involves two parties i.e. netting between two companies, mostly between holding and its subsidiary.
- (5) Multilateral netting: The netting which involves more than two parties is known as multilateral netting.
- (v) **Interest rate parity:** According to this parity the high interest rate on a currency is offset by forward discount and low interest rate is offset by forward premium. In other words, it states that difference in interest rates between two countries is equal to the difference between the forward and spot exchange rates.

Purchasing power parity: This approach states that the exchange rate between the currencies of two countries equals the ratio between the prices of goods in these countries, further the exchange rate must change to adjust to change in prices of goods. Thus purchasing power parity states that exchange rate between countries will adjust to change in inflation rates.

2013 - June [5] (c)

- (A) Convert U \$ 1 crore into ₹ (at spot rate of ₹ 48.30)

$$\text{So, } 1,00,00,000 \times 48.30 = 48,30,00,000$$

- (B) Converting the amount of ₹ 48,30,00,000 into GBP (@ 77.52)

$$\text{So, } \frac{48,30,00,000}{77.52} = 62,30,650.16$$

- (C) Converting the amount of GBP 62,30,650.16 into US (at the rate of 1.6231)

$$62,30,650.16 \times 1.6231 = 1,01,12,968$$

Thus,

Gain on arbitrage :-

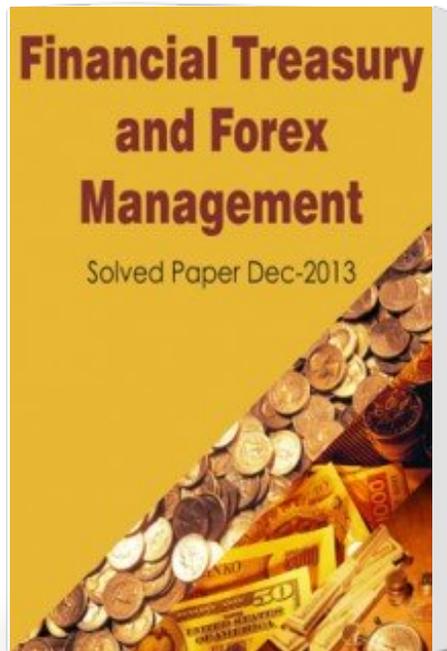
$$\begin{array}{r} 1,01,12,968 \\ (-) \underline{1,00,00,000} \\ \hline 1,12,968 \end{array}$$

Hence, arbitrage will result in a gain of US \$ 1,12, 968

2013 - June [7] (ii), (iii)

- (ii) – There are three different kinds of foreign currency exposures namely:
 - Translation exposure
 - Transaction exposure
 - Economic exposure.
- **Translation exposure:**
 - As the name suggests translation exposure measures the impact of variation in exchange rate on account of translation i.e. in relation to reporting in the financial statement of business enterprise.
 - Translation exposure is merely paper based gain or loss.
 - This is short term in nature.

ICSI Financial Treasury and Forex Management Solved Question Paper 2013



Publisher : Faculty Notes

Author :

Type the URL : <http://www.kopykitab.com/product/3107>



Get this eBook