



Chapter 1

Scope & Objectives of Financial Management

Question 1

STATE Agency Cost. DISCUSS The Ways to Reduce the Effect of It. (MTP 4 Marks, Aug'18)

OR

DISCUSS Agency Problem and Agency Cost. [MTP 4 Marks, Oct'20, MTP 4 Marks March '23, MTP 4 Marks Apr'21, MTP 5 Marks April '23, RTP Nov 20, May'22 & Nov '23]

Answer 1

Agency Cost: In a sole proprietorship firm, partnership etc., owners participate in management but in corporate, owners are not active in management so, there is a separation between owner/ shareholders and managers. In theory managers should act in the best interest of shareholders however in reality, managers may try to maximize their individual goal like salary, perks etc., so there is a principal-agent relationship between managers and owners, which is known as Agency Problem. In a nutshell, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost. Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behavior so as to maximize shareholder's wealth. Generally, Agency Costs are of four types (i) monitoring (ii) bonding (iii) opportunity (iv) structuring

Addressing the agency problem

The agency problem arises if manager's interests are not aligned to the interests of the debt lender and equity investors. The agency problem of debt lender would be addressed by imposing negative covenants i.e. the managers cannot borrow beyond a point. This is one of the most important concepts of modern day finance and the application of this would be applied in the Credit Risk Management of Bank, Fund Raising, Valuing distressed companies.

Agency problem between the managers and shareholders can be addressed if the interests of the managers are aligned to the interests of the shareholders. It is easier said than done.

However, following efforts have been made to address these issues:

- (A) Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.
- (B) Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.
- (C) Effecting monitoring can be done.

Question 2

EXPLAIN as to how the wealth maximization objective is superior to the profit maximization objective What is the cost of these sources? [MTP 4 Marks, March'19]

Answer 2

A firm's financial management may often have the following as their objectives:

- (i) The maximization of firm's profit.
- (ii) The maximization of firm's value / wealth.

The maximization of profit is often considered as an implied objective of a firm. To achieve the aforesaid objective various type of financing decisions may be taken. Options resulting into maximization of profit may be selected by the firm's decision makers. They even sometime may adopt policies yielding exorbitant profits in short run which may prove to be unhealthy for the growth, survival and overall interests of the firm. The profit of the firm in this case is measured in terms of its total accounting profit available to its shareholders.

The value/wealth of a firm is defined as the market price of the firm's stock. The market price of a firm's stock



represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock.

The value maximization objective of a firm is superior to its profit maximization objective due to following reasons.

1. The value maximization objective of a firm considers all future cash flows, dividends, earning per share, risk of a decision etc. whereas profit maximization objective does not consider the effect of EPS, dividend paid or any other returns to shareholders or the wealth of the shareholder.
2. A firm that wishes to maximize the shareholder's wealth may pay regular dividends whereas a firm with the objective of profit maximization may refrain from dividend payment to its shareholders.
3. Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.
4. The market price of a share reflects the shareholders expected return, considering the long- term prospects of the firm, reflects the differences in timings of the returns, considers risk and recognizes the importance of distribution of returns.

The maximization of a firm's value as reflected in the market price of a share is viewed as a proper goal of a firm. The profit maximization can be considered as a part of the wealth maximization strategy.

Question 3

DISCUSS the Inter relationship between investment, financing and dividend decisions. (MTP 4 Marks, Oct'19)

OR

DISCUSS the three major decisions taken by a finance manager to maximize the wealth of shareholders. (MTP 4 Marks, Oct'18)

OR

BRIEFLY explain the three finance function decisions. [MTP 4 Marks, Oct'21, RTP Nov '19, RTP May'19, PYP 3 Marks Nov'19]

OR

What are the two main aspects of the Finance Function? (PYP 2 Marks, May '18, Old & New SM)

Answer 3

Inter-relationship between Investment, Financing and Dividend Decisions: The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. It is correct to say that these decisions are inter-related because the underlying objective of these three decisions is the same, i.e. maximization of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one has to consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their inter-relationship and to see how they can help in maximizing the shareholders' wealth i.e. market price of the company's shares.

Investment decision: The investment of long term funds is made after a careful assessment of the various projects through capital budgeting and uncertainty analysis. However, only that investment proposal is to be accepted which is expected to yield at least so much return as is adequate to meet its cost of financing. This have an influence on the profitability of the company and ultimately on its wealth.

Financing decision: Funds can be raised from various sources. Each source of funds involves different issues. The finance manager has to maintain a proper balance between long-term and short-term funds. With the total volume of long-term funds, he has to ensure a proper mix of loan funds and owner's funds. The optimum financing mix will increase return to equity shareholders and thus maximize their wealth.

Dividend decision: The finance manager is also concerned with the decision to pay or declare dividend. He



assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximizes shareholders' wealth.

The above discussion makes it clear that investment, financing and dividend decisions are interrelated and are to be taken jointly keeping in view their joint effect on the shareholders' wealth.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

This was a theoretical question based on explanation of three finance functions decision. Only a handful number of examinees attempted the question, but performance observed was above average.

Question 4

DISCUSS the advantages and disadvantages of Wealth maximization principle. (MTP 4 Marks, March'21, PYP 2 Marks May'22)

Answer 4

Advantages and disadvantages of Wealth maximization principle.

Advantages:

- (i) Emphasizes the long term gains
- (ii) Recognizes risk or uncertainty
- (iii) Recognizes the timing of returns
- (iv) Considers shareholders' return.

Disadvantages:

- (i) Offers no clear relationship between financial decisions and share price.
- (ii) Can lead to management anxiety and frustration.

Question 5

WRITE two main objectives of Financial Management. [MTP 2 Marks, Oct'21, PYP 2 Marks Nov '18]

Answer 5

Two main objectives of Financial Management

Profit Maximization

It has traditionally been argued that the primary objective of a company is to earn profit; hence the objective of financial management is also profit maximization. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximized. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit.

Wealth / Value Maximization

We will first like to define what is Wealth / Value Maximization Model. Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money.

So, $\text{Wealth} = \text{Present Value of benefits} - \text{Present Value of Costs}$

It is important that benefits measured by the finance manager are in terms of cash flow. Finance manager should emphasis on Cash flow for investment or financing decisions not on Accounting profit. The shareholder value maximization model holds that the primary goal of the firm is to maximize its market value and implies that business decisions should seek to increase the net present value of the economic profits of the firm.

Question 6

A finance executive of an organisation plays an important role in the company's goals, policies, and financial success. WHAT his responsibilities include? (MTP 4 Marks Sep'22)

Answer 6

A finance executive of an organisation plays an important role in the company's goals,policies, and financial success. His responsibilities include:

- (i) **Financial analysis and planning:** Determining the proper amount of funds to employ in the firm, i.e. designating



the size of the firm and its rate of growth.

- (ii) **Investment decisions:** The efficient allocation of funds to specific assets.
- (iii) **Financing and capital structure decisions:** Raising funds on favourable terms as possible i.e. determining the composition of liabilities.
- (iv) **Management of financial resources** (such as working capital).
- (v) **Risk management:** Protecting assets.

Question 7

EXPLAIN Financial Distress and explain its relationship with Insolvency. (MTP 4 Marks, March'18)

OR

'Financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.' Based on above mentioned context, **EXPLAIN Financial Distress along with Insolvency. [MTP 4 Marks March 22]**

Answer 7

There are various factors like price of the product/ service, demand, price of inputs e.g. raw material, Labour etc., which is to be managed by an organization on a continuous basis. Proportion of debt also needs to be managed by an organization very delicately. Higher debt requires higher interest and if the cash inflow is not sufficient then it will put lot of pressure to the organization. Both short term and long term creditors will put stress to the firm. If all the above factors are not well managed by the firm, it can create situation known as distress, so financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.

Now if distress continues for a long period of time, firm may have to sell its asset, even many times at a lower price. Further when revenue is inadequate to revive the situation, firm will not be able to meet its obligations and become insolvent. So, insolvency basically means inability of a firm to repay various debts and is a result of continuous financial distress.

Question 8

DISTINGUISH between Profit maximisation vis-a-vis wealth maximization. (MTP 5 Marks April '23)

OR

'Profit maximisation is not the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems can arise.' **DISCUSS** four of such problems. (RTP May 22, RTP May 21)

OR

EXPLAIN "Wealth maximisation" and "Profit maximisation" objectives of financial management (Old & New SM)

Answer 8

It has traditionally been argued that the primary objective of a company is to earn profit; hence the objective of financial management is also profit maximisation. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit.

However, profit maximisation cannot be the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems can arise. Some of these have been discussed below:

- (i) The term profit is vague. It does not clarify what exactly it means. It conveys a different meaning to different people. For example, profit may be in short term or long term period; it may be total profit or rate of profit etc.
- (ii) Profit maximisation has to be attempted with a realisation of risks involved. There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher



is the possibility of profits. If profit maximisation is the only goal, then risk factor is altogether ignored. This implies that finance manager will accept highly risky proposals also, if they give high profits. In practice, however, risk is very important consideration and has to be balanced with the profit objective.

- (iii) Profit maximisation as an objective does not take into account the time pattern of returns. Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns of proposal A begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.
- (iv) Profit maximisation as an objective is too narrow. It fails to take into account the social considerations as also the obligations to various interests of workers, consumers, society, as well as ethical trade practices. If these factors are ignored, a company cannot survive for long. Profit maximization at the cost of social and moral obligations is a short sighted policy.

Wealth / Value Maximisation

We will first like to define what is Wealth / Value Maximization Model. Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money.

So, It is important that benefits measured by the finance manager are in terms of cash flow. Finance manager should emphasis on Cash flow for investment or financing decisions not on Accounting profit. The shareholder value maximization model holds that the primary goal of the firm is to maximize its market value and implies that business decisions should seek to increase the net present value of the economic profits of the firm. So for measuring and maximising shareholders wealth finance manager should follow:

- A) Cash Flow approach not Accounting Profit
- B) Cost benefit analysis
- C) Application of time value of money.

How do we measure the value/wealth of a firm?

According to Van Horne, "Value of a firm is represented by the market price of the company's common stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock. The market price serves as a performance index or report card of the firm's progress. It indicates how well management is doing on behalf of stockholder's".

Why Wealth Maximization Works? Before we answer this question it is important to first understand and know what other goals a business enterprise may have. Some of the other goals a business enterprise may follow are:-

- A) Achieving a higher growth rate
- B) Attaining a larger market share
- C) Gaining leadership in the market in terms of products and technology
- D) Promoting employee welfare
- E) Increasing customer satisfaction
- F) Improving community life, supporting education and research, solving societal problems, etc.

Though, the above goals are important but the primary goal remains to be wealth maximization, as it is critical for the very existence of the business enterprise. If this goal is not met, public/institutions would lose confidence in the enterprise and will not invest further in the growth of the organization. If the growth of the



organization is restricted than the other goals like community welfare will not get fulfilled.

Conflicts in Profit vs. Value maximisation principle

In any company, the management is the decision taking authority. As a normal tendency the management may pursue its own personal goals (profit maximization). But in an organization where there is a significant outside participation (shareholding, lenders etc.), the management may not be able to exclusively pursue its personal goals due to the constant supervision of the various stakeholders of the company-employees, creditors, customers, government, etc.

Every entity associated with the company will evaluate the performance of the management from the fulfilment of its own objective. The survival of the management will be threatened if the objective of any of the entities remains unfulfilled.

The wealth maximization objective is generally in accord with the interests of the various groups such as owners, employees, creditors and society, and thus, it may be consistent with the management objective of survival.

Owing to limitation (timing, social consideration etc.) in profit maximization, in today's real world situations which is uncertain and multi-period in nature, wealth maximization is a better objective. Where the time period is short and degree of uncertainty is not great, wealth maximization and profit maximization amount to essentially the same.

The table below highlights some of the advantages and disadvantages of both profit maximization and wealth maximization goals:-

| Goal | Objective | Advantages | Disadvantages |
|----------------------------------|---------------------------------|---|--|
| Profit Maximization | Large amount of profits | (i) Easy to calculate profits (ii) Easy to determine the link between financial decisions and profits. | (i) Emphasizes the short term gains (ii) Ignores risk or uncertainty (iii) Ignores the timing of returns (iv) Requires immediate resources. |
| Shareholders Wealth Maximisation | Highest market value of shares. | (i) Emphasizes the long term gains (ii) Recognises risk or uncertainty (iii) Recognises the timing of returns (iv) Considers shareholders' return. | (i) Offers no clear relationship between financial decisions and share price. (ii) Can lead to management anxiety and frustration. |

Example: Profit maximization can be achieved in the short term at the expense of the long term goal, that is, wealth maximization. For example, a costly investment may experience losses in the short term but yield substantial profits in the long term. Also, a firm that wants to show a short term profit may, for example, postpone major repairs or replacement, although such postponement is likely to hurt its long term profitability.

Question 9

"The profit maximization is not an operationally feasible criterion. DISCUSS (RTP May '18, Nov '18 & May'20)

Answer 9



“The profit maximization is not an operationally feasible criterion.” This statement is true because Profit maximization can be a short-term objective for any organization and cannot be its sole objective. Profit maximization fails to serve as an operational criterion for maximizing the owner's economic welfare. It fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency. It suffers from the following limitations:

- (a) **Vague term:** The definition of the term profit is ambiguous. Does it mean short term or long term profit? Does it refer to profit before or after tax? Total profit or profit per share?
- (b) **Timing of Return:** The profit maximization objective does not make distinction between returns received in different time periods. It gives no consideration to the time value of money, and values benefits received today and benefits received after a period as the same.
- (c) It ignores the risk factor.
- (d) The term maximization is also vague

Question 10

Functions of Finance Manager. (RTP May '19)

Answer 10

Functions of Finance Manager

The Finance Manager's main objective is to manage funds in such a way so as to ensure their optimum utilization and their procurement in a manner that the risk, cost and control considerations are properly balanced in a given situation. To achieve these objectives the Finance Manager performs the following functions:

- (i) **Estimating the requirement of Funds:** Both for long-term purposes i.e. investment in fixed assets and for short-term i.e. for working capital. Forecasting the requirements of funds involves the use of techniques of budgetary control and long-range planning.
- (ii) **Decision regarding Capital Structure:** Once the requirement of funds has been estimated, a decision regarding various sources from which these funds would be raised has to be taken. A proper balance has to be made between the loan funds and own funds. He has to ensure that he raises sufficient long term funds to finance fixed assets and other long term investments and to provide for the needs of working capital.
- (iii) **Investment Decision:** The investment of funds, in a project has to be made after careful assessment of various projects through capital budgeting. Assets management policies are to be laid down regarding various items of current assets. For e.g. receivable in coordination with sales manager, inventory in coordination with production manager.
- (iv) **Dividend decision:** The finance manager is concerned with the decision as to how much to retain and what portion to pay as dividend depending on the company's policy. Trend of earnings, trend of share market prices, requirement of funds for future growth, cash flow situation etc., are to be considered.
- (v) **Evaluating financial performance:** A finance manager has to constantly review the financial performance of the various units of organisation generally in terms of ROI Such a review helps the management in seeing how the funds have been utilised in various divisions and what can be done to improve it.
- (vi) **Financial negotiation:** The finance manager plays a very important role in carrying out negotiations with the financial institutions, banks and public depositors for raising of funds on favourable terms.
- (vii) **Cash management:** The finance manager lays down the cash management and cash disbursement policies with a view to supply adequate funds to all units of organisation and to ensure that there is no excessive cash.
- (viii) **Keeping touch with stock exchange:** Finance manager is required to analyse major trends in stock market and their impact on the price of the company share.

Question 11



DISCUSS the points that demonstrates the Importance of good financial management. (RTP Nov '21, PYP 4 Marks Jan'21)

Answer 11

Points that demonstrate the "Importance of good financial management":

- **Taking care** not to over-invest in fixed assets
- **Balancing** cash-outflow with cash-inflows
- **Ensuring** that there is a sufficient level of short-term working capital
- **Setting sales** revenue targets that will deliver growth
- **Increasing gross** profit by setting the correct pricing for products or services
- **Controlling** the level of general and administrative expenses by finding more cost-efficient ways of running the day-to-day business operations, and
- **Tax planning** that will minimize the taxes a business has to pay.

Question 12

List out the steps to be followed by the manager to measure and maximize the Shareholder's Wealth? (PYP 2 Marks, July'21)

Answer 12

For measuring and maximizing shareholders' wealth, manager should follow:

- Cash Flow approach not Accounting Profit
- Cost benefit analysis
- Application of time value of money.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

This theoretical question required the examinees to list out the steps to measure and maximize shareholder's wealth. Very few examinees attempted the question and below average performance was observed.

Question 13

List out the role of Chief Financial Officer in today's World. (PYP 4 Marks, Nov'20)

OR

What are the roles of Finance Executive in Modern World? (PYP 2 Marks, May'18)

Answer 13

Role of Chief Financial Officer (CFO) in Today's World: Today, the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the chief executive officer, or CEO. Some of the role of a CFO in today's world are as follows-

- Budgeting
- Forecasting
- Managing M&As
- Profitability analysis (for example, by customer or product)
- Pricing analysis
- Decisions about outsourcing
- Overseeing the IT function.
- Overseeing the HR function.
- Strategic planning (sometimes overseeing this function).
- Regulatory compliance.
- Risk management



Question 14

Explain in brief the phases of the evolution of financial management. (PYP 2 Marks Dec '21)

Answer 14

Evolution of Financial Management: Financial management evolved gradually over the past 50 years. The evolution of financial management is divided into three phases. Financial Management evolved as a separate field of study at the beginning of the century.

The three stages of its evolution are:

The Traditional Phase: During this phase, financial management was considered necessary only during occasional events such as takeovers, mergers, expansion, liquidation, etc. Also, when taking financial decisions in the organization, the needs of outsiders (investment bankers, people who lend money to the business and other such people) to the business was kept in mind.

The Transitional Phase: During this phase, the day-to-day problems that financial managers faced were given importance. The general problems related to funds analysis, planning and control were given more attention in this phase.

The Modern Phase: Modern phase is still going on. The scope of financial management has greatly increased now. It is important to carry out financial analysis for a company. This analysis helps in decision making. During this phase, many theories have been developed regarding efficient markets, capital budgeting, option pricing, valuation models and also in several other important fields in financial management. Here, financial management is viewed as a supportive and facilitative function, not only for top management but for all levels of management.





Chapter 2

Types of Financing

Question 1

EXPLAIN the importance of trade credit and accruals as source of short-term finance. DISCUSS the cost of these sources?. (MTP 4 Marks, Aug'18)

Answer 1

Trade credit and accruals as source of short-term finance like working capital refers to credit facility given by suppliers of goods during the normal course of trade. It is a short term source of finance. Micro small and medium enterprises (MSMEs) in particular are heavily dependent on this source for financing their working capital needs. The major advantages of trade credit are easy availability, flexibility and informality.

There can be an argument that trade credit is a cost free source of finance. But it is not. It involves implicit cost. The supplier extending trade credit incurs cost in the form of opportunity cost of funds invested in trade receivables. Generally, the supplier passes on these costs to the buyer by increasing the price of the goods or alternatively by not extending cash discount facility.

Question 2

DESCRIBE Bridge Finance. (MTP 4 Marks, April'19)

OR

Briefly DESCRIBE bridge finance. [MTP 2 Marks, Nov'21, RTP May '18]

Answer 2

Bridge finance refers, normally, to loans taken by the business, usually from commercial banks for a short period, pending disbursement of term loans by financial institutions, normally it takes time for the financial institution to finalize procedures of creation of security, tie-up participation with other institutions etc. even though a positive appraisal of the project has been made. However, once the loans are approved in principle, firms in order not to lose further time in starting their projects arrange for bridge finance. Such temporary loan is normally repaid out of the proceeds of the principal term loans. It is secured by hypothecation of moveable assets, personal guarantees and demand promissory notes. Generally, rate of interest on bridge finance is higher as compared with that on term loans.

Question 3

EXPLAIN the limitations of Leasing? (MTP 4 Marks, April'19, PYP 2 Marks, May '19)

Answer 3

Limitations are:

The lease rentals become payable soon after the acquisition of assets and no moratorium period is permissible as in case of term loans from financial institutions. The lease arrangement may, therefore, not be suitable for setting up of the new projects as it would entail cash outflows even before the project comes into operation.

- 1) The leased assets are purchased by the lessor who is the owner of equipment. The seller's warranties for satisfactory operation of the leased assets may sometimes not be available to lessee.
- 2) Lessor generally obtains credit facilities from banks etc. to purchase the leased equipment which are subject to hypothecation charge in favor of the bank. Default in payment by the lessor may sometimes result in seizure of assets by banks causing loss to the lessee.
- 3) Lease financing has a very high cost of interest as compared to interest charged on term loans by financial institutions/banks.

Despite all these disadvantages, the flexibility and simplicity offered by lease finance is bound to make it popular. Lease operations will find increasing use in the near future.

Question 4

What is debt securitization? EXPLAIN the basics of debt securitization process. (MTP 4 Marks, Oct'19 & March '23, RTP May '19, RTP May '20, PYP 4 Marks, May '19, RTP May'23)

Answer 4

Debt Securitization: It is a method of recycling of funds. It is especially beneficial to financial intermediaries



to support the lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued, e.g. housing finance, auto loans, and credit card receivables.

Process of Debt Securitization

- (i) **The origination function** – A borrower seeks a loan from a finance company, bank, HDFC. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.
- (ii) **The pooling function** – Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favor of Special Purpose Vehicle (SPV), which acts as a trustee for investors.
- (iii) **The securitization function** – SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and expected maturity which can be asset-based/mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds.

The process of securitization is generally without recourse i.e. investors bear the credit risk and issuer is under an obligation to pay to investors only if the cash flows are received by him from the collateral. The benefits to the originator are that assets are shifted off the balance sheet, thus giving the originator recourse to off-balance sheet funding.

Question 5

EXPLAIN in short the term Letter of Credit. [MTP 4 Marks, May'20 & Sep '23]

Answer 5

Letter of Credit: It is an arrangement by which the issuing bank on the instructions of a customer or on its own behalf undertakes to pay or accept or negotiate or authorizes another bank to do so against stipulated documents subject to compliance with specified terms and conditions.

Question 6

DISCUSS in brief the characteristics of Debentures. (MTP 4 Marks, March'21)

Answer 6

Characteristics of Debentures are as follows:

- Normally, debentures are issued on the basis of a debenture trust deed which lists the terms and conditions on which the debentures are floated.
- Debentures are either secured or unsecured.
- May or may not be listed on the stock exchange.
- The cost of capital raised through debentures is quite low since the interest payable on debentures can be charged as an expense before tax.
- From the investors' point of view, debentures offer a more attractive prospect than the preference shares since interest on debentures is payable whether or not the company makes profits.
- Debentures are thus instruments for raising long-term debt capital.
- The period of maturity normally varies from 3 to 10 years and may also increase for projects having high gestation period.

Question 7

DEFINE Secured Premium Notes. (MTP 2 Marks, March'21 & March '23, Old & New SM)

Answer 7

Secured Premium Notes: Secured Premium Notes is issued along with a detachable warrant and is redeemable after a notified period of say 4 to 7 years. The conversion of detachable warrant into equity shares will have to be done within time period notified by the company.

Question 8

DEFINE Masala bond. (MTP 2 Marks, March'21, PYP 2 Marks May '18)

Answer 8



Masala bond: Masala (means spice) bond is an Indian name used for Rupee denominated bond that Indian corporate borrowers can sell to investors in overseas markets. These bonds are issued outside India but denominated in Indian Rupees. NTPC raised Rest. 2,000 crores via masala bonds for its capital expenditure in the year 2016.

Question 9

DEFINE Debt Securitization. (MTP 2 Marks, April'21)

Answer 9

Debt Securitization is a process in which illiquid assets are pooled into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. These assets are generally secured by personal or real property such as automobiles, real estate, or equipment loans but in some cases are unsecured.

Question 8

BRIEF out any four types of Preference shares along with its feature. [MTP 4 Marks, Nov'21]

Answer 8

| Sl. No. | Type of Preference Shares | Salient Features |
|---------|---------------------------|--|
| 1 | Cumulative | Arrear Dividend will accumulate. |
| 2 | Non-cumulative | No right to arrear dividend. |
| 3 | Redeemable | Redemption should be done. |
| 4 | Participating | Can participate in the surplus which remains after payment to equity shareholders. |
| 5 | Non- Participating | Cannot participate in the surplus after payment of fixed rate of Dividend. |
| 6 | Convertible | Option of converting into equity Shares. |

Question 9

EXPLAIN any four types of Packing Credit. [MTP 4 Marks, Nov'21, Mar'22, & Oct '23 Old & New SM]

Answer 9

- (i) **Clean packing credit:** This is an advance made available to an exporter only on production of a firm export order or a letter of credit without exercising any charge or control over raw material or finished goods. It is a clean type of export advance. Each proposal is weighed according to particular requirements of the trade and credit worthiness of the exporter. A suitable margin has to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank.
- (ii) **Packing credit against hypothecation of goods:** Export finance is made available on certain terms and conditions where the exporter has pledge able interest and the goods are hypothecated to the bank as security with stipulated margin. At the time of utilizing the advance, the exporter is required to submit, along with the firm export order or letter of credit relative stock statements and thereafter continue submitting them every fortnight and/or whenever there is any movement in stocks.
- (iii) **Packing credit against pledge of goods:** Export finance is made available on certain terms and conditions where the exportable finished goods are pledged to the banks with approved clearing agents who will ship the same from time to time as required by the exporter. The possession of the goods so pledged lies with the bank and is kept under its lock and key.
- (iv) **E.C.G.C. guarantee:** Any loan given to an exporter for the manufacture, processing, purchasing, or packing of goods meant for export against a firm order qualifies for the packing credit guarantee issued by Export Credit Guarantee Corporation.
- (v) **Forward exchange contract:** Another requirement of packing credit facility is that if the export bill is to be drawn in a foreign currency, the exporter should enter into a forward exchange contract with the



bank, thereby avoiding risk involved in a possible change in the rate of exchange.

Question 10

EXPLAIN: Callable bonds and Puttable bonds. (MTP 2 Marks, Nov '21 & March '22, PYP 2 Marks Jan'21)

Answer 10

- (i) **Callable bonds:** A callable bond has a call option which gives the issuer the right to redeem the bond before maturity at a predetermined price known as the call price (Generally at a premium).
- (ii) **Puttable bonds:** Puttable bonds give the investor a put option (i.e. the right to sell the bond) back to the company before maturity.

Question 11

STATE in brief four features of Samurai Bond. [MTP 2 Marks March 22, RTP Nov'22]

Answer 11

Features of Samurai Bond:

- Samurai bonds are denominated in Japanese Yen JPY
- Issued in Tokyo
- Issuer Non- Japanese Company
- Regulations: Japanese
- Purpose: Access of capital available in Japanese market
- Issue proceeds can be used to fund Japanese operation
- Issue proceeds can be used to fund a company's local opportunities.
- It can also be used to hedge foreign exchange risk

Question 12

DISCUSS in briefly any two long term sources of finance for a partnership firm. (MTP 4 Marks April 22)

Answer 12

The two sources of long-term finance for a partnership firm are as follows:

Loans from Commercial Banks: Commercial banks provide long term loans for the purpose of expansion or setting up of new units. Their repayment is usually scheduled over a long period of time. The liquidity of such loans is said to depend on the anticipated income of the borrowers.

As part of the long term funding for a partnership firm, the banks also fund the long term working capital requirement (it is also called WCTL i.e. working capital term loan).

Lease financing: Leasing is a general contract between the owner and user of the asset over a specified period of time. The asset is purchased initially by the lessor (leasing company) and thereafter leased to the user (lessee firm) which pays a specified rent at periodical intervals. Thus, leasing is an alternative to the purchase of an asset out of own or borrowed funds. Moreover, lease finance can be arranged much faster as compared to term loans from financial institutions.

Question 13

WHAT is the meaning of Venture Capital Financing. STATE some characteristics of it. [MTP 4 Marks Sep'22]

Answer 13

Venture Capital Financing: The venture capital financing refers to financing of new high risky venture promoted by qualified entrepreneurs who lack experience and funds to give shape to their ideas. In broad sense, under venture capital financing, venture capitalist make investment to purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with potential to succeed in future.



Some of the characteristics of Venture Capital financing are:

- ◆ It is basically an equity finance in new companies.
- ◆ It can be viewed as a long-term investment in growth-oriented small/medium firms.
- ◆ Apart from providing funds, the investor also provides support in form of sales strategy, business networking and management expertise, enabling the growth of the entrepreneur.

Question 14

BRIEF OUT certain sources of finance- Inter Corporate Deposits and Certificate of Deposit. (MTP 2 Marks Sep'22)

Answer 14

Inter Corporate Deposits: The companies can borrow funds for a short period, say 6 months, from other companies which have surplus liquidity. The rate of interest on inter corporate deposits varies depending upon the amount involved and the time period.

Certificate of Deposit (CD): The certificate of deposit is a document of title similar to a time deposit receipt issued by a bank except that there is no prescribed interest rate on such funds.

The main advantage of CD is that banker is not required to encash the deposit before maturity period and the investor is assured of liquidity because he can sell the CD in secondary market

Question 15

STATE in brief four features of Plain Vanilla Bond. (MTP 2 Marks Sep'22)

Answer 15

Features of Plain Vanilla Bond:

- The issuer would pay the principal amount along with the interest rate.
- This type of bond would not have any options.
- This bond can be issued in the form of discounted bond or can be issued in the form of coupon bearing bond.

Question 16

Write a short note on seed capital assistance. (MTP 2 Marks Oct'22)

Answer 16

Seed Capital Assistance: The seed capital assistance has been designed by IDBI for professionally or technically qualified entrepreneurs. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme. The project cost should not exceed ₹ 2 crores and the maximum assistance under the project will be restricted to 50% of the required promoter's contribution or ₹ 15 lacs whichever is lower.

The seed capital assistance is interest free but carries a security charge of one percent per annum for the first five years and an increasing rate thereafter

Question 17

EXPLAIN in brief the features of Commercial Papers. [MTP 4 Marks Oct'22, Oct'20, Apr'21, & Oct '23 Old & New SM]

Answer 17

Commercial Paper: A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note. The Reserve Bank of India introduced the commercial paper scheme in the year 1989 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Subsequently, in addition to the Corporate, Primary Dealers and All India Financial Institutions have also been allowed to issue Commercial Papers. Commercial papers are issued in denominations of ₹ 5 lakhs or multiples thereof and the interest rate is generally linked to the yield on the one-year government bond.

All eligible issuers are required to get the credit rating from Credit Rating Information Services of India Ltd, (CRISIL), or the Investment Information and Credit Rating Agency of India Ltd (ICRA) or the Credit Analysis and Research Ltd (CARE) or the FITCH Ratings India Pvt. Ltd or any such other credit rating agency as is specified by the Reserve Bank



of India.

Question 18

BRIEFLY describe the financial needs of a business. [MTP 2 Marks, Oct'21]

Answer 18

Financial Needs of a Business: Business enterprises need funds to meet their different types of requirements. All the financial needs of a business may be grouped into the following three categories-
Long-term financial needs: Such needs generally refer to those requirements of funds which are for a period exceeding 5-10 years. All investments in plant, machinery, land, buildings, etc., are considered as long-term financial needs.

Medium- term financial needs: Such requirements refer to those funds which are required for a period exceeding one year but not exceeding 5 years.

Short- term financial needs: Such type of financial needs arises to finance current assets such as stock, debtors, cash, etc. Investment in these assets is known as meeting of working capital requirements of the concern for a period not exceeding one year.

Question 19

EXPLAIN the followings:

- (a) Floating Rate Bonds
- (b) Packing Credit. (RTP May '18)

Answer 19

- (a) **Floating Rate Bonds:** These are the bonds where the interest rate is not fixed and is allowed to float depending upon the market conditions. These are ideal instruments which can be resorted to by the issuers to hedge themselves against the volatility in the interest rates. They have become more popular as a money market instrument and have been successfully issued by financial institutions like IDBI, ICICI etc.
- (b) **Packing Credit:** Packing credit is an advance made available by banks to an exporter. Any exporter, having at hand a firm export order placed with him by his foreign buyer on an irrevocable letter of credit opened in his favour, can approach a bank for availing of packing credit. An advance so taken by an exporter is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. Thus Packing Credit is essentially a short-term advance.

Question 20

EXPLAIN the difference between Financial Lease and Operating Lease. (RTP Nov '18 & Nov '20)

OR

Under financial lease, lessee bears the risk of obsolescence; while under operating lease, lessor bears the risk of obsolescence. In view of this, you are required to COMPARE the financial lease and operating lease. (RTP Nov'22)

Answer 20

Difference between Financial Lease and Operating Lease

| | Financial Lease | Operating Lease |
|----|--|--|
| 1. | The risk and reward incident to ownership are passed on to the lessee. The lessor only remains the legal owner of the asset. | The lessee is only provided the use of the asset for a certain time. Risk incident to ownership belong wholly to the lessor. |
| 2. | The lessee bears the risk of obsolescence. | The lessor bears the risk of obsolescence. |



| | | |
|----|---|---|
| 3. | The lessor is interested in his rentals and not in the asset. He must get his principal back along with interest. Therefore, the lease is non- cancellable by either party. | As the lessor does not have difficulty in leasing the same asset to other willing lessor, the lease is kept cancelable by the lessor. |
| 4. | The lessor enters into the transaction only as financier. He does not bear the cost of repairs, maintenance or operations. | Usually, the lessor bears cost of repairs, maintenance or operations. |
| 5. | The lease is usually full payout, that is, the single lease repays the cost of the asset together with the interest. | The lease is usually non-payout, since the lessor expects to lease the same asset over and over again to several users. |

Question 21

DISCUSS the advantages and disadvantages of raising funds by issue of preference shares. (RTP May '21)

Answer 21

Advantages and disadvantages of raising funds by issue of preference shares Advantages

- No dilution in EPS on enlarged capital base – On the other hand if equity shares are issued it reduces EPS, thus affecting the market perception about the company.
- There is also the advantage of leverage as it bears a fixed charge (because companies are required to pay a fixed rate of dividend in case of issue of preference shares). Non-payment of preference dividends does not force a company into liquidity.
- There is no risk of takeover as the preference shareholders do not have voting rights except where dividend payment are in arrears.
- The preference dividends are fixed and pre-decided. Hence preference shareholders cannot participate in surplus profits as the ordinary shareholders can except in case of participating preference shareholders.
- Preference capital can be redeemed after a specified period.

Disadvantages

- One of the major disadvantages of preference shares is that preference dividend is not tax deductible and so does not provide a tax shield to the company. Hence, preference shares are costlier to the company than debt e.g. debenture.
- Preference dividends are cumulative in nature. This means that if in a particular year preference dividends are not paid they shall be accumulated and paid later. Also, if these dividends are not paid, no dividend can be paid to ordinary shareholders. The non-payment of dividend to ordinary shareholders could seriously impair the reputation of the concerned company.

Question 22

EXPLAIN some common methods of Venture capital financing. (RTP Nov '21, PYP 4 Marks, Nov '20)

Answer 22

Some common methods of venture capital financing are as follows:

- Equity financing:** The venture capital undertakings generally require funds for a longer period but may not be able to provide returns to the investors during the initial stages. Therefore, the venture capital finance is generally provided by way of equity share capital. The equity contribution of venture capital firm does not exceed 49% of the total equity capital of venture capital undertakings so that the effective control and ownership remains with the entrepreneur.
- Conditional loan:** A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India venture capital financiers charge royalty ranging between 2 and 15 per cent; actual rate depends on other factors of the venture such as gestation



period, cash flow patterns, risk and other factors of the enterprise. Some Venture capital financiers give a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sound.

- (iii) **Income note:** It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBI's VCF provides funding equal to 80 – 87.50% of the projects cost for commercial application of indigenous technology.
- (iv) **Participating debenture:** Such security carries charges in three phases — in the start-up phase no interest is charged, next stage a low rate of interest is charged up to a particular level of operation, after that, a high rate of interest is required to be paid.

Question 23

HIGHLIGHT the similarities and differences between Samurai Bond and Bull Dog Bond. (RTP May 23)

Answer 23

| | |
|--------------|--|
| Samurai Bond | <ul style="list-style-type: none"> • Samurai bonds are denominated in Japanese Yen JPY • Issued in Tokyo • Issuer Non- Japanese Company • Regulations: Japanese • Purpose: Access of capital available in Japanese market • Issue proceeds can be used to fund Japanese operation • Issue proceeds can be used to fund a company's local opportunities. • It can also be used to hedge foreign exchange risk |
| Bulldog Bond | <ul style="list-style-type: none"> • It is denominated in Bulldog Pound Sterling/Great Britain Pound (GBP) |
| | <ul style="list-style-type: none"> • Issued in London • Issuer Non- UK Company • Regulations: Great Britain • Purpose: Access of capital available in UK market • Issue proceeds can be used to fund UK operation • Issue proceeds can be used to fund a company's local opportunities |

Question 24

DESCRIBE the inter relationship between investing, financing, and dividend decisions. (RTP Nov '23)

Answer 24

Inter-relationship between Investment, Financing and Dividend Decisions

The finance functions are divided into three major decisions, viz., investment, financing, and dividend decisions. It is correct to say that these decisions are inter - related because the underlying objective of these three decisions is the same, i.e., maximisation of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one must consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their inter - relationship and to see how they can help in maximising the shareholders' wealth i.e., market price of the company's shares.



Investment decision: The investment of long-term funds is made after a careful assessment of the various projects through capital budgeting and uncertainty analysis. However, only that investment proposal is to be accepted which is expected to yield at least so much return as is adequate to meet its cost of financing. This has an influence on the profitability of the company and ultimately on its wealth.

Financing decision: Funds can be raised from various sources. Each source of funds involves different issues. The finance manager must maintain a proper balance between long-term and short-term funds. With the total volume of long-term funds, he must ensure a proper mix of loan funds and owner's funds. The optimum financing mix will increase return to equity shareholders and thus maximise their wealth.

Dividend decision: The finance manager is also concerned with the decision to pay or declare dividend. He assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximises shareholders' wealth.

The above discussion makes it clear that investment, financing, and dividend decisions are interrelated and are to be taken jointly keeping in view their joint effect on the shareholders' wealth.

Question 25

STATE the meaning of debt securitization (RTP Nov '23)

Answer 25

Debt Securitisation: It is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued, e.g., housing finance, auto loans, and credit card receivables.

Process of Debt Securitisation

- (i) The origination function – A borrower seeks a loan from a finance company, bank. The credit worthiness of borrower is evaluated, and contract is entered into with repayment schedule structured over the life of the loan.
- (ii) The pooling function – Similar loans on receivables are clubbed together to create an underlying pool of assets. The pool is transferred in favour of Special purpose Vehicle (SPV), which acts as a trustee for investors.
- (iii) The securitisation function – SPV will structure, and issue securities based on asset pool. The securities carry a coupon and expected maturity which can be asset-based/mortgage based. These are generally sold to investors through merchant bankers. Investors are – pension funds, mutual funds, insurance funds.

Question 26

Explain in brief the forms of Post Shipment Finance. (PYP 4 Marks, July'21)

Answer 26

Post-shipment Finance: It takes the following forms:

- a. **Purchase/discounting of documentary export bills:** Finance is provided to exporters by purchasing export bills drawn payable at sight or by discounting since export bills covering confirmed sales and backed by documents including documents of the title of goods such as bill of lading, post parcel receipts, or air consignment notes.
- b. **E.C.G.C. Guarantee:** Post-shipment finance, given to an exporter by a bank through purchase, negotiation or discount of an export bill against an order, qualifies for post-shipment export credit guarantee. It is necessary, however, that exporters should obtain a shipment or contracts risk policy of E.C.G.C. Banks insist on the exporters to take a contracts shipment (comprehensive risks) policy



covering both political and commercial risks. The Corporation, on acceptance of the policy, will fix credit limits for individual exporters and the Corporation's liability will be limited to the extent of the limit so fixed for the exporter concerned irrespective of the amount of the policy.

- c. **Advance against export bills sent for collection:** Finance is provided by banks to exporters by way of advance against export bills forwarded through them for collection, taking into account the creditworthiness of the party, nature of goods exported, since, standing of drawee, etc.
- d. **Advance against duty draw backs, cash subsidy, etc.:** To finance export losses sustained by exporters, bank advance against duty draw-back, cash subsidy, etc., receivable by them against export performance. Such advances are of clean nature; hence necessary precaution should be exercised.

Question 27

Briefly describe any four sources of short-term finance. (PYP 4 Marks, Nov'19)

OR

What are the sources of short term financial requirement of the company? (PYP 4 Marks, May'18)

Answer 27

Sources of Short Term Finance: There are various sources available to meet short-term needs of finance. The different sources are discussed below-

- (i) **Trade Credit:** It represents credit granted by suppliers of goods, etc., as an incident of sale. The usual duration of such credit is 15 to 90 days. It generates automatically in the course of business and is common to almost all business operations. It can be in the form of an 'open account' or 'bills payable'.
- (ii) **Accrued Expenses and Deferred Income:** Accrued expenses represent liabilities which a company has to pay for the services which it has already received like wages, taxes, interest and dividends. Such expenses arise out of the day-to-day activities of the company and hence represent a spontaneous source of finance.
Deferred Income: These are the amounts received by a company in lieu of goods and services to be provided in the future. Since these receipts increase a company's liquidity, they are also considered to be an important source of short-term finance.
- (iii) **Advances from Customers:** Manufacturers and contractors engaged in producing or constructing costly goods involving considerable length of manufacturing or construction time usually demand advance money from their customers at the time of accepting their orders for executing their contracts or supplying the goods. This is a cost free source of finance and really useful.
- (iv) **Commercial Paper:** A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note. The Reserve Bank of India introduced the commercial paper scheme in the year 1989 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.
- (v) **Treasury Bills:** Treasury bills are a class of Central Government Securities. Treasury bills, commonly referred to as T-Bills are issued by Government of India to meet short term borrowing requirements with maturities ranging between 14 to 364 days.
- (vi) **Certificates of Deposit (CD):** A certificate of deposit (CD) is basically a savings certificate with a fixed maturity date of not less than 15 days up to a maximum of one year.
- (vii) **Bank Advances:** Banks receive deposits from public for different periods at varying rates of interest. These funds are invested and lent in such a manner that when required, they may be called back. Lending results in gross revenues out of which costs, such as interest on deposits, administrative costs, etc., are met and a reasonable profit is made. A bank's lending policy is not merely profit motivated but has to also keep in mind the socio-economic development of the country. Some of the facilities provided by banks are Short Term Loans, Overdraft, Cash Credits, Advances against goods, Bills Purchased/Discounted.
- (viii) **Financing of Export Trade by Banks:** Exports play an important role in accelerating the economic growth of developing countries like India. Of the several factors influencing export growth, credit is a very important factor which enables exporters in efficiently executing their export orders. The commercial banks provide short-term export finance mainly by way of pre and post-shipment credit.



Export finance is granted in Rupees as well as in foreign currency.

- (ix) **Inter Corporate Deposits:** The companies can borrow funds for a short period say 6 months from other companies which have surplus liquidity. The rate of interest on inter corporate deposits varies depending upon the amount involved and time period.
- (x) **Certificate of Deposit (CD):** The certificate of deposit is a document of title similar to a time deposit receipt issued by a bank except that there is no prescribed interest rate on such funds. The main advantage of CD is that banker is not required to encase the deposit before maturity period and the investor is assured of liquidity because he can sell the CD in secondary market.
- (xi) **Public Deposits:** Public deposits are very important source of short-term and medium term finances particularly due to credit squeeze by the Reserve Bank of India. A company can accept public deposits subject to the stipulations of Reserve Bank of India from time to time maximum up to 35 per cent of its paid up capital and reserves, from the public and shareholders. These deposits may be accepted for a period of six months to three years. Public deposits are unsecured loans; they should not be used for acquiring fixed assets since they are to be repaid within a period of 3 years. These are mainly used to finance working capital requirements.

Question 28

Explain in brief following Financial Instruments:

- (i) **Euro Bonds**
- (ii) **Floating Rate Notes**
- (iii) **Euro Commercial paper**
- (iv) **Fully Hedged Bond (PYP 4 Marks, Nov'18)**

Answer 28

- i. **Euro bonds:** Euro bonds are debt instruments which are not denominated in the currency of the country in which they are issued. E.g. a Yen note floated in Germany.
- ii. **Floating Rate Notes:** Floating Rate Notes: are issued up to seven years' maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than foreign loans.
- iii. **Euro Commercial Paper(ECP):** ECPs are short term money market instruments. They are for maturities less than one year. They are usually designated in US Dollars.
- iv. **Fully Hedged Bond:** In foreign bonds, the risk of currency fluctuations exists. Fully hedged bonds eliminate the risk by selling in forward markets the entire stream of principal and interest payments.

Question 29

Discuss the Advantages of Leasing. (PYP 4 Marks, Nov'18)

Answer 29

- i. **Lease may low cost alternative:** Leasing is alternative to purchasing. As the lessee is to make a series of payments for using an asset, a lease arrangement is similar to a debt contract. The benefit of lease is based on a comparison between leasing and buying an asset. Many lessees find lease more attractive because of low cost.
- ii. **Tax benefit:** In certain cases, tax benefit of depreciation available for owning an asset may be less than that available for lease payment
- iii. **Working capital conservation:** When a firm buy an equipment by borrowing from a bank (or financial institution), they never provide 100% financing. But in case of lease one gets normally 100% financing. This enables conservation of working capital.
- iv. **Preservation of Debt Capacity:** So, operating lease does not matter in computing debt equity ratio. This enables the lessee to go for debt financing more easily. The access to and ability of a firm to get debt financing is called debt capacity (also, reserve debt capacity).
- v. **Obsolescence and Disposal:** After purchase of leased asset there may be technological obsolescence of the asset. That means a technologically upgraded asset with better capacity may come into existence after purchase. To retain competitive advantage, the lessee as user may have to go for the upgraded asset.

Question 30

Write short notes on Bridge Finance and Clean Packing Credit. (PYP 4 Marks Dec '21)

Answer 30

Bridge Finance: Bridge finance refers to loans taken by a company normally from commercial banks for a short period because of pending disbursement of loans sanctioned by financial institutions. Though it is of short-term nature but since it is an important step in the facilitation of long-term loan, therefore it is being discussed along with the long term sources of funds. Normally, it takes time for financial institutions to disburse loans to companies. However, once the loans are approved by the term lending institutions, companies, in order not to lose further time in starting their projects, arrange short term loans from commercial banks. The bridge loans are repaid/ adjusted out of the term loans as and when disbursed by the concerned institutions. Bridge loans are normally secured by hypothecating movable assets, personal guarantees and demand promissory notes. Generally, the rate of interest on bridge finance is higher as compared with that on term loans.

Clean packing credit: This is an advance made available to an exporter only on production of a firm export order or a letter of credit without exercising any charge or control over raw material or finished goods. It is a clean type of export advance. Each proposal is weighed according to particular requirements of the trade and credit worthiness of the exporter. A suitable margin has to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank.

Question 31

Distinguish between American Depository Receipts and Global Depository Receipts. (PYP 2 Marks May'22)

Answer 31

Distinguish Between American Depository Receipts and Global Depository Receipts:

| | American Depository Receipts | Global Depository Receipts |
|---------------------|--|---|
| Meaning | It is a negotiable instrument which is issued by US bank, which represent the nazon-US Company stock that is being traded in US stock Exchange | It is a negotiable instrument which is issued by the international depository bank that represent the foreign company's stock trading world-wide. |
| Issued where | In the US domestic capital market. | European capital market. |
| Listed in | In the American Stock Exchange | In the Non-US Stock Exchange |
| Relevance | Foreign companies are able to trade in the US Stock Market. | Foreign companies can trade in any country's stock market other than that of the US. |

Alternatively:

American Depository Receipts (ADRs): These are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange.

Global Depository Receipts (GDRs): These are negotiable certificates held in the bank of one country representing a specific number of shares of a stock traded on the exchange of another country. These financial instruments are used by companies to raise capital in either dollars or Euros. These are mainly traded in European countries and particularly in London.

Question 32

These bonds are issued by non-US Banks and non-US corporations in US. What this bond is called and what are the other features of this Bond? (PYP 4 Marks Nov '22)



Answer 32

The Bond is called as Yankee Bond. Features of the bond:

- These bonds are denominated in Dollars
- Bonds are to be registered in SEC (Securities and Exchange Commission)
- Bonds are issued in tranches
- Time taken can be up to 14 weeks

Question 33

List out the conditions, framed by SEBI, which a company needs to fulfil in order to issue of bonus shares. (PYP 4 Marks May '23)

Answer 33

To issue Bonus shares, a Company needs to fulfill all the conditions given by Securities Exchange Board of India (SEBI):

- (i) As per SEBI, the bonus shares are issued not in lieu of cash dividends.
- (ii) A bonus issue should be authorized by Article of Association (AOA) and not to be declared unless all partly paid-up shares have been converted into fully paid-up shares.
- (iii) The Company should not have defaulted on re-payment of loan, interest, and any statutory dues.
- (iv) Bonus shares are to be issued only from share premium and free reserves and not from capital reserve on account of fixed assets revaluation.

Question 34

Discuss features of Secured Premium Notes. (PYP 2 Marks May '23)

Answer 34

Features of Secured Premium Notes:

- SPN instruments are issued with a detachable warrant.
- These instruments are redeemable after a notified period of say 4 to 7 years.
- No interest is paid during the lock in period.
- The conversion of detachable warrant into equity shares will have to be done within time period notified by the company.

Chapter 3

Financial Analysis & Planning- Ratio Analysis

Question 1

The following accounting information and financial ratios of PQR Ltd. relates to the year ended 31st March, 2021:

| | | |
|-----------|--|-------------------|
| I | Accounting Information: | |
| | Gross Profit | 15% of Sales |
| | Net profit | 8% of sales |
| | Raw materials consumed | 20% of works cost |
| | Direct wages | 10% of works cost |
| | Stock of raw materials | 3 months' usage |
| | Stock of finished goods | 6% of works cost |
| | Debt collection period | 60 days |
| | (All sales are on credit) | |
| II | Financial Ratios: | |
| | Fixed assets to sales | 1 : 3 |
| | Fixed assets to Current assets | 13 : 11 |
| | Current ratio | 2 : 1 |
| | Long-term loans to Current liabilities | 2 : 1 |
| | Share Capital to Reserves and Surplus | 1 : 4 |

If value of Fixed Assets as on 31st March, 2020 amounted to ₹ 26 lakhs, PREPARE a summarised Profit and Loss Account of the company for the year ended 31st March, 2021 and also the Balance Sheet as on 31st March, 2021. (Old SM) (Same concept different figures RTP Nov'22)

Answer 1

a) Working Notes:

i. Calculation of Sales = $\frac{\text{Fixed Assets}}{\text{Sales}} = \frac{1}{3}$

$\therefore \frac{26,000}{\text{sales}} = \frac{1}{3} \Rightarrow \text{Sales} = ₹ 78,00,000$

ii. Calculation of Current Assets = $\frac{\text{Fixed Assets}}{\text{Current Assets}} = \frac{13}{11}$

$\therefore \frac{26,000}{\text{Current Assets}} = \frac{13}{11} \Rightarrow \text{Sales} = ₹ 22,00,000$

iii. Calculation of Raw Material Consumption and Direct Wages

| | ₹ |
|--------------------------|-----------|
| Sales | 78,00,000 |
| Less: Gross Profit @ 15% | 11,70,000 |
| Works Cost | 66,30,000 |

Raw Material Consumption (20% of Works Cost) = ₹ 13,26,000
 Direct Wages (10% of Works Cost) = ₹ 6,63,000

iv. Calculation of Stock of Raw Materials (= 3 months usage)



$$= 13,26,000 \times \frac{13}{12} = ₹ 3,31,500$$

- v. Calculation of Stock of Finished Goods (= 6% of Works Cost)

$$= 66,30,000 \times \frac{6}{100} = ₹ 3,97,800$$

- vi. Calculation of Current Liabilities

$$= \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2$$

$$\therefore \frac{22,000}{\text{Current Liabilities}} = 2 \Rightarrow \text{Sales} = ₹ 11,00,000$$

- vii. Calculation of Receivables

$$\text{Average collection period} = \frac{\text{receivables}}{\text{credit sales}} \times 365$$

$$\frac{\text{receivables}}{78,00,000} \times 365 = 60$$

$$\Rightarrow \text{Receivables} = ₹ 12,82,191.78 \text{ or } ₹ 12,82,192$$

- viii. Calculation of Long term Loan

$$\frac{\text{Long term Loan}}{\text{Current Liabilities}} = \frac{2}{1} = \frac{\text{Long term Loan}}{11,00,000} \Rightarrow \text{Long term}$$

$$\text{loan} = ₹ 22,00,000.$$

- ix. Calculation of Cash Balance

| | | ₹ |
|----------------------|-----------|-----------|
| Current assets | | 22,00,000 |
| Less: Receivables | 12,82,192 | |
| Raw materials stock | 3,31,500 | |
| Finished goods stock | 3,97,800 | 20,11,492 |
| Cash balance | | 1,88,508 |

- x. Calculation of Net worth

| | | |
|----------------------|-----------|-----------|
| Fixed Assets | | 26,00,000 |
| Current Assets | | 22,00,000 |
| Total Assets | | 48,00,000 |
| Less: Long term Loan | 22,00,000 | |
| Current Liabilities | 11,00,000 | 33,00,000 |
| Net worth | | 15,00,000 |

$$\text{Net worth} = \text{Share capital} + \text{Reserves} = 15,00,000$$

$$\text{Also, } \frac{1}{4} = \frac{\text{share capital}}{\text{Reserves and Surplus}}$$

$$\text{So, Share capital} = 15,00,000 \times \frac{1}{4} = ₹ 12,00,000$$

Profit and Loss Account of PQR Ltd. for the year ended 31st March, 2021

| Particulars | ₹ | Particulars | ₹ |
|---------------------|-----------|-------------|-----------|
| To Direct Materials | 13,26,000 | By Sales | 78,00,000 |
| To Direct Wages | 6,63,000 | | |



| | | | | |
|----|---|-----------|---------------------|-----------|
| To | Works (Overhead) (Balancing figure) | 46,41,000 | | |
| To | Gross Profit c/d | 11,70,000 | | |
| | | 78,00,000 | | 78,00,000 |
| To | Selling and Distribution Expenses (Balancingfigure) | 5,46,000 | By Gross Profit b/d | 11,70,000 |
| To | Net Profit (8% ofSales) | 6,24,000 | | |
| | | 11,70,000 | | 11,70,000 |

Balance Sheet of PQR Ltd. as at 31st March, 2021

| Liabilities | ₹ | Assets | ₹ |
|----------------------|-----------|----------------------------|-----------|
| Share Capital | 3,00,000 | Fixed Assets | 26,00,000 |
| Reserves and Surplus | 12,00,000 | Current Assets: | |
| Long term loans | 22,00,000 | Stock of Raw Material | 3,31,500 |
| Current liabilities | 11,00,000 | Stock of Finished Goods | 3,97,800 |
| | | Receivables | 12,82,192 |
| | | Cash | 1,88,508 |
| | 48,00,000 | | 48,00,000 |

Question 2

Based on the following particulars, PREPARE a balance sheet showing various assets and liabilities of T Ltd. (MTP 5 Marks, March'18 & March '23, RTP May '18)

| | |
|-----------------------------|---------|
| Fixed assets turnover ratio | 8 times |
| Capital turnover ratio | 2 times |
| Inventory Turnover | 8 times |
| Receivable turnover | 4 times |
| Payable turnover | 6 times |
| GP Ratio | 25% |

Gross profit during the year amounts to Rs.8,00,000. There is no long-term loan or overdraft. Reserve and surplus amount to RS.2,00,000. Ending inventory of the year is RS. 20,000 above the beginning inventory.

Answer 2

a. G.P. ratio = $\frac{\text{Gross Profit}}{\text{Sales}}$

$$\text{Sales} = \frac{\text{Gross Profit}}{25} \times 100$$

$$\frac{8,00,000}{25} \times 100 = 32,00,000$$

b. Cost of Sales = Sales – Gross profit
= RS.32,00,000 - Rs.8,00,000
= RS.24,00,000

c. Receivable turnover $r = \frac{\text{Sales}}{\text{Receivables}} = 4$
= Receivables = $\frac{\text{Sales}}{4}$
= $\frac{\text{Rs.32,00,000}}{4} = \text{Rs.8,00,000}$



d. Fixed assets turnover = $\frac{\text{Cost of Sales}}{\text{Fixed Assets}} = 8$

Fixed assets = $\frac{\text{Cost of Sales}}{8} = \frac{\text{Rs.24,00,000}}{8} = \text{RS.3,00,000}$

e. Inventory turnover = $\frac{\text{Cost of Sales}}{\text{Average Stock}} = 8$

Average Stock = $\frac{\text{Cost of Sales}}{\text{Average Stock}} = \frac{\text{Rs.24,00,000}}{8} = \text{RS.3,00,000}$

Average Stock = $\frac{\text{Opening Stock} + \text{Closing Stock}}{2}$

Average Stock = $\frac{\text{Opening Stock} + \text{Closing Stock} + 20,000}{2}$

Average Stock = Opening Stock + RS. 10,000

Opening Stock = Average Stock - RS.10,000

= RS.3,00,000 - ₹10,000

= RS.2,90,000

Closing Stock = Opening Stock + RS.20,000

= RS.2,90,000 + RS. 20,000 = RS.3,10,000

f. Payable turnover = $\frac{\text{Purchase}}{\text{Capital Employed}} = 2$

Purchases = Cost of Sales + Increase in Stock

= RS.24,00,000 + RS. 20,000 = RS.24,20,000

Payables = $\frac{\text{Purchase}}{6} = \frac{24,20,000}{2} = 12,00,000$

g. Capital turnover = $\frac{\text{Cost of Sales}}{\text{Capital Employed}} = 2$

Capital Employed = $\frac{\text{Cost of Sales}}{\text{Capital Employed}} = 2 = \frac{24,20,000}{2} = 12,00,000$

h. Capital = Capital Employed – Reserves & Surplus
= Rs 12,00,000 – Rs 2,00,000 = Rs 10,00,000

Balance Sheet of T Ltd as on.....

| Liabilities | Amount (₹) | Assets | Amount (₹) |
|-------------------|------------|----------------------|------------|
| Capital | 10,00,000 | Fixed Assets | 3,00,000 |
| Reserve & Surplus | 2,00,000 | Inventories | 3,10,000 |
| Payables | 4,03,333 | Receivables | 8,00,000 |
| | | Other Current Assets | 1,93,333 |
| | 16,03,333 | | 16,03,333 |

Question 3

Following information relate to a concern:

| | |
|----------------------|----------|
| Debtors Velocity | 3 months |
| Credits Velocity | 2 months |
| Stock Turnover Ratio | 1.5 |

| | |
|---------------------------------------|---------------------|
| Gross Profit Ratio | 25% |
| Bills Receivables | Rs. 25,000 |
| Bills Payables | Rs. 10,000 |
| Gross Profit | Rs. 4,00,000 |
| Fixed Assets to turnover Ratio | 4 |

Closing stock of the period is Rs. 10,000 above the opening stock. **CALCULATE**

- (i) Sales and cost of goods sold
- (ii) Sundry Debtors
- (iii) Sundry Creditors
- (iv) Closing Stock
- (v) Fixed Assets (MTP 5 Marks, Oct'18, RTP May 22, Old & New SM)

Answer 3

(I) Determination of Sales and Cost of goods sold:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

$$\text{Or } \frac{25}{100} = \frac{4,00,000}{\text{Sales}}$$

$$\text{Sales} = \frac{4,00,000}{25} = \text{Rs. 16,00,000}$$

Cost of Goods Sold = Sales – Gross Profit

$$= \text{Rs. 16,00,000} - \text{Rs. 4,00,000} = \text{Rs. 12,00,000}$$

(ii) Determination of Sundry Debtors:

Debtors velocity is 3 months or Debtors' collection period is 3 months,

$$\text{So, Debtors' turnover ratio} = \frac{12 \text{ month}}{3 \text{ month}} = 4$$

$$\text{Debtors' turnover ratio} = \frac{\text{Credits Sales}}{\text{Average Accounts Receivable}}$$

$$= \frac{\text{Rs. 16,00,000}}{\text{Bills Receivable} + \text{Sundry Debtors}} = 4$$

$$\text{Or, Sundry Debtors} + \text{Bills receivable} = \text{Rs. 4,00,000} \quad \text{Sundry Debtors} = \text{Rs. 4,00,000} - \text{Rs. 25,000}$$

$$= \text{Rs. 3,75,000}$$

(iii) Determination of Sundry Creditors:

Creditors velocity of 2 months or credit payment period is 2 months

$$\text{So, Creditors' turnover ratio} = \frac{12 \text{ month}}{2 \text{ month}} = 6$$

$$\text{Creditors turnover ratio} = \frac{\text{Credits Sales}}{\text{Average Accounts Receivable}}$$

$$= \frac{\text{Rs. 12,00,000}}{\text{Sundry Creditors} + \text{Bills Payables}} = 6$$

$$\text{So, Sundry Creditors} + \text{Bills Payable} = \text{Rs. 2,01,667} \quad \text{Or, Sundry Creditors} + \text{Rs. 10,000} = \text{Rs. 2,01,667}$$

$$\text{Or, Sundry Creditors} = \text{Rs. 2,01,667} - \text{Rs. 10,000} = \text{Rs. 1,91,667}$$

(iv) Closing Stock

Stock Turnover Ratio

$$= \frac{\text{Cost of Goods Sold}}{\text{Average Stock}} = \frac{\text{Rs. 12,00,000}}{\text{Average Stock}} = 1.5$$



So, Average Stock = Rs. 8,00,000

$$\text{Now Average Stock} = \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

$$= \frac{\text{Opening Stock} + \text{Rs.10,000}}{2} = \text{Rs.8,00,000}$$

Or, Opening Stock = Rs. 7,95,000

So, Closing Stock = Rs. 7,95,000 + Rs. 10,000 = Rs. 8,05,000

(v) Calculation of Fixed Assets

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Cost of Good sold}}{\text{Fixed Assets}} = 4$$

$$\text{or} = \frac{\text{Rs.12,00,000}}{\text{Fixed Assets}} = 4 \text{ Or, Fixed Asset} = \text{Rs. 3,00,000}$$

Workings:

*Calculation of Credit purchases:

Cost of goods sold = Opening stock + Purchases – Closing stock
Rs. 12,00,000 = Rs. 7,95,000 + Purchases – Rs. 8,05,000

Rs. 12,00,000 + Rs. 10,000 = Purchases
Rs. 12,10,000 = Purchases (credit).

Assumption:

- (i) All sales are credit sales
- (ii) All purchases are credit purchase
- (iii) Stock Turnover Ratio and Fixed Asset Turnover Ratio may be calculated either on Sales or on Cost of Goods Sold.

Question 4

Using the following information, PREPARE and complete the Balance Sheet given below:

- (I) Total debt to net worth 1 : 2
- (ii) Total assets turnover 2
- (iii) Gross profit on sales 30%
- (iv) Average collection period 40 days
(Assume 360 days in a year)
- (v) Inventory turnover ratio based on cost of goods sold and year-end inventory 3
- (vi) Acid test ratio 0.75

Balance Sheet as on [MTP 5 Marks, March 19]

| Liabilities | Rs. | Assets | Rs. |
|-----------------------|-----------|------------------------|-----------|
| Equity Shares Capital | 4,00,000 | Plant and Machinery | 4,25,000 |
| Reserves and Surplus | 6,00,000 | and other Fixed Assets | |
| Total Debt: | | Current Assets: | |
| Current Liabilities | 5,00,000 | Inventory | 7,00,000 |
| | | Debtors | 3,33,333 |
| | - | Cash | 41,667 |
| | 15,00,000 | | 15,00,000 |



Answer 4

$$\begin{aligned}\text{Net worth} &= \text{Capital} + \text{Reserves and surplus} \\ &= 4,00,000 + 6,00,000 = \text{Rs. } 10,00,000 \\ \therefore \text{Total debt} &= \text{Rs. } 5,00,000\end{aligned}$$

$$\begin{aligned}\text{Total Liability side} &= \text{Rs. } 4,00,000 + \text{Rs. } 6,00,000 + \text{Rs. } 5,00,000 \\ &= \text{Rs. } 15,00,000 \\ &= \text{Total Assets} = \frac{\text{Total Debit}}{\text{Networth}}\end{aligned}$$

$$\begin{aligned}\text{Rs. Total debt} &= \text{Rs. } 5,00,000 \\ \text{Total Liability side} &= \text{Rs. } 4,00,000 + \text{Rs. } 6,00,000 + \text{Rs. } 5,00,000 \\ &= \text{Rs. } 15,00,000 \\ &= \text{Total Assets} \\ \text{Total Assets Turnover} &= \frac{\text{Sales}}{\text{Total assets}} \\ 2 &= \frac{\text{Sales}}{\text{Rs. } 1,50,00,000}\end{aligned}$$

$$\begin{aligned}\therefore \text{Sales} &= \text{Rs. } 30,00,000 \text{ Gross Profit on Sales: } 30\% \text{ i.e. Rs. } 9,00,000 \\ \therefore \text{Cost of Goods Sold (COGS)} &= \text{Rs. } 30,00,000 - \text{Rs. } 9,00,000 \\ &= \text{Rs. } 21,00,000\end{aligned}$$

$$\begin{aligned}\text{Inventory turnover} &= \frac{\text{COGS}}{\text{Inventory}} = 3 = \frac{\text{Rs. } 21,00,000}{\text{Inventory}} \\ \therefore \text{Inventory} &= \text{Rs. } 7,00,000\end{aligned}$$

Average collection period=

$$= \frac{\text{Average debtors}}{\text{Sales / day}}$$

$$40 = \frac{\text{Debtors}}{\text{Rs. } 30,00,000 / 360}$$

$$\text{Debtors} = \text{Rs. } 3,33,333.$$

Acid test ratio=

$$= \frac{\text{Current Assets} - \text{Stock (Quick Asset)}}{\text{Current liabilities}}$$

$$0.70 = \frac{\text{Current Assets} - \text{Rs. } 7,00,000}{\text{Rs. } 5,00,000}$$

$$\therefore \text{Current Assets} = \text{Rs. } 10,75,000.$$

$$\begin{aligned}\therefore \text{Fixed Assets} &= \text{Total Assets} - \text{Current Assets} \\ &= \text{Rs. } 15,00,000 - \text{Rs. } 10,75,000 = \text{Rs. } 4,25,000\end{aligned}$$

$$\begin{aligned}\text{Cash and Bank balance} &= \text{Current Assets} - \text{Inventory} - \text{Debtors} \\ &= \text{Rs. } 10,75,000 - \text{Rs. } 7,00,000 - \text{Rs. } 3,33,333 = \text{Rs. } 41,667\end{aligned}$$

Balance Sheet as on March 31, 20X8

| Liabilities | Rs. | Assets | Rs. |
|----------------------|----------|--|----------|
| Equity Share Capital | 4,00,000 | Plant and Machinery and other Fixed Assets | 4,25,000 |
| Reserves & Surplus | 6,00,000 | | |
| Total Debt: | | Current Assets: | |
| Current liabilities | 5,00,000 | Inventory | 7,00,000 |

| | | | |
|--|-----------|---------|-----------|
| | | Debtors | 3,33,333 |
| | | Cash | 41,667 |
| | 15,00,000 | | 15,00,000 |

Question 5

MNP Limited has made plans for the year 2019 -20. It is estimated that the company will employ total assets of Rs.50,00,000; 30% of assets being financed by debt at an interest cost of 9% p.a. The direct costs for the year are estimated at Rs. 30,00,000 and all other operating expenses are estimated at Rs. 4,80,000. The sales revenue is estimated at Rs. 45,00,000. Tax rate is assumed to be 40%. CALCULATE:

- Net profit margin (After tax);
- Return on Assets (After tax);
- Asset turnover; and
- Return on Equity. [MTP 5 Marks, Oct'19]

Answer 5

The net profit is calculated as follows:

| | Rs. |
|---|-----------|
| Sales Revenue | 45,00,000 |
| Less: Direct Costs | 30,00,000 |
| Gross Profits | 15,00,000 |
| Less: Operating Expense | 4,80,000 |
| Earnings before Interest and tax (EBIT) | 10,20,000 |
| Less: Interest on debt (9% × 15,00,000) | 1,35,000 |
| Earnings before Tax) (EBT) | 8,85,000 |
| Less: Taxes (@ 40%) | 3,54,000 |
| Profit after Tax (PAT) | 5,31,000 |

(i) Net Profit Margin (After Tax)

$$\text{Net Profit Margin} = \frac{\text{EBIT} (1 - t)}{\text{Sales}} \times 100 = \frac{\text{Rs.} 10,20,000 \times (1 - 0.4)}{\text{Rs.} 45,00,000} = 13.6\%$$

(ii) Return on Assets (ROA) (After tax)

$$\text{ROA} = \frac{\text{EBIT} (1 - t)}{\text{Total Assets}} = \frac{\text{Rs.} 10,20,000 (1 - 0.4)}{\text{Rs.} 50,00,000} = \frac{\text{Rs.} 6,12,000}{\text{Rs.} 50,00,000} = 0.1224 = 12.24\%$$

(iii) Asset Turnover

$$\frac{\text{Sales}}{\text{Assets}} = \frac{\text{Rs.} 45,00,000}{\text{Rs.} 50,00,000} = 0.9$$

Asset Turnover = 0.9 times

(iv) Return on Equity (ROE)

$$\text{ROE} = \frac{\text{PAT}}{\text{Equity}} = \frac{\text{Rs.} 5,31,000}{\text{Rs.} 35,00,000} = 15.17\%$$

$$\text{ROE} = 15.17\%$$

Question 6

The following accounting information and financial ratios of A&R Limited relate to the year ended 31st March, 2020:

Inventory Turnover Ratio

6 Times

Creditors Turnover Ratio

10 Times



| | |
|------------------------|---------|
| Debtors Turnover Ratio | 8 Times |
| Current Ratio | 2.4 |
| Gross Profit Ratio | 25% |

Total sales Rs.6,00,00,000; cash sales 25% of credit sales; cash purchases Rs.46,00,000; working capital Rs.56,00,000; closing inventory is Rs.16,00,000 more than opening inventory.

You are required to CALCULATE:

- (i) Average Inventory
- (ii) Purchases
- (iii) Average Debtors
- (iv) Average Creditors
- (v) Average Payment Period
- (vi) Average Collection Period
- (vii) Current Assets
- (viii) Current Liabilities.

Take 365 days a year [MTP 10 Marks, May'20]

Answer 6

(i) Computation of Average Inventory

Gross Profit = 25% of Rs.6,00,00,000 = Rs.1,50,00,000

Cost of goods sold (COGS) = Sales - Gross Profit

= Rs.6,00,00,000 – Rs.1,50,00,000

= Rs.4,50,00,000

Inventory Turnover Ratio = $\frac{\text{CPGS}}{\text{Average inventory}}$

= 6 = $\frac{\text{Rs.4,50,00,000}}{\text{Average inventory}}$

Average inventory = Rs.75,00,000

Computation of Purchases

Purchases = COGS + (Closing Stock – Opening Stock)

= Rs.4,50,00,000 + 16,00,000*

Purchases = Rs.4,66,00,000

* Increase in Stock = Closing Stock – Opening Stock = Rs.16,00,000

Computation of Average Debtors

Let Credit Sales be Rs.100, Cash sales = $\frac{25}{100} \times 100 = \text{Rs.25}$

Total Sales = 100 + 25 = Rs.125

Total sales are Rs.125 credit sales is Rs.100

If total sales is Rs.6,00,00,000, then credit sales is = $\frac{\text{Rs.6,00,00,000}}{125} \times 100$

Credit Sales = Rs.4,80,00,000

Cash Sales = (Rs.6,00,00,000 – Rs.4,80,00,000) = Rs.1,20,00,000

Debtors Turnover Ratio =

= $\frac{\text{Net credit sales}}{\text{average debtors}} = 8$

= $\frac{\text{Rs.4,80,00,000}}{\text{average debtors}} = 8$

average debtors = $\frac{\text{Rs.4,80,00,000}}{8}$

Average Debtors = Rs.60,00,000

(ii) Computation of Average Creditors

Credit Purchases = Purchases – Cash Purchases

= Rs.4,66,00,000 – Rs.46,00,000 = Rs.4,20,00,000

$$\text{Creditors Turnover Ratio} = \frac{\text{credit purchases}}{\text{average creditors}}$$

$$10 = \frac{\text{Rs.4,20,00,000}}{\text{average creditors}}$$

$$\text{Average Creditors} = \text{Rs.42,00,000}$$

(iii) Computation of Average Payment Period

$$\text{Average Payment Period} = \frac{\text{verage creditors}}{\text{average Daily Credit Purchases}}$$

$$= \frac{\text{Rs.42,00,000}}{\frac{\text{Credit Purchases}}{365}} = \frac{\text{Rs.42,00,000}}{\frac{\text{Rs.4,20,00,000}}{365}}$$

$$\frac{\text{Rs.42,00,000}}{\text{RS.4,20,00,000}} \times 365 = 36.5 \text{ days}$$

Alternatively

$$\text{Average Payment Period} = 365 / \text{Creditors Turnover Ratio}$$

$$= \frac{365}{10} = 36.5 \text{ days}$$

(iv) Computation of Average Collection Period

$$\text{Average Collection Period} =$$

$$= \frac{\text{Average Debtors}}{\text{Net Credit Sales}} \times 365$$

$$= \frac{\text{Rs.60,00,000}}{\text{Rs.4,80,00,000}} \times 365 = 45.625 \text{ days}$$

Alternatively

$$\text{Average collection period} = \frac{365}{\text{Debtors Turnover Ratio}}$$

$$= \frac{365}{8} = 45.625 \text{ days}$$

(v) Computation of Current Assets

$$\text{Current Ratio} = \frac{\text{Current Assets (CA)}}{\text{Current Liabilities (CL)}}$$

$$2.4 \text{ Current Liabilities} = \text{Current Assets}$$

$$\text{or } \text{CL} = \frac{\text{CA}}{2.4}$$

Further, Working capital = Current Assets – Current liabilities

$$\text{So, Rs.56,00,000} = \text{CA} - \frac{\text{CA}}{2.4}$$

$$\text{Rs.56,00,000} = \frac{1.4 \text{CA}}{2.4} \text{ Or, } 1.4 \text{ CA} = \text{Rs.1,34,40,000}$$

$$\text{CA} = \text{Rs.96,00,000}$$

(vi) Computation of Current Liabilities

Current liabilities

$$= \frac{\text{Rs.96,00,000}}{2.4} = \text{Rs.40,00,000}$$

Question 7

Using the information given below, PREPARE the Balance Sheet of SKY Private Limited:

| | | |
|--------|---|-----------------------------|
| (i) | Current ratio | 1.6 :1 |
| (ii) | Cash and Bank balance | 15% of total current assets |
| (iii) | Debtors turnover ratio | 12 times |
| (iv) | Stock turnover (cost of goods sold) ratio | 16 times |
| (v) | Creditors turnover (cost of goods sold) ratio | 10 times |
| (vi) | Gross profit ratio | 20% |
| (vii) | Capital gearing ratio | 0.6 |
| (viii) | Depreciation rate | 15% on W.D.V. |
| (ix) | Net fixed Assets | 20% of total assets |

(Assume all purchase and sales are on credit)

Balance Sheet of SKY Private Limited as at 31.03.2020

| Liabilities | | Amount in ₹ | Assets | | Amount in ₹ |
|---------------------|---------------|-------------|-------------------------|---|-------------|
| Share Capital | | 25,00,000 | Fixed assets | | |
| Reserve & surplus | | ? | Opening WDV | ? | |
| 12% Long term debt | | ? | Less: Depreciation | ? | ? |
| Current liabilities | | | Current Assets | | |
| Creditors | ? | | Stock | ? | |
| Provisions expenses | outstanding ? | 68,50,000 | Debtors | ? | |
| | | | Cash and bank balance ? | ? | |
| Total | | ? | Total | | ? |

(Detailed working notes are not required to be shown) [MTP 5 Marks, Oct'20]

Answer 7
Working Notes
1. Computation of Current Assets and Cash & Bank Balance

Current Ratio=

$$= \frac{\text{Current Assets (CA)}}{\text{Current Liabilities (CL)}}$$

Current Assets = 1.6 Current Liabilities = 1.6 × ₹ 68,50,000 = RS.1,09,60,000/- So, Cash and Bank

Balance=15% of Current Assets = RS.16,44,000

2. Computation of Total Assets, Fixed assets and Depreciation

Total Assets = Net Fixed assets+ Current Asset

Or, Total Assets = 20% of Total Asset + RS.1,09,60,000 Or, Total Assets = RS.1,37,00,000

So, Net Fixed assets = 20% of Total Asset = RS.27,40,000

Depreciation = $\frac{27,40,000}{58\%} = 15\% = \text{Rs}4,83,$

Fixed Assets = RS.27,40,000 + Rs 4,83,529 = RS.32,23,529

3. Calculation of stock, Debtors and Creditors

Stock + Debtors = Current Assets – Cash & Bank

= RS.1,09,60,000 – RS.16,44,000



$$= ₹ 93,16,000$$

Now, let Sales be x

$$\text{So, Debtors (Credit Sales)} = \frac{\text{Credit Sales}}{\text{Debit turnover ratio}} = \frac{X}{12}$$

= Further, Stock (on Cost of Goods Sold) =

$$= \frac{\text{Sales} - 20\% \text{ of Sales}}{16}$$

$$= \frac{X - 20\% \text{ of } X}{16}$$

$$= \frac{X - \frac{X}{5}}{16} = \frac{\frac{4X}{5}}{16} = \frac{X}{20}$$

$$\text{So } = \frac{X}{12} + \frac{X}{20}$$

$$\text{OR } = \frac{10X + 6X}{120} = \text{Rs. } 93,16,000$$

$$\text{OR } = \frac{16X}{120} = \text{Rs. } 93,16,000$$

Or, x = ₹ 6,98,70,000 So, Sales = ₹ 6,98,70,000

Cash of Goods Sold (COGS) = ₹ 5,58,96,000 Stock (COGS/16) = RS.34,93,500

Debtors (Sales/12) = ₹ 58,22,500

Creditors (COGS/10) = ₹ 55,89,600

4. Calculation of Provision of outstanding Expenses

$$= ₹ 68,50,000 - ₹ 55,89,600$$

$$= \text{RS.} 12,60,400$$

5. Share Capital + Reserve of surplus + long term debt = Total Asset or total liability – Current liability

$$\text{Or, Reserve \& surplus + long term debt} = \text{RS.} 1,37,00,000 - 68,50,000 - 25,00,000$$

$$= ₹ 43,50,000$$

Calculation of long term Debt and Reserve & Surplus Now, Capital Earning ratio = 0.6

$$\text{So, } = \frac{12\% \text{ long term Debt}}{\text{Equity Share Capital + Reserve \& Surplus}} = 0.6$$

$$\text{Or } = \frac{43,50,000 - \text{Reserve \& Surplus}}{25,00,000 + \text{Reserve \& Surplus}} = 8$$

Or, Reserve & Surplus = RS.17,81,250

So, 12% long term debt = RS.25,68,750

Balance Sheet of SKY Private Limited as at 31.03.2020

| Liabilities | ₹ | Assets | ₹ |
|---------------------|-----------|--------------------|-----------|
| Share Capital | 25,00,000 | Fixed assets | |
| Reserve & Surplus | 17,81,250 | Opening WDV | 32,23,529 |
| 12% Long term debt | 25,68,750 | Less: Depreciation | 4,83,529 |
| Current Liabilities | | | 27,40,000 |

| | | | | | |
|-----------------------------------|-----------|-------------|-----------------------|-----------|-------------|
| Creditors | 55,89,600 | | Current Assets | | |
| Provisions & outstanding expenses | 12,60,400 | 68,50,000 | Stock | 34,93,500 | |
| | | | Debtors | 58,22,500 | |
| | | | Cash and bank balance | 16,44,000 | 1,09,60,000 |
| Total | | 1,37,00,000 | | | 1,37,00,000 |

Question 8

XYZ Ltd. has Owner's equity of Rs. 2,00,000 and the ratios of the company are as follows: (MTP 5 Marks, April'21) (Same concept different figures MTP 5 Marks March 22, PYP 5 Marks Jan'21, MTP 5 Marks Apr'19)

| | |
|---------------------------------|----------|
| Current debt to total debt | 0.3 |
| Total debt to Owner's equity | 0.5 |
| Fixed assets to Owner's equity | 0.6 |
| Total assets turnover Inventory | 2 times |
| Inventory turnover | 10 times |

COMPLETE the following Balance Sheet from the information given above:

| Liabilities | (Rs.) | Assets | (Rs.) |
|----------------|-------|----------------------|-------|
| Current Debt | - | Cash | - |
| Long-term Debt | - | Inventory | - |
| Total Debt | - | Total Current Assets | - |
| Owner's Equity | - | Fixed Assets | - |
| | | | |

Answer 8
Balance Sheet

| Liabilities | (Rs.) | Assets | (Rs.) |
|-------------------|----------|-------------------------|----------|
| Current debt | 30,000 | Cash (balancing figure) | 1,20,000 |
| Long term debt | 70,000 | Inventory | 60,000 |
| Total Debt | 1,00,000 | Total Current Assets | 1,80,000 |
| Owner's Equity | 2,00,000 | Fixed Assets | 1,20,000 |
| Total liabilities | 3,00,000 | Total Assets | 3,00,000 |

Workings:

Total debt = $0.50 \times \text{Owner's Equity} = 0.50 \times \text{Rs. } 2,00,000 = \text{Rs. } 1,00,000$ Further, Current debt to Total debt = 0.30

So, Current debt = $0.30 \times \text{Rs. } 1,00,000 = \text{Rs. } 30,000$ Long term debt = $\text{Rs. } 1,00,000 - \text{Rs. } 30,000 = \text{Rs. } 70,000$

2. Fixed assets = $0.60 \times \text{Owner's Equity} = 0.60 \times \text{Rs. } 2,00,000 = \text{Rs. } 1,20,000$

3. Total Liabilities = Total Debt + Owner's Equity
 = $\text{Rs. } 1,00,000 + \text{Rs. } 2,00,000 = \text{Rs. } 3,00,000$

Total Assets = Total Liabilities = $\text{Rs. } 3,00,000$

Total assets to turnover = 2 Times; Inventory turnover = 10 Times

Hence, Inventory / Total assets = $2/10 = 1/5$,

Therefore, Inventory = $\text{Rs. } 3,00,000/5 = \text{Rs. } 60,000$

Question 9

SN Ltd. has furnished the following ratios and information relating to the year ended 31 st March 2021:

| | |
|-----------------------------------|--------------|
| Share Capital | Rs. 6,25,000 |
| Working Capital | Rs. 2,00,000 |
| Gross Margin | 25% |
| Inventory Turnover | 5 times |
| Average Collection Period | 1.5 months |
| Current Ratio | 1.5:1 |
| Quick Ratio | 0.7:1 |
| Reserves & Surplus to Bank & Cash | 3 times |

Further, the assets of the company consist of fixed assets and current assets, while its current liabilities comprise bank credit and others in the ratio of 3:1. Assume 360 days in a year.

You are required to PREPARE the Balance Sheet as on 31st March 2021.

(Note- Balance sheet may be prepared in traditional T Format.) (MTP 5 Marks, March 21)

Answer 9
Workings:

$$1. \text{ Current Ratio} = \frac{\text{Current Assets(CA)}}{\text{Current Liabilities(CL)}} = \frac{1.5}{1}$$

$$\therefore \text{CA} = 1.5 \text{ CL}$$

$$\text{Also, CA - CL} = \text{Rs. 2,00,000} \quad 1.5 \text{ CL} - \text{CL} = \text{Rs. 2,00,000}$$

$$\text{CL} = \frac{2,00,000}{0.5}$$

$$\text{CA} = 1.5 \times \text{Rs. 4,00,000} = \text{Rs. 6,00,000}$$

$$2. \text{ Bank Credit (BC) to Other Current Liabilities (OCL) ratio} = 3:1$$

$$= \frac{\text{Bank Credit (BC)}}{\text{Other Current Liabilities(OCL)}} = \frac{3}{1}$$

$$\text{BC} = 3 \text{ OCL}$$

$$\text{Also, BC + OCL} = \text{CL}$$

$$3 \text{ OCL} + \text{OCL} = \text{Rs. 4,00,000}$$

$$\text{OCL} = \frac{\text{Rs. 4,00,000}}{4} = \text{Rs. 1,00,000}$$

$$\text{Bank Credit} = 3 \times \text{Rs. 1,00,000} = \text{Rs. 3,00,000}$$

$$3. \text{ Quick Ratio} = \frac{\text{Current Assets-Invetores}}{\text{Current Liabilities}}$$

$$0.7 = \frac{\text{Rs. 6,00,000} - \text{Inventories}}{\text{Rs. 4,00,000}}$$

$$\text{Inventories} = \text{Rs. 6,00,000} - \text{Rs. 2,80,000} = \text{Rs. 3,20,000}$$

$$4. \text{ Inventory Turnover} = 5 \text{ times}$$

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold (COGS)}}{\text{Average Inventory}}$$

$$\text{Average Inventory}$$



$$\frac{\text{Cost of Goods Sold (COGS)}}{\text{Inventory Turnover}}$$

$$\text{COGS} = \text{Rs. } 3,20,000 \times 5 = \text{Rs. } 16,00,000$$

$$5. \text{ Gross Margin} = \frac{\text{Sales} - \text{COGS}}{\text{Sales}} \times 100 = 25\%$$

$$\text{Sales} = \frac{16,00,000}{0.75} = \text{Rs. } 21,33,333.33$$

$$6. \text{ Average Collection Period (ACP)} = 1.5 \text{ months} = 45 \text{ days}$$

$$\text{Debtors Turnover} = \frac{360}{\text{ACP}} = \frac{360}{45} = 8 \text{ times}$$

$$\begin{aligned} &= \text{Also, Debtors Turnover} \\ &= \frac{\text{Sales}}{\text{Average debtors}} \end{aligned}$$

$$\text{Hence, Debtors} = \frac{\text{Rs. } 21,33,333.33}{8} = \text{Rs. } 2,66,667$$

$$\begin{aligned} 7. \text{ Bank \& Cash} &= \text{CA} - (\text{Debtors} + \text{Inventory}) \\ &= \text{Rs. } 6,00,000 - (\text{Rs. } 2,66,667 + 3,20,000) = \text{Rs. } 13,333 \end{aligned}$$

$$8. \frac{\text{Reserves \& Surplus}}{\text{Bank \& Cash}} = 3$$

$$\text{Reserves \& Surplus} = 3 \times \text{Rs. } 13,333 = \text{Rs. } 40,000$$

Balance Sheet of SN Ltd. as on 31st March 2021

| Liabilities | (Rs.) | Assets | (Rs.) |
|---------------------------|-----------|--------------------|-----------|
| Share Capital | 6,25,000 | Fixed Assets | 4,65,000 |
| Reserves & Surplus | 40,000 | (Balancing Figure) | |
| Current Liabilities: | | Current Assets: | |
| Bank Credit | 3,00,000 | Inventories | 3,20,000 |
| Other Current Liabilities | 1,00,000 | Debtors | 2,66,667 |
| | | Bank & Cash | 13,333 |
| | 10,65,000 | | 10,65,000 |

Question 10

- ABC Ltd. has total sales of 10,00,000 all of which are credit sales. It has a gross profit ratio of 25% and a current ratio of 2. The company's current liabilities are RS.2,00,000. Further, it has inventories of Rs. 80,000, marketable securities of ₹ 50,000 and cash of RS. 30,000. From the above information:
- CALCULATE the average inventory, if the expected inventory turnover ratio is three times?
- Also CALCULATE the average collection period if the opening balance of debtors is expected to be RS.1,50,000.
- Assume 360 days a year. (MTP 5 Marks, Oct'21 & Oct '23)(Same concept different figures Old & New SM)

Answer 10

I. Calculation of Average Inventory

Since gross profit is 25% of sales, the cost of goods sold should be 75% of the sales.



$$\text{Cost of goods sold} = 10,00,000 \times \frac{75}{100} = 7,50,000$$

$$\text{Inventory Turnover} = \frac{\text{Cost of goods sold}}{\text{Average Inventory}}$$

$$3 = \frac{7,50,000}{\text{Average Inventory}}$$

$$\text{Average Inventory} = \frac{7,50,000}{3} = 2,50,000$$

II. Calculation of Average Collection Period

Average Collection Period =

$$= \frac{\text{Average debtors}}{\text{Credits Sales}} \times 360$$

$$\text{Where, Average Debtors} = \frac{\text{Opening Debtors} + \text{Closing Debtors}}{2}$$

Calculation of Closing balance of debtors

| | ₹ | ₹ |
|-------------------------------|--------|----------|
| Current Assets (2 x 2,00,000) | | 4,00,000 |
| Less: Inventories | 80,000 | |
| Marketable Securities | 50,000 | |
| Cash | 30,000 | 1,60,000 |
| Debtors Closing Balance | | 2,40,000 |

$$\text{Now, Average Debtors} = \frac{1,50,00,00 + 2,40,000}{2} = 1,95,000$$

$$\text{So, Average Collection Period} = \frac{1,95,000}{10,00,000} \times 360 = 70.2 \text{ or } 70 \text{ days}$$

Question 11

Jensen and spencer pharmaceutical is in the business of manufacturing pharmaceutical drugs including the newly invented Coved vaccine. Due to increase in demand of Coved vaccines, the production had increased at all-time high level and the company urgently needs a loan to meet the cash and investment requirements. It had already submitted a detailed loan proposal and project report to Expo-Imp bank, along with the financial statements of previous three years as follows:

Statement of Profit and Loss (In ₹ '000)

| | 2018-19 | 2019-20 | 2020-21 |
|---|---------|---------|---------|
| Sales | | | |
| Cash | 400 | 960 | 1,600 |
| Credit | 3,600 | 8,640 | 14,400 |
| Total sales | 4,000 | 9,600 | 16,000 |
| Cost of goods sold | 2,480 | 5,664 | 9,600 |
| Gross profit | 1,520 | 3,936 | 6,400 |
| Operating expenses: | | | |
| General, administration, and selling expenses | 160 | 900 | 2,000 |
| Depreciation | 200 | 800 | 1,320 |
| Interest expenses (on borrowings) | 120 | 316 | 680 |
| Profit before tax (PBT) | 1,040 | 1,920 | 2,400 |
| Tax @ 30% | 312 | 576 | 720 |
| Profit after tax (PAT) | 728 | 1,344 | 1,680 |



BALANCE SHEET

(In ₹ '000)

| | 2018-19 | 2019-20 | 2020-21 |
|---|--------------|---------------|---------------|
| Assets | | | |
| Non-Current Assets | | | |
| Fixed assets (net of depreciation) | 3,800 | 5,000 | 9,400 |
| Current Assets | | | |
| Cash and cash equivalents | 80 | 200 | 212 |
| Accounts receivable | 600 | 3,000 | 4,200 |
| Inventories | 640 | 3,000 | 4,500 |
| Total | 5,120 | 11,200 | 18,312 |
| Equity & Liabilities | | | |
| Equity share capital (shares of ₹10 each) | 2,400 | 3,200 | 4,000 |
| Other Equity | 728 | 2,072 | 3,752 |
| Non-Current borrowings | 1,472 | 2,472 | 5,000 |
| Current liabilities | 520 | 3,456 | 5,560 |
| Total | 5,120 | 11,200 | 18,312 |

INDUSTRY AVERAGE OF KEY RATIOS

| Ratio | Sector Average |
|---|----------------|
| Current ratio | 2.30:1 |
| Acid test ratio (quick ratio) | 1.20:1 |
| Receivable turnover ratio | 7 times |
| Inventory turnover ratio | 4.85 times |
| Long-term debt to total debt | 24% |
| Debt-to-equity ratio | 35% |
| Net profit ratio | 18% |
| Return on total assets | 10% |
| Interest coverage ratio (times interest earned) | 10 |

As a loan officer of Expo-Imp Bank, you are REQUIRED to apprise the loan proposal on the basis of comparison with industry average of key ratios considering closing balance for accounts receivable of ₹ 6,00,000 and inventories of ₹ 6,40,000 respectively as on 31st March, 2018. [MTP 10 Marks, Nov'21]

Answer 11

(In ₹ '000)

| Ratio | Formula | 2018-19 | 2019-20 | 2020-21 | Industry Average |
|---------------|--|---------------------|-----------------------|-----------------------|------------------|
| Current ratio | $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ | $\frac{1,320}{520}$ | $\frac{6,200}{3,456}$ | $\frac{8,912}{5,560}$ | 2.30:1 |
| | | = 2.54 | = 1.80 | = 1.60 | |



| | | | | | |
|---|--|---|---|---|------------|
| Acid test ratio (quick ratio) | $\frac{\text{Quick Assets}}{\text{Current Liabilities}}$ | $\frac{680}{520} = 1.31$ | $\frac{3,200}{3,456} = 0.93$ | $\frac{4,412}{5,560} = 0.79$ | 1.20:1 |
| Receivable turnover ratio | $\frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$ | $\frac{3,600}{(600+600)/2} = 6$ | $\frac{8,640}{(600+3000)/2} = 4.80$ | $\frac{14,400}{(3000+4,200)/2} = 4$ | 7 times |
| Inventory turnover ratio | $\frac{\text{COGS}}{\text{Average Inventory}}$ | $\frac{2,480}{(640+640)/2} = 3.88$ | $\frac{5,664}{(640+3000)/2} = 3.11$ | $\frac{9,600}{(3,000+4,500)/2} = 2.56$ | 4.85 times |
| Long-term debt to total debt | $\frac{\text{Long term Debt}}{\text{Total Debt}} \times 100$ | $\frac{1472}{1992} \times 100 = 73.90\%$ | $\frac{2472}{5,948} \times 100 = 41.70\%$ | $\frac{5,000}{10,560} \times 100 = 47.35\%$ | 24% |
| Debt-to-equity ratio | $\frac{\text{Long term Debt}}{\text{Shareholders' Equity}} \times 100$ | $\frac{1472}{3,128} \times 100 = 47.07\%$ | $\frac{2472}{5272} \times 100 = 46.89\%$ | $\frac{5,000}{7,752} \times 100 = 64.50\%$ | 35% |
| Net profit ratio | $\frac{\text{Net Profit}}{\text{Sales}} \times 100$ | $\frac{728}{5,120} \times 100 = 14.22\%$ | $\frac{1344}{9,600} \times 100 = 14\%$ | $\frac{1680}{16,000} \times 100 = 10.5\%$ | 18% |
| Return on total assets | $\frac{\text{Net Profit after taxes}}{\text{Total asset}} \times 100$ | $\frac{728}{5,120} \times 100 = 14.22\%$ | $\frac{1344}{11,200} \times 100 = 12\%$ | $\frac{1680}{18,312} \times 100 = 9.17\%$ | 10% |
| Interest coverage ratio (times interest earned) | $\frac{\text{EBIT}}{\text{Interest}}$ | $\frac{1160}{120} = 9.67\%$ | $\frac{2236}{316} = 7.08$ | $\frac{3080}{680} = 4.53$ | 10 |

Conclusion:

In the last two years, the current ratio and quick ratio are less than the ideal ratio (2:1 and 1:1 respectively) indicating that the company is not having enough resources to meet its current

obligations. Receivables are growing slower. Inventory turnover is slowing down as well, indicating a relative build-up in inventories or increased investment in stock. High Long-term debt to total debt ratio and Debt to equity ratio compared to that of industry average indicates high dependency on

long term debt by the company. The net profit ratio is declining substantially and is much lower than the industry norm. Additionally, though the Return on Total Asset (ROTA) is near to industry average, it is declining as well. The interest coverage ratio measures how many times a company can cover its current interest payment with its available earnings. A high interest coverage ratio means that an enterprise can easily meet its interest obligations, however, it is declining in the case of Jensen & Spencer and is also below the industry average indicating excessive use of debt or inefficient operations.

On overall comparison of the industry average of key ratios than that of Jensen & Spencer, the company is in deterioration position. The company's profitability has declined steadily over the period. However, before jumping to the conclusion relying only on the key ratios, it is pertinent to keep in mind the industry, the company dealing in with i.e. manufacturing of pharmaceutical drugs. The pharmaceutical industry is one of the major contributors to the economy and is expected to grow further. After the covid situation, people are more cautious towards their health and are going to spend relatively more on health medicines. Thus, while analyzing the loan proposal, both the factors, financial and non-financial, needs to be kept in mind.

Question 12

From the following information, you are required to PREPARE a summarised Balance Sheet for Rudra Ltd. for the year ended 31st March, 2022

| | |
|--|-------------|
| Debt Equity Ratio | 1:1 |
| Current Ratio | 3:1 |
| Acid Test Ratio | 8:3 |
| Fixed Asset Turnover (on the basis of sales) | 4 |
| Stock Turnover (on the basis of sales) | 6 |
| Cash in hand | 5,00,000 |
| Stock to Debtor | 1:1 |
| Sales to Net Worth | 4 |
| Capital to Reserve | 1:2 |
| Gross Profit | 20% of Cost |
| COGS to Creditor | 10:1 |

Interest for entire year is yet to be paid on Long Term loan @ 10%.
 (MTP 5 Marks April 22, New SM)

Answer 12

Balance Sheet of Rudra Ltd.

| Liabilities | Amount (₹) | Assets | Amount (₹) |
|----------------------|------------|-----------------|------------|
| Capital | 10,00,000 | Fixed Assets | 30,00,000 |
| Reserves | 20,00,000 | Current Assets: | |
| Long Term Loan @ 10% | 30,00,000 | Stock in Trade | 20,00,000 |

| | | | |
|---|-----------|---------|-----------|
| Current Liabilities: | | Debtors | 20,00,000 |
| Creditors | 10,00,000 | Cash | 5,00,000 |
| Other Short-term Current Liability (Other STCL) | 2,00,000 | | |
| Outstanding Interest | 3,00,000 | | |
| | 75,00,000 | | 75,00,000 |

Working Notes:

Let sales be ₹ x

Balance Sheet of Rudra Ltd.

| Liabilities | Amount (₹) | Assets | Amount (₹) |
|------------------------------------|----------------|-----------------|------------|
| Capital | | Fixed Assets | x/4 |
| Reserves | | Current Assets: | |
| Net Worth | x/4 | Stock in Trade | x/6 |
| Long Term Loan @ 10% | x/4 | Debtors | x/6 |
| | | Cash | 5,00,000 |
| Current liabilities: | | | |
| Creditors | x/12 | | |
| Other Short-term Current Liability | | | |
| Outstanding Interest | | | |
| Total Current Liabilities | x/9+5,00,000/3 | | |
| Total | | Total | |

$$1. \text{ Fixed Asset Turnover} = 4 = \frac{X}{\text{Fixed Assets}}$$

$$\text{Fixed Assets} = \frac{X}{4}$$

$$2. \text{ Stock Turnover} = 6 = \frac{X}{\text{Stock}}$$

$$\text{Stock} = \frac{X}{6}$$

$$3. \text{ Sales to net worth} = 4 = \frac{X}{\text{net worth}}$$

$$\text{Net worth} = \frac{X}{4}$$

$$4. \text{ Debt : Equity} = 1:1$$

$$\frac{\text{Long term Loan}}{\text{Net worth}} = \frac{1}{1}$$

$$\text{Long term loan} = \text{Net worth} = \frac{X}{4}$$

$$5. \text{ Gross Profit to cost} = 20\%$$

$$\frac{GP}{\text{Sales} - GP} = 20\%$$



$$\frac{GP}{X-GP} = 20\%$$

$$GP = 0.2 X - 0.2 GP$$

$$1.2 GP = 0.2X$$

$$GP = \frac{0.2X}{1.2}$$

$$GP = X/6$$

$$\text{Cost of Goods Sold} = x - x/6 = 5/6 x$$

6. COGS to creditors = 10:1

$$\frac{\text{CoGs}}{\text{Creditors}} = 10/1$$

$$\frac{\frac{5}{6}X}{\text{Creditors}} = 10/1$$

$$\text{Creditors} = \frac{5x}{60} = X/12$$

7. $\frac{\text{Stock}}{\text{Debtor}} = 1$

$$\text{Debtor} = \text{Stock} = X/6$$

8. Current Ratio = 3:1

$$\frac{\text{Stock} + \text{Debtors} + \text{Cash}}{\text{Current Liabilities}} = 3/1$$

$$\frac{\frac{X}{6} + \frac{x}{6} + 5,00,000}{\text{Current Liabilities}} = 3$$

$$\frac{\frac{x}{3} + 5,00,000}{3} = CL$$

$$CL = \frac{X}{9} + \frac{5,00,000}{3}$$

9. CA = 3CL

$$= 3\left(\frac{X}{9} + \frac{5,00,000}{3}\right)$$

$$CA = \frac{X}{3} + 5,00,000$$

10. Net worth + Long Term Loan + Current Liability = Fixed Asset + Current Assets

$$\frac{X}{4} + \frac{X}{4} + \frac{X}{9} + 5,00,000/3 = \frac{X}{4} + \frac{X}{3} + 5,00,000$$

$$\frac{X}{4} + \frac{X}{9} - \frac{X}{3} = 5,00,000 - \frac{5,00,000}{3}$$

$$\frac{9x + 4x - 12X}{36} = \frac{15,00,000 - 5,00,000}{3}$$



$$\frac{X}{36} = 10,00,000/3$$

$$X = 1,20,00,000$$

11. Now, from above calculations, we get,

$$\text{Fixed Asset} = \frac{X}{4} = \frac{1,20,00,000}{4} = 30,00,000$$

$$\text{Stock} = \frac{X}{6} = \frac{1,20,00,000}{6} = 20,00,000$$

$$\text{Debtor} = \frac{X}{6} = \frac{1,20,00,000}{6} = 20,00,000$$

$$\text{Net worth} = x/4 = 30,00,000$$

Now, Capital to Reserve is 1 : 2

$$\text{Capital} = ₹ 10,00,000$$

$$\text{and, Reserve} = ₹ 20,00,000$$

$$\text{Long Term Loan} = X/4 = 30,00,000$$

$$\text{Outstanding Interest} = 30,00,000 \times 10\% = 3,00,000$$

$$\text{Creditors} = x/12 = 1,20,00,000 / 12 = 10,00,000$$

$$\text{Current Liabilities} = \text{Creditors} + \text{Other STCL} + \text{Outstanding Interest}$$

$$X/9 \times 5,00,000/3 = 10,00,000 + \text{Other STCL} + 3,00,000$$

$$\frac{1,20,00,000}{6} + \frac{5,00,000}{3} = 13,00,000 + \text{Other STCL}$$

$$15,00,000 = \text{Other STCL} + 13,00,000$$

$$\text{Other STCL} = 2,00,000$$

Question 13

DISCUSS the limitations of financial ratios. (MTP 4 Marks April 22, Old & New SM)

Answer 13

The limitations of financial ratios are listed below:

- (i) Diversified product lines: Many businesses operate a large number of divisions in quite different industries. In such cases ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons.
- (ii) Financial data are badly distorted by inflation: Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios.
- (iii) Seasonal factors may also influence financial data.
- (iv) To give a good shape to the popularly used financial ratios (like current ratio, debt- equity ratios, etc.): The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change.
- (v) Differences in accounting policies and accounting period: It can make the accounting data of

two firms non-comparable as also the accounting ratios.

- (vi) There is no standard set of ratios against which a firm's ratios can be compared: Sometimes a firm's ratios are compared with the industry average. But if a firm desires to be above the average, then industry average becomes a low standard. On the other hand, for a below average firm, industry averages become too high a standard to achieve.
- (vii) Financial ratios are inter-related, not independent: Viewed in isolation one ratio may highlight efficiency. But when considered as a set of ratios they may speak differently. Such interdependence among the ratios can be taken care of through multivariate analysis.

Question 14

PI Limited has the following Balance Sheet as on March 31, 2020 and March 31, 2021:

Balance Sheet

| Particulars | March 31, 2020 | March 31, 2021 |
|-------------------------------|-----------------|-----------------|
| Sources of Funds: | | |
| Shareholders' Funds | 87,500 | 87,500 |
| Loan Funds | 1,22,500 | 1,05,000 |
| | 2,10,000 | 1,92,500 |
| Applications of Funds: | | |
| Fixed Assets | 87,500 | 1,05,000 |
| Cash and bank | 15,750 | 14,000 |
| Receivables | 49,000 | 38,500 |
| Inventories | 87,500 | 70,000 |
| Other Current Assets | 35,000 | 35,000 |
| Less: Current Liabilities | (64,750) | (70,000) |
| | 2,10,000 | 1,92,500 |

The Income Statement of the PI Ltd. for the year ended is as follows:

| Particulars | March 31, 2020 | March 31, 2021 |
|--|----------------|----------------|
| Sales | 7,87,500 | 8,33,000 |
| Less: Cost of Goods sold | (7,30,100) | (7,38,500) |
| Gross Profit | 57,400 | 94,500 |
| Less: Selling, General and Administrative expenses | (38,500) | (61,250) |
| Earnings before Interest and Tax (EBIT) | 18,900 | 33,250 |
| Less: Interest Expense | (12,250) | (10,500) |
| Earnings before Tax (EBT) | 6,650 | 22,750 |
| Less: Tax | (1,995) | (6,825) |
| Profits after Tax (PAT) | 4,655 | 15,925 |

You are required to CALCULATE for the year 2020-21:

- (i) Inventory turnover ratio
- (ii) Financial Leverage
- (iii) Return on Capital Employed (after tax) (MTP Sep'22 5 Marks)

Answer 14

Ratios for the year 2020-21

- (i) Inventory turnover ratio



$$\frac{\text{COGS}}{\text{Average Inventory}} = \frac{\text{₹ } 7,38,500}{\frac{\text{₹}(87,500+70,000)}{2}} = 9.4$$

(ii) Financial leverage

$$= \frac{EBIT}{EBT} = \frac{\text{Rs.} 33,250}{\text{Rs.} 22,750} = 1.46$$

(iii) ROCE

$$= \frac{EBIT(1-t)}{\text{Average Capital Employed}} = \frac{\text{₹ } 33,250 (1-0.3)}{\frac{\text{₹}(2,10,000+1,92,500)}{2}} = \frac{\text{₹ } 23,275}{\text{₹ } 201,250} \times 100 = 11.56 \%$$

Question 15

From the following information and ratios, PREPARE the Balance sheet as at 31st March 2022 and Income statement for the year ended on that date for M/s Ganguly & Co -

| | |
|---|-----------|
| Average Stock | ₹10 lakh |
| Current Ratio | 3:1 |
| Acid Test Ratio | 1:1 |
| PBIT to PBT | 2.2:1 |
| Average Collection period (Assume 360 days in a year) | 30 days |
| Stock Turnover Ratio (Use sales as turnover) | 5 times |
| Fixed assets turnover ratio | 0.8 times |
| Working Capital | ₹10 lakh |
| Net profit Ratio | 10% |
| Gross profit Ratio | 40% |
| Operating expenses (excluding interest) | ₹ 9 lakh |
| Long term loan interest | 12% |
| Tax | Nil |

(MTP 10 Marks Oct'22, 10 Marks, New SM)

Answer 15

1. Current Ratio = 3:1

$$\text{Current Assets (CA) / Current Liability (CL)} = 3:1 \text{ CA} = 3\text{CL}$$

$$\text{WC} = 10,00,000$$

$$\text{CA} - \text{CL} = 10,00,000 \quad 3\text{CL} - \text{CL} = 10,00,000$$

$$2\text{CL} = 10,00,000$$

$$\text{CL} = \frac{10,00,000}{2}$$

$$\text{CL} = \text{₹} 5,00,000 \quad \text{CA} = 3 \times 5,00,000 \quad \text{CA} = \text{₹} 15,00,000$$

2. Acid Test Ratio = CA – Stock / CL = 1:1

$$\frac{15,00,000 - \text{Stock}}{5,00,000} = 1$$

$$15,00,000 - \text{stock} = 5,00,000$$

$$\text{Stock} = \text{₹} 10,00,000$$

3. Stock Turnover ratio (on sales) = 5

$$= \frac{\text{Sales}}{\text{Avg stock}} = 5$$

$$\frac{\text{Sales}}{10,00,000} = 5 \quad \text{Sales} = \text{₹} 50,00,000$$



4. **Gross Profit** = 50,00,000 x 40% = ₹20,00,000

Net profit (PBT)

= 50,00,000 x 10% = ₹5,00,000

5. **PBIT/PBT = 2.2**

PBIT = 2.2 x 5,00,000

PBIT = 11,00,000

Interest = 11,00,000 – 5,00,000 = ₹6,00,000

Long term loan = $\frac{6,00,000}{0.12} \times 50,00,000$

6. **Average collection period = 30 days**

Receivables = $\frac{30}{360} \times 50,00,000 = 4,16,667$

7. **Fixed Assets Turnover Ratio = 0.8**

50,00,000 / Fixed Assets = 0.8

Fixed Assets = ₹62,50,000

Income Statement

| | Amount (₹) |
|--------------------------|------------|
| Sales | 50,00,000 |
| Less: Cost of Goods Sold | 30,00,000 |
| Gross Profit | 20,00,000 |
| Less: Operating Expenses | 9,00,000 |
| Less: Interest. | 6,00,000 |
| Net Profit | 5,00,000 |

Balance sheet

| Liabilities | Amount (₹) | Assets | Amount (₹) |
|----------------------|------------|-----------------|------------|
| Equity share capital | 22,50,000 | Fixed asset | 62,50,000 |
| Long term debt | 50,00,000 | Current assets: | |
| Current liability | 5,00,000 | Stock | 10,00,000 |
| | | Receivables | 4,16,667 |
| | | Other | 83,333 |
| | 77,50,000 | | 15,00,000 |
| | | | 77,50,000 |

Question 16

Using the following information, **PREPARE** the balance sheet:

| | |
|-----------------------------|--------|
| Long-term debt to net worth | 0.25 |
| Total asset turnover | 3 |
| Average collection period | 9 days |
| Inventory turnover | 13 |
| Gross profit margin | 20% |
| Acid-test ratio | 1.5 |

*Assume a 360-day year and all sales on credit.



| Liabilities | ₹ | Assets | ₹ |
|------------------------------|-----------|---------------------|---|
| Notes and payables | 2,50,000 | Cash | ? |
| Long-term debt | ? | Accounts receivable | ? |
| Common stock | 8,00,000 | Inventory | ? |
| Retained earnings | 16,00,000 | Plant and equipment | ? |
| Total liabilities and equity | ? | Total assets | ? |

(MTP 5 Marks April '23, Old & New SM)

Answer 16

Working Notes:

(i) Long term Debt

$$\text{Long Term Debt/ Net worth} = 0.25$$

$$\text{Long Term Debt/ (8,00,000+16,00,000)} = 0.25$$

$$\text{Long term debt} = 6,00,000$$

(ii) Total assets

Total liabilities and Equity = Notes and payables + Long-term debt + Common stock + Retained earnings

$$= 2,50,000 + 6,00,000 + 8,00,000 + 16,00,000$$

$$\text{Total assets} = \text{Total liabilities and Equity} = 32,50,000$$

(iii) Sales and Cost of Goods sold

$$\begin{aligned} \text{Total asset turnover} = 3 &= \text{Sales/ Total Assets} = \text{Sales}/32,50,000 \\ \text{Sales} &= 97,50,000 \end{aligned}$$

$$\begin{aligned} \text{Cost of goods sold} &= (100\% - \text{Gross Profit margin}) \times \text{Sales} \\ &= (100\% - 20\%) \times 97,50,000 = 78,00,000. \end{aligned}$$

(iv) Current Assets

$$\text{Inventory turnover} = 13 = \text{COGS/ Inventory} = 78,00,000/\text{Inventory}$$

$$\text{Inventory} = ₹ 6,00,000$$

$$\text{Average collection period} = 9 = \text{Receivables/Sales} \times 360 = \text{Receivables}/ 97,50,000 \times 360$$

$$\text{Accounts receivables} = 2,43,750$$

$$\begin{aligned} \text{Acid-test ratio} = 1.5 &= (\text{Cash+ Accounts Receivables}) / \text{Notes and Payables} \\ &= (\text{Cash} + 2,43,750) / 2,50,000 = 1.5 \end{aligned}$$

$$\text{Cash} = 1,31,250$$

(v) Plant and equipment

$$= \text{Total Assets} - \text{Current Assets}$$

$$= 32,50,000 - (1,31,250 + 2,43,750 + 6,00,000) = 22,75,000$$

Balance Sheet

| Liabilities | ₹ | Assets | ₹ |
|-------------|---|--------|---|
|-------------|---|--------|---|

| | | | |
|------------------------------|-----------|---------------------|-----------|
| Notes and payables | 2,50,000 | Cash | 1,31,250 |
| Long-term debt | 6,00,000 | Accounts receivable | 2,43,750 |
| Common stock | 8,00,000 | Inventory | 6,00,000 |
| Retained earnings | 16,00,000 | Plant and equipment | 22,75,000 |
| Total liabilities and equity | 32,50,000 | Total assets | 32,50,000 |

Question 17

Assuming the current ratio of a Company is 2, STATE in each of the following cases whether the ratio will improve or decline or will have no change:

- Payment of current liability
- Purchase of fixed assets by cash
- Cash collected from Customers
- Bills receivable dishonored
- Issue of new shares (RTP Nov '18)

Answer 17

$$\text{Current Ratio} = \frac{\text{Current Assets (CA)}}{\text{Current Liabilities (CL)}} = 2 \text{ i.e. } 2:1$$

| S. No. | Situation | Improve/ Decline/ Change | No | Reason |
|--------|----------------------------------|--------------------------------|----|---|
| (i) | Payment of Current liability | Current Ratio will improve | | Let us assume CA is ₹ 2 lakhs & CL is ₹ 1 lakh. If payment of Current Liability = ₹10,000 then, CA = 1, 90,000 CL = 90,000. Current Ratio = 1,90,000 / 90,000 = 2.11 : 1. When Current Ratio is 2:1 Payment of Current liability will reduce the same amount in the numerator and denominator. Hence, the ratio will improve. |
| (ii) | Purchase of Fixed Assets by cash | Current Ratio will decline | | Since the cash being a current asset converted into fixed asset, current assets reduced, thus current ratio will fall. |
| (iii) | Cash collected from Customers | Current Ratio will not change | | Cash will increase and Debtors will reduce. Hence No Change in Current Asset. |
| (iv) | Bills Receivable dishonored | Current Ratio will not change | | Bills Receivable will come down and debtors will increase. Hence no change in Current Assets. |
| (v) | Issue of New Shares | Current Ratio will improve | | As Cash will increase, Current Assets will increase and current ratio will increase. |

Question 18

From the following table of financial ratios of Prabhu Chemicals Limited, comment on various ratios given at the end:

| Ratios | 2021 | 2022 | Average of Chemical Industry |
|------------------|------|------|------------------------------|
| Liquidity Ratios | | | |
| Current ratio | 2.1 | 2.3 | 2.4 |



| | | | |
|--------------------------------------|----------------|----------------|----------------|
| Quick ratio | 1.4 | 1.8 | 1.4 |
| Receivable turnover ratio | 8 | 9 | 8 |
| Inventory turnover | 8 | 9 | 5 |
| Receivables collection period | 46 days | 41 days | 46 days |
| Operating profitability | | | |
| Operating income –ROI | 24% | 21% | 18% |
| Operating profit margin | 18% | 18% | 12% |
| Financing decisions | | | |
| Debt ratio | 45% | 44% | 60% |
| Return | | | |
| Return on equity | 26% | 28% | 18% |

COMMENT on the following aspect of Prabhu Chemicals Limited

- (i) Liquidity
- (ii) Operating profits
- (iii) Financing
- (iv) Return to the shareholders (RTP Nov '23 & May '19)

Answer 18

| Ratios | Comment |
|----------------------------|--|
| Liquidity | <p>Current ratio has improved from last year and matching the industry average.</p> <p>Quick ratio also improved than last year and above the industry average.</p> <p>The reduced inventory levels (evidenced by higher inventory turnover ratio) have led to better quick ratio in FY 2022 compared to FY 2021.</p> <p>Further the decrease in current liabilities is greater than the collective decrease in inventory and debtors as the current ratio have increase from FY2021 to FY 2022.</p> |
| Operating Profits | <p>Operating Income-ROI reduced from last year, but Operating Profit Margin has been maintained. This may happen due to decrease in operating cost. However, both the ratios are still higher than the industry average.</p> |
| Financing | <p>The company has reduced its debt capital by 1% and saved earnings for equity shareholders. It also signifies that dependency on debt compared to other industry players (60%) is low.</p> |
| Return to the shareholders | <p>Prabhu's ROE is 26 per cent in 2021 and 28 per cent in 2022 compared to an industry average of 18 per cent. The ROE is stable and improved over the last year.</p> |

Question 19

The following is the Profit and loss account and Balance sheet of KLM LLP.

| Particulars | Amount (₹) | Particulars | Amount (₹) |
|------------------------------------|-------------|---------------------------|-------------|
| To Opening stock | 12,46,000 | By Sales | 1,96,56,000 |
| To Purchases | 1,56,20,000 | By Closing stock | 14,28,000 |
| To Gross profit c/d | 42,18,000 | | |
| | 2,10,84,000 | | 2,10,84,000 |
| | | By Gross profit b/d | 42,18,000 |
| To Administrative expenses | 18,40,000 | By Interest on investment | 24,600 |
| To Selling & distribution expenses | 7,56,000 | By Dividend received | 22,000 |
| To Interest on loan | 2,60,000 | | |
| To Net profit | 14,08,600 | | |
| | 42,64,600 | | 42,64,600 |

Balance Sheet as on.....

| Capital & Liabilities | Amount (₹) | Assets | Amount (₹) |
|-----------------------|-------------|---------------------|-------------|
| Capital | 20,00,000 | Plant & machinery | 24,00,000 |
| Retained earnings | 42,00,000 | Building | 42,00,000 |
| General reserve | 12,00,000 | Furniture | 12,00,000 |
| Term loan from bank | 26,00,000 | Sundry receivables | 13,50,000 |
| Sundry Payables | 7,20,000 | Inventory | 14,28,000 |
| Other liabilities | 2,80,000 | Cash & Bank balance | 4,22,000 |
| | 1,10,00,000 | | 1,10,00,000 |

You are required to COMPUTE:

- (i) Gross profit ratio (ii) Net profit ratio (iii) Operating cost ratio
 (iv) Operating profit ratio (v) Inventory turnover ratio (vi) Current ratio
 (vii) Quick ratio (viii) Interest coverage ratio (ix) Return on capital employed
 (x) Debt to assets ratio. (RTP Nov '19)

Answer 19

$$i. \text{ Gross Profit ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100 = \frac{\text{Rs. } 42,18,000}{\text{Rs. } 1,96,56,000} \times 100 = 21.46\%$$

$$ii. \text{ Net Profit ratio} = \frac{\text{Net Profit}}{\text{Sales}} \times 100 = \frac{\text{Rs. } 14,08,600}{\text{Rs. } 1,96,56,000} \times 100 = 7.17\%$$

$$iii. \text{ Operating ratio} = \frac{\text{Operating Cost}}{\text{Sales}} \times 100$$

Operating cost = Cost of goods sold + Operating expenses

Cost of goods sold = Sales – Gross profit

$$= 1,96,56,000 - 42,18,000 = 1,54,38,000$$

Operating expenses = Administrative expenses + Selling & distribution expenses

$$= 18,40,000 + 7,56,000 = 25,96,000$$

$$\text{Therefore, Operating ratio} = \frac{1,54,38,000 + 25,96,000}{1,96,56,000} \times 100$$

$$= \frac{1,80,34,000}{1,96,56,000} \times 100 = 91.75\%$$



iv. Operating profit ratio = 100 – Operating cost ratio

$$= 100 - 91.75\% = 8.25\%$$

v. Inventory turnover ratio = $\frac{\text{Cost of goods Sold}}{\text{Average Stock}}$
 $= \frac{1,54,38,000}{(14,28,000 + 12,46,000)/2} = \frac{1,54,38,000}{13,37,000} = 11.55 \text{ times}$

vi. Current Ratio = $\frac{\text{Current assets}}{\text{Current Liabilities}}$

Current assets = Sundry receivables + Inventory + Cash & Bank balance

$$= 13,50,000 + 14,28,000 + 4,22,000 = 32,00,000$$

Current liabilities = Sundry Payables + Other liabilities

$$= 7,20,000 + 2,80,000 = 10,00,000$$

$$\text{Current ratio} = \frac{32,00,000}{10,00,000} = 3.2 \text{ times}$$

vii. Quick Ratio = $\frac{\text{Current assets} - \text{Inventories}}{\text{Current Liabilities}}$
 $= \frac{32,00,000 - 14,28,000}{10,00,000} = 1.77 \text{ times}$

viii. Interest Coverage ratio = $\frac{\text{EBIT}}{\text{Interest}} = \frac{\text{Net Profit} + \text{Interest}}{\text{Interest}}$
 $= \frac{14,08,600 + 2,60,000}{2,60,000} = 6.42 \text{ times}$

ix. Return on Capital employed (ROCE) = $\frac{\text{EBIT}}{\text{Capital Employed}} \times 100$

Capital employed = Capital + Retained earnings + General reserve + Term loan

$$= 20,00,000 + 42,00,000 + 12,00,000 + 26,00,000$$

$$= 1,00,00,000$$

$$\text{Therefore, ROCE} = \frac{16,68,600}{1,00,00,000} \times 100 = 16.69\%$$

x. Debt to assets ratio = $\frac{\text{Debts}}{\text{Total assets}} \times 100 = \frac{26,00,000}{1,10,00,000} \times 100 = 23.64\%$

Question 20

MT Limited has the following Balance Sheet as on March 31, 2019 and March 31, 2020: Balance Sheet

| | ₹ in lakhs | |
|----------------------------------|----------------|----------------|
| | March 31, 2019 | March 31, 2020 |
| Sources of Funds: | | |
| Shareholders' Funds | 2,500 | 2,500 |
| Loan Funds | 3,500 | 3,000 |
| | 6,000 | 5,500 |
| Applications of Funds: | | |
| Fixed Assets | 3,500 | 3,000 |
| Cash and bank | 450 | 400 |
| Receivables | 1,400 | 1,100 |
| Inventories | 2,500 | 2,000 |
| Other Current Assets | 1,500 | 1,000 |
| Less: Current Liabilities | (1,850) | (2,000) |

| | | |
|--|-------|-------|
| | 6,000 | 5,500 |
|--|-------|-------|

The Income Statement of the MT Ltd. for the year ended is as follows:

| | ₹ in lakhs | |
|--|----------------|----------------|
| | March 31, 2019 | March 31, 2020 |
| Sales | 22,500 | 23,800 |
| Less: Cost of Goods sold | (20,860) | (21,100) |
| Gross Profit | 1,640 | 2,700 |
| Less: Selling, General and Administrative expenses | (1,100) | (1,750) |
| Earnings before Interest and Tax (EBIT) | 540 | 950 |
| Less: Interest Expense | (350) | (300) |
| Earnings before Tax (EBT) | 190 | 650 |
| Less: Tax | (57) | (195) |
| Profits after Tax (PAT) | 133 | 455 |

Required:

CALCULATE for the year 2019-20-

- Financial Leverage
- Return on Capital Employed (ROCE)
- Return on Equity (ROE)
- Average Collection period. [Take 1 year = 365 days] (RTP May '20)

Answer 20

Ratios for the year 2019-2020

(a) Inventory turnover ratio

$$= \frac{\text{COGS}}{\text{Average Inventory}}$$

$$= \frac{\text{Rs.21,100}}{\frac{\text{Rs.}(2,500+2,000)}{2}} = 9.4$$

(b) Financial leverage

$$= \frac{\text{EBIT}}{\text{EBT}} = \frac{\text{Rs.950}}{\text{Rs.650}} = 1.46$$

(c) ROCE

$$= \frac{\text{EBIT}(1-t)}{\text{Average Capital Employed}} = \frac{\text{Rs.950}(1-0.3)}{\text{Rs.}\left(\frac{6,000+5,500}{2}\right)} = \frac{\text{Rs.665}}{\text{Rs.5,750}} \times 100 = 11.56\%$$

[Here Return on Capital Employed (ROCE) is calculated after Tax]

(d) ROE

$$= \frac{\text{Profits after tax}}{\text{Average Shareholders' funds}} = \frac{\text{Rs.455}}{\text{Rs.2,500}} \times 100 = 18.2\%$$

(e) Average Collection Period

$$\text{Average Sales per day} = \frac{\text{Rs.23,800}}{365} = \text{Rs. 65.20 Lakhs}$$

$$\text{Average Collection Period} = \frac{\text{Average Receivables}}{\text{Average Sales per day}}$$

$$= \frac{\frac{Rs.(1,400+1,100)}{2}}{Rs.65.2} = \frac{Rs.1,250}{Rs.65.2} = 19.17 \text{ days}$$

Question 21

Following information has been provided from the books of M/s Laxmi & Co. for the year ending on 31st March, 2020:

| | |
|-----------------------------------|------------|
| Net Working | ₹ 4,80,000 |
| Capital | ₹ 80,000 |
| Bank overdraft | 0.75 |
| Fixed Assets to Proprietary ratio | |
| Reserves and Surplus | ₹ 3,20,000 |
| Current ratio | 2.5 |
| Liquid ratio (Quick Ratio) | 1.5 |

You are required to PREPARE a summarized Balance Sheet as at 31st March, 2020. (RTP Nov '20, Old & New SM) (Same concept different figures MTP 5 Marks Aug'18 & Sep '23)

Answer 21

Working notes:

(i) Current Assets and Current Liabilities computation:

$$\frac{\text{Current assets}}{\text{Current Liabilities}} = \frac{2.5}{1}$$

Or Current assets = 2.5 Current liabilities

Now, Working capital = Current assets - Current liabilities Or ₹ 4,80,000

$$= 2.5 \text{ Current liability} - \text{Current liability Or } 1.5$$

Current liability = ₹ 4,80,000

∴ Current Liabilities = ₹ 3,20,000

So, Current Assets = ₹ 3,20,000 X 2.5 = ₹ 8,00,000

(ii) Computation of stock

$$\text{Liquid ratio} = \frac{\text{Liquid assets}}{\text{Current Liabilities}}$$

Or 1.5 = $\frac{\text{Current assets} - \text{Inventories}}{Rs.3,20,000}$

Or 1.5 X ₹ 3, 20,000 = ₹ 8,00,000 - Inventories

Or Inventories = ₹ 8,00,000 - ₹ 4, 80,000

Or Stock = ₹ 3,20,000

(iii) Computation of Proprietary fund; Fixed assets; Capital and Sundry creditors

$$\text{Fixed Asset to Proprietary ratio} = \frac{\text{Fixed assets}}{\text{Proprietary fund}} = 0.75$$

∴ Fixed Assets = 0.75 Proprietary fund (PF)[FA+NWC = PF] or

NWC = PF- FA [(i.e. .75 PF)]

and Net Working Capital (NWC) = 0.25 Proprietary fund Or ₹ 4,80,000/0.25

= Proprietary fund

Or Proprietary fund = ₹ 19,20,000

| | | |
|------------------|---|---|
| and Fixed Assets | = | 0.75 proprietary fund |
| | = | 0.75 X ₹ 19,20,000 = ₹ 14,40,000 |
| Capital | = | Proprietary fund - Reserves & Surplus |
| | = | ₹ 19,20,000 - ₹ 3,20,000 = ₹ 16,00,000 |
| Sundry Creditors | = | (Current liabilities - Bank overdraft) (₹ |
| | = | 3,20,000 - ₹ 80,000) = ₹ 2,40,000 |

Balance Sheet as at 31st March, 2020

| Liabilities | ₹ | Assets | ₹ |
|--------------------|-----------|----------------------|-----------|
| Capital | 16,00,000 | Fixed Assets | 14,40,000 |
| Reserves & Surplus | 3,20,000 | Stock | 3,20,000 |
| Bank overdraft | 80,000 | Other Current Assets | 4,80,000 |
| Sundry creditors | 2,40,000 | | |
| | 22,40,000 | | 22,40,000 |

Question 22

Given below are the estimations for the next year by Niti Ltd.:

| Particulars | (₹ in crores) |
|---------------------|---------------|
| Fixed Assets | 5.20 |
| Current Liabilities | 4.68 |
| Current Assets | 7.80 |
| Sales | 23.00 |
| EBIT | 2.30 |

The company will issue equity funds of ₹ 5 crores in the next year. It is also considering the debt alternatives of ₹ 3.32 crores for financing the assets. The company wants to adopt one of the policies given below:

| Financing Policy | Short term debt @ 12% | Long term debt @ 16% | Total |
|------------------|-----------------------|----------------------|-------|
| Conservative | 1.08 | 2.24 | 3.32 |
| Moderate | 2.00 | 1.32 | 3.32 |
| Aggressive | 3.00 | 0.32 | 3.32 |

Assuming corporate tax rate at 30%, CALCULATE the following for each of the financing policy:

- Return on total assets
- Return on owner's equity
- Net Working capital
- Current Ratio

Also advise which Financing policy should be adopted if the company wants high returns. (RTP May '21)

Answer 22

- Return on total assets

$$\begin{aligned}
 \text{Return on total assets} &= \frac{EBIT(1-T)}{\text{Total assets}(FA+CA)} \\
 &= \frac{Rs.2.30 \text{ Crores}(1-0.3)}{Rs.5.20 \text{ Crores} + Rs.7.80 \text{ Crores}} = \frac{Rs.1.61 \text{ Crores}}{Rs.13 \text{ Crores}} = 0.1238 \text{ or } 12.38\%
 \end{aligned}$$

(ii) Return on owner's equity

(Amount in ₹)

| | Financing policy (₹) | | |
|---|---|---|---|
| | Conservative | Moderate | Aggressive |
| Expected EBIT | 2,30,00,000 | 2,30,00,000 | 2,30,00,000 |
| Less: Interest | | | |
| Short term Debt @ 12% Long | 12,96,000 | 24,00,000 | 36,00,000 |
| term Debt @ 16% | 35,84,000 | 21,12,000 | 5,12,000 |
| Earnings before tax (EBT) | 1,81,20,000 | 1,84,88,000 | 1,88,88,000 |
| Less: Tax @ 30% | 54,36,000 | 55,46,400 | 56,66,400 |
| Earnings after Tax (EAT) | 1,26,84,000 | 1,29,41,600 | 1,32,21,600 |
| Owner's Equity | 5,00,00,000 | 5,00,00,000 | 5,00,00,000 |
| Return on owner's equity = $\frac{\text{Net Profit after taxes (EAT)}}{\text{Owners' equity}}$ | $= \frac{1,26,84,000}{5,00,00,000}$ = 0.2537 or 25.37% | $= \frac{1,29,41,600}{5,00,00,000}$ = 0.2588 or 25.88% | $= \frac{1,32,21,600}{5,00,00,000}$ = 0.2644 or 26.44% |

(iii) Net Working capital

(₹ in crores)

| | Financing policy | | |
|---|-----------------------|-----------------------|-----------------------|
| | Conservative | Moderate | Aggressive |
| Current Liabilities (Excluding Short Term Debt) | 4.68 | 4.68 | 4.68 |
| Short term Debt | 1.08 | 2.00 | 3.00 |
| Total Current Liabilities | 5.76 | 6.68 | 7.68 |
| Current Assets | 7.80 | 7.80 | 7.80 |
| Net Working capital = Current Assets - Current Liabilities | 7.80 - 5.76 = 2.04 | 7.80 - 6.68 = 1.12 | 7.80 - 7.68 = 0.12 |

(iv) Current ratio

(₹ in crores)

| | Financing policy | | |
|--|---------------------------------|---------------------------------|---------------------------------|
| | Conservative | Moderate | Aggressive |
| Current Ratio | $= \frac{7.80}{5.76}$ = 1.35 | $= \frac{7.80}{6.68}$ = 1.17 | $= \frac{7.80}{7.68}$ = 1.02 |
| $= \frac{\text{Current Assets}}{\text{Current Liabilities}}$ | | | |

Advise: It is advisable to adopt aggressive financial policy, if the company wants high return as the return on owner's equity is maximum in this policy i.e. 26.44%.

Question 23

From the following information, find out missing figures and REWRITE the balance sheet of Mukesh Enterprise.

Current Ratio = 2:1



Acid Test ratio = 3:2

Reserves and surplus = 20% of equity share capital

Long term debt = 45% of net worth

Stock turnover velocity = 1.5 months Receivables turnover velocity = 2 months

You may assume closing Receivables as average Receivables. Gross profit ratio = 20%

Sales is ₹ 21,00,000 (25% sales are on cash basis and balance on credit basis) Closing stock is ₹ 40,000 more than opening stock.

Accumulated depreciation is 1/6 of original cost of fixed assets. Balance sheet of the company is as follows:

| Liabilities | (₹) | Assets | (₹) |
|----------------------|----------|--------------------------------|-----|
| Equity Share Capital | ? | Fixed Assets (Cost) | ? |
| Reserves & Surplus | ? | Less: Accumulated Depreciation | ? |
| Long Term Loans | 6,75,000 | Fixed Assets (WDV) | ? |
| Bank Overdraft | 60,000 | Stock | ? |
| Creditors | ? | Debtors | ? |
| | | Cash | ? |
| Total | ? | Total | ? |

(RTP May 23)

Answer 23

| Liabilities | (₹) | Assets | (₹) |
|----------------------|-----------|-------------------------|------------|
| Equity Share Capital | 12,50,000 | Fixed Assets (cost) | 20,58,000 |
| Reserves & Surplus | 2,50,000 | Less: Acc. Depreciation | (3,43,000) |
| Long Term Loans | 6,75,000 | Fixed Assets (WDV) | 17,15,000 |
| Bank Overdraft | 60,000 | Stock | 2,30,000 |
| Payables | 4,00,000 | Receivables | 2,62,500 |
| | | Cash | 4,27,500 |
| Total | 26,35,000 | Total | 26,35,000 |

Working Notes:

| | |
|---------------------------|-------------|
| (i) Sales | ₹ 21,00,000 |
| Less: Gross Profit (20%) | ₹ 4,20,000 |
| Cost of Goods Sold (COGS) | ₹ 16,80,000 |

$$(ii) \text{ Receivables Turnover Velocity} = \frac{\text{Average Receivables}}{\text{Credit Sales}} \times 12$$

$$2 = \frac{\text{Average Receivables}}{\text{Rs.21,00,000} \times 75\%} \times 12$$

$$\text{Average Receivables} = \frac{\text{Rs.21,00,000} \times 75\% \times 2}{\text{Credit Sales}}$$

$$\text{Average Receivables} = ₹ 2,62,500 \quad \text{Closing}$$

$$\text{Receivables} = ₹ 2,62,500$$

$$(iii) \text{ Stock Turnover Velocity} = \frac{\text{Average Stock}}{\text{COGS}} \times 12$$



$$\text{Or } 1.5 = \frac{\text{Average Stock}}{\text{Rs.16,80,000}} \times 12$$

$$\text{Or Average Stock} = \text{Rs. } 2,10,000$$

$$\frac{\text{Opening Stock} + \text{Closing Stock}}{2} = \text{Rs. } 2,10,000$$

$$\text{Opening Stock} + \text{Closing Stock} = ₹ 4,20,000 \dots\dots\dots (1)$$

$$\text{Also, Closing Stock} - \text{Opening Stock} = ₹ 40,000 \dots\dots\dots (2)$$

Solving (1) and (2), we get closing stock = ₹ 2,30,000

$$\text{(iv) Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Stock} + \text{Receivables} + \text{Cash}}{\text{Bank Overdraft} + \text{Creditors}}$$

$$\text{Or } 2 = \frac{\text{Rs. } 2,30,000 + \text{Rs. } 2,62,500 + \text{Cash}}{\text{Rs. } 60,000 + \text{Creditors}}$$

$$\text{Or } ₹ 1,20,000 + 2 \text{ Payables} = ₹ 4,92,500 + \text{Cash Or}$$

$$2 \text{ Payables} - \text{Cash} = ₹ 3,72,500$$

$$\text{Or Cash} = 2 \text{ Payables} - ₹ 3,72,500 \dots\dots\dots (3)$$

$$\text{Acid Test Ratio} = \frac{\text{Current assets} - \text{Stock}}{\text{Current Liabilities}} = \frac{\text{Debtor} + \text{Cash}}{\text{Current Liabilities}}$$

$$\text{Or } \frac{3}{2} = \frac{\text{Rs. } 2,62,500 + \text{Cash}}{60,000 + \text{Creditors}}$$

$$\text{Or } ₹ 1,80,000 + 3 \text{ Payables} = ₹ 5,25,000 + 2 \text{ Cash}$$

$$\text{Or } 3 \text{ Payables} - 2 \text{ Cash} = ₹ 3,45,000 \dots\dots\dots (4)$$

Substitute (3) in (4)

$$\text{Or } 3 \text{ Payables} - 2(2 \text{ Payables} - ₹ 3,72,500) = ₹ 3,45,000$$

$$\text{Or } 3 \text{ Payables} - 4 \text{ Payables} + ₹ 7,45,000 = ₹ 3,45,000$$

$$(\text{Payables}) = ₹ 3,45,000 - ₹ 7,45,000$$

$$\text{Payables} = ₹ 4,00,000$$

$$\text{So, Cash} = 2 \times ₹ 4,00,000 - ₹ 3,72,500$$

$$\text{Cash} = ₹ 4,27,500$$

$$\text{(ii) Long term Debt} = 45\% \text{ of Net Worth Or } ₹$$

$$6,75,000 = 45\% \text{ of Net Worth Net Worth} = ₹$$

$$15,00,000$$

$$\text{(iii) Equity Share Capital (ESC) + Reserves} = ₹ 15,00,000$$

$$\text{Or ESC} + 0.2 \text{ESC} = ₹ 15,00,000 \text{ Or } 1.2 \text{ESC} = ₹ 15,00,000$$

$$\text{Equity Share Capital (ESC)} = ₹ 12,50,000$$

$$\text{(iv) Reserves} = 0.2 \times ₹ 12,50,000$$

$$\text{Reserves} = ₹ 2,50,000$$

$$\text{(v) Total of Liabilities} = \text{Total of Assets}$$

$$\text{Or } ₹ 12,50,000 + ₹ 2,50,000 + ₹ 6,75,000 + ₹ 60,000 + ₹ 4,00,000 + \text{Fixes Assets (FA)}$$



$$(WDV) + ₹ 2,30,000 + ₹ 2,62,000 + ₹ 4,27,500$$

$$\text{Or } ₹ 26,35,000 = ₹ 9,20,000 + \text{FA(WDV)}$$

$$\text{FA (WDV)} = ₹ 17,15,000$$

$$\text{Now FA(Cost) - Depreciation} = \text{FA(WDV)}$$

$$\text{Or FA(Cost) - FA(Cost)/6} = ₹ 17,15,000$$

$$\text{Or } 5 \text{ FA(Cost)/6} = ₹ 17,15,000$$

$$\text{Or FA(Cost)} = ₹ 17,15,000 \times 6/5$$

$$\text{So, FA(Cost)} = ₹ 20,58,000$$

$$\text{Depreciation} = ₹ 20,58,000/6 = ₹ 3,43,000$$

Question 24

Masco Limited has furnished the following ratios and information relating to the year ended 31st March 2021

| | |
|--|--------------|
| Sales | Rs.75,00,000 |
| Return on net worth | 25% |
| Rate of income tax | 50% |
| Share capital to reserves | 6:4 |
| Current ratio | 2.5 |
| Net profit to sales (After Income Tax) | 6.50% |
| Inventory turnover (based on cost of goods sold) | 12 |
| Cost of goods sold | Rs.22,50,000 |
| Interest on debentures | Rs.75,000 |
| Receivables (includes debtors Rs.1,25,000) | Rs.2,00,000 |
| Payables | Rs.2,50,000 |
| Bank Overdraft | Rs.1,50,000 |

You are required to:

- Calculate the operating expenses for the year ended 31st March, 2021.
- Prepare a balance sheet as on 31st March in the following format:

| Liabilities | Rs | Assets | Rs. |
|----------------------|----|----------------|-----|
| Share Capital | | Fixed Assets | |
| Reserves and Surplus | | Current Assets | |
| 15% Debentures | | Stock | |
| Payables | | Receivables | |
| Bank Term Loan | | Cash | |

(PYP 10 Marks, July'21, Old & New SM)

Answer 24

- Calculation of Operating Expenses for the year ended 31st March, 2021

| Particulars | | (Rs.) |
|------------------------------|--|----------|
| Net Profit [@ 6.5% of Sales] | | 4,87,500 |
| Add: Income Tax (@ 50%) | | 4,87,500 |

| | | |
|---------------------------------------|-----------|-----------|
| Profit Before Tax (PBT) | | 9,75,000 |
| Add: Debenture Interest | | 75,000 |
| Profit before interest and tax (PBIT) | | 10,50,000 |
| Sales | | 75,00,000 |
| Less: Cost of goods sold | 22,50,000 | |
| PBIT | 10,50,000 | 33,00,000 |
| Operating Expenses | | 42,00,000 |

(b) **Balance Sheet as on 31st March, 2021**

| Liabilities | Rs. | Assets | Rs. |
|--------------------------------------|-----------|----------------|-----------|
| Share Capital | 11,70,000 | Fixed Assets | 18,50,000 |
| Reserve and Surplus | 7,80,000 | Current Assets | |
| 15% Debentures | 5,00,000 | Stock | 1,87,500 |
| Payables | 2,50,000 | Receivables | 2,00,000 |
| Bank Overdraft(or Bank Term Loan) | 1,50,000 | Cash | 6,12,500 |
| | 28,50,000 | | 28,50,000 |

Working Notes:

(i) **Calculation of Share Capital and Reserves**

The return on net worth is 25%. Therefore, the profit after tax of Rs.4,87,500 should be equivalent to 25% of the net worth.

$$\text{Net worth} \times \frac{25}{100} = 4,87,500$$

$$\therefore \text{Net worth} = \frac{4,87,500 \times 100}{25} = 19,50,000$$

The ratio of share capital to reserves is 6:4

$$\text{Share Capital} = 19,50,000 \times \frac{6}{10} = \text{Rs.}11,70,000 \quad \text{Reserves} = 19,50,000 \times \frac{4}{10} = \text{Rs.}7,80,000$$

(ii) **Calculation of Debentures**

Interest on Debentures @ 15% (as given in the balance sheet format) = Rs. 75,000

$$\therefore \text{Debentures} = \frac{75,000 \times 100}{15} = \text{Rs.}5,00,000$$

(iii) **Calculation of Current Assets**

Current Ratio = 2.5 Payables = Rs.2,50,000 Bank overdraft = Rs.1,50,000

Total Current Liabilities = Rs.2,50,000 + Rs.1,50,000 = Rs.4,00,000

$$\therefore \text{Current Assets} = 2.5 \times \text{Current Liabilities} = 2.5 \times 4,00,000 = \text{Rs.}10,00,000$$

(iv) **Calculation of Fixed Assets**

| Particulars | ₹ |
|----------------------|-----------|
| Share capital | 11,70,000 |
| Reserves | 7,80,000 |
| Debentures | 5,00,000 |
| Payables | 2,50,000 |
| Bank Overdraft | 1,50,000 |
| Total Liabilities | 28,50,000 |
| Less: Current Assets | 10,00,000 |
| Fixed Assets | 18,50,000 |

(v) **Calculation of Composition of Current Assets**

Inventory Turnover = 12

$$= \frac{\text{Cost of goods sold}}{\text{Closing stock}} = 12$$

$$\text{Closing stock} = \frac{22,50,000}{12} = \text{Closing Stock Rs.1,87,500}$$

| Particulars | ₹ |
|-------------------------|-----------|
| Stock | 1,87,500 |
| Receivables | 2,00,000 |
| Cash (balancing figure) | 6,12,500 |
| Total Current Assets | 10,00,000 |

Question 25

Following information relates to RM Co. Ltd.

(Rs.)

| | |
|-----------------------|-----------|
| Total Assets employed | 10,00,000 |
| Direct Cost | 5,50,000 |
| Other Operating Cost | 90,000 |

Goods are sold to the customers at 150% of direct costs.

50% of the assets being financed by borrowed capital at an interest cost of 8% per annum. Tax rate is 30%.

You are required to calculate:

Net profit margin

Return on Assets

Asset turnover

Return on owners' equity. (PYP 5 Marks, Nov'20)

Answer 25

Computation of net profit:

| Particulars | (₹) |
|--------------------------------------|----------|
| Sales (150% of Rs.5,50,000) | 8,25,000 |
| Direct Costs | 5,50,000 |
| Gross profit | 2,75,000 |
| Other Operating Costs | 90,000 |
| Operating profit (EBIT) | 1,85,000 |
| Interest charges (8% of Rs.5,00,000) | 40,000 |
| Profit before taxes (EBT) | 1,45,000 |
| Taxes (@ 30%) | 43,500 |
| Net profit after taxes (EAT) | 1,01,500 |

i. Net profit margin (After tax) = $\frac{\text{Profit after taxes}}{\text{Sales}} = \frac{\text{Rs.1,01,500}}{\text{Rs.8,25,000}} = 0.12303 \text{ or } 12.303\%$

Net profit margin (Before tax) = $\frac{\text{Profit before taxes}}{\text{Sales}} = \frac{\text{Rs.1,45,00,00}}{\text{Rs.8,25,000}} = 0.17576 \text{ or } 17.576\%$

ii. Return on assets = $\frac{\text{EBIT}(1-T)}{\text{Total Assets}} = \frac{\text{Rs.1,85,000}(1-0.3)}{\text{Rs.10,00,000}} = 0.1295 \text{ or } 12.95\%$

iii. Asset turnover = $\frac{\text{Sales}}{\text{Assets}} = \frac{\text{Rs.8,25,000}}{\text{Rs.10,00,000}} = 0.825 \text{ times}$



$$\text{iv. Return on owner's equity} = \frac{\text{Profit before taxes}}{\text{Owners equity}} = \frac{\text{Rs.1,01,500}}{50\% \times \text{Rs.10,00,000}} = 0.203 \text{ or } 20.3\%$$

Question 26

Following information has been gathered from the books of Tram Ltd. the equity shares of which is trading in the stock market at Rs.14.

| Particulars | Amount (₹) |
|---|------------|
| Equity Share Capital (face value Rs.10) | 10,00,000 |
| 10% Preference Shares | 2,00,000 |
| Reserves | 8,00,000 |
| 10% Debentures | 6,00,000 |
| Profit before Interest and Tax for the year | 4,00,000 |
| Interest | 60,000 |
| Profit after Tax for the year | 2,40,000 |

Calculate the following:

- Return on Capital Employed
- Earnings per share
- PE ratio. (PYP 5 Marks, Nov'19) (Same concept different figures RTP Nov'21)

Answer 26

- Calculation of Return on capital employed (ROCE)
 Capital employed = Equity Shareholders' funds + Debenture + Preference shares
 = ₹ (10,00,000 + 8,00,000 + 6,00,000 + 2,00,000)
 = Rs.26,00,000

$$\text{Return on capital employed [ROCE-(Pre-tax)]} = \frac{\text{PBIT}}{\text{Capital Employed}} \times 100$$

$$= \frac{\text{Rs.4,00,000}}{\text{Rs.26,00,000}} \times 100 = 15.38\% \text{ (approx.)}$$

$$\text{Return on capital employed [ROCE-(Post-tax)]} = \frac{\text{Profit After tax}}{\text{Capital Employed}} \times 100$$

$$\text{ii. } \frac{\text{Rs.240,000}}{\text{Rs.26,00,000}} \times 100 = 9.23\% \text{ (approx.)}$$

iii. Calculation of Earnings per share

$$\text{Earnings per share} = \frac{\text{Earnings available to equity shareholders}}{\text{No of equity shares}}$$

$$= \frac{\text{Profit after tax} - \text{preference Dividend}}{\text{No of equity shares}}$$

$$= \frac{\text{Rs.}(2,40,000 - 20,000)}{\text{Rs.1,00,000}} = \text{Rs.2.20}$$

iv. Calculation of PE ratio

$$\text{PE} = \frac{\text{Market Price per Share (MPS)}}{\text{Earning per Shares (EPS)}}$$

$$= \frac{\text{Rs}14}{\text{Rs}2.20} = 6.364 \text{ (approx.)}$$

Question 27

Following figures and ratios are related to a company Q Ltd.:

| | |
|--|---------------------|
| Sales for the year (all credit) | Rs.30,00,000 |
| i. Gross Profit ratio | 25 per cent |
| ii. Fixed assets turnover (based on cost of goods sold) | 1.5 |
| iii. Stock turnover (based on cost of goods sold) | 6 |
| iv. Liquid ratio | 1 : 1 |
| v. Current ratio | 1.5 : 1 |
| vi. Receivables (Debtors) collection period | 2 months |
| vii. Reserves and surplus to share capital | 0.6 : 1 |
| viii. Capital gearing ratio | 0.5 |
| ix. Fixed assets to net worth | 1.20 : 1 |

You are required to calculate:

Closing stock, Fixed Assets, Current Assets, Debtors and Net worth.

(PYP 5 Marks May'19)

Answer 27
(i) Calculation of Closing Stock:

Cost of Goods Sold = Sales – Gross Profit (25% of Sales)

= Rs.30,00,000 – Rs.7,50,000

= Rs.22,50,000

Closing Stock = Cost of Goods Sold / Stock Turnover

= Rs.22,50,000/6 = Rs.3,75,000

(ii) Calculation of Fixed Assets:

Fixed Assets = Cost of Goods Sold / Fixed Assets Turnover

= Rs.22,50,000/1.5

= Rs.15,00,000

(iii) Calculation of Current Assets:

Current Ratio = 1.5 and Liquid Ratio = 1

Stock = 1.5 – 1 = 0.5

Current Assets = Amount of Stock × 1.5/0.5

= Rs.3,75,000 × 1.5/0.5 = Rs.11,25,000

(iv) Calculation of Debtors:

Debtors = Sales × Debtors Collection period / 12

= Rs.30,00,000 × 2 / 12

= Rs.5,00,000

(v) Calculation of Net Worth:

Net worth = Fixed Assets / 1.2

= Rs.15,00,000/1.2 = Rs.12,50,000

Question 28

The following is the information of XML Ltd. relate to the year ended 31-03-2018:



| | |
|--|--------------|
| Gross Profit | 20% of Sales |
| Net Profit | 10% of Sales |
| Inventory Holding period | 3 months |
| Receivable collection period | 3 months |
| Non-Current Assets to Sales | 1 : 4 |
| Non-Current Assets to Current Assets | 1 : 2 |
| Current Ratio | 2 : 1 |
| Non-Current Liabilities to Current Liabilities | 1 : 1 |
| Share Capital to Reserve and Surplus | 4 : 1 |
| Non-current Assets as on 31st March, 2017 | Rs.50,00,000 |
| Assume that: | |

- (i) No change in Non-Current Assets during the year 2017-18
- (ii) No depreciation charged on Non-Current Assets during the year 2017-18.
- (iii) Ignoring Tax

You are required to Calculate cost of goods sold, Net profit, Inventory, Receivables and Cash for the year ended on 31st March, 2018(PYP 5 Marks, Nov'18)

Answer 28

Workings

$$\frac{\text{Non Current Assets}}{\text{Current Assets}} = \frac{1}{2}$$

$$\text{Or } \frac{50,00,000}{\text{Current Assets}} = \frac{1}{2}$$

So, Current Assets = Rs.1,00,00,000 Now further,

$$\frac{\text{Non Current Assets}}{\text{Sales}} = \frac{1}{4}$$

$$\text{Or } \frac{50,00,000}{\text{Current Assets}} = \frac{1}{4}$$

So, Sales = Rs.2,00,00,000

Calculation of Cost of Goods sold, Net profit, Inventory, Receivables and Cash:

Cost of Goods Sold (COGS):

$$\begin{aligned} \text{Cost of Goods Sold} &= \text{Sales} - \text{Gross Profit} \\ &= \text{Rs.2,00,00,000} - 20\% \text{ of Rs.2,00,00,000} \\ &= \text{Rs.1,60,00,000} \end{aligned}$$

$$\begin{aligned} \text{Net Profit} &= 10\% \text{ of Sales} = 10\% \text{ of Rs.2,00,00,000} \\ &= \text{Rs.20,00,000} \end{aligned}$$

Inventory:

$$\text{Inventory Holding Period} = \frac{12 \text{ month}}{\text{Inventory Turnover Ratio}}$$

$$4 = \frac{\text{COGS}}{\text{Average Inventory}}$$

$$4 = \frac{1,60,00,000}{\text{Average Inventory}}$$

Average or Closing Inventory = Rs.40,00,000

Receivables:

$$\text{Receivable Collection Period} = \frac{12 \text{ month}}{\text{Receivables Turnover Ratio}}$$

$$\text{Or Receivables Turnover Ratio} = 12 / 3 = 4 = \frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$$

$$\text{Or } 4 = \frac{2,00,00,000}{\text{Average Accounts Receivable}}$$



So, Average Accounts Receivable/Receivables = Rs.50,00,000/-

Cash:

$$\begin{aligned}\text{Cash}^* &= \text{Current Assets}^* - \text{Inventory} - \text{Receivables} \\ \text{Cash} &= \text{Rs.1,00,00,000} - \text{Rs.40,00,000} - \text{Rs.50,00,000} \\ &= \text{Rs.10,00,000}\end{aligned}$$

(it is assumed that no other current assets are included in the Current Asset)

Question 29

The accountant of Moon Ltd. has reported the following data:

| | |
|------------------------------------|-------------|
| Gross profit | Rs.60,000 |
| Gross Profit Margin | 20 per cent |
| Total Assets Turnover | 0.30:1 |
| Net Worth to Total Assets | 0.90:1 |
| Current Ratio | 1.5:1 |
| Liquid Assets to Current Liability | 1:1 |
| Credit Sales to Total Sales | 0.80:1 |
| Average Collection Period | 60 days |

Assume 360 days in a year You are required to complete the following:

Balance Sheet of Moon Ltd. (PYP 5 Marks, May'18)

| Liabilities | ₹ | Assets | ₹ |
|---------------------|---|--------------|---|
| Net Worth | | Fixed Assets | |
| Current Liabilities | | Stock | |
| | | Debtors | |
| | | Cash | |
| Total Liabilities | | Total Assets | |

Answer 29

Preparation of Balance Sheet Working Notes:

$$\begin{aligned}\text{Sales} &= \text{Gross Profit} / \text{Gross Profit Margin} \\ &= 60,000 / 0.2 = \text{Rs.3,00,000} \\ \text{Total Assets} &= \text{Sales} / \text{Total Asset Turnover} \\ &= 3,00,000 / 0.3 = \text{Rs.10,00,000} \\ \text{Net Worth} &= 0.9 \times \text{Total Assets} \\ &= 0.9 \times \text{Rs.10,00,000} = \text{Rs.9,00,000} \\ \text{Current Liability} &= \text{Total Assets} - \text{Net Worth} \\ &= \text{Rs.10,00,000} - \text{Rs.9,00,000} \\ &= \text{Rs.1,00,000} \\ \text{Current Assets} &= 1.5 \times \text{Current Liability} \\ &= 1.5 \times \text{Rs.1,00,000} = \text{Rs.1,50,000} \\ \text{Stock} &= \text{Current Assets} - \text{Liquid Assets} \\ &= \text{Current Assets} - (\text{Liquid Assets} / \text{Current Liabilities} = 1) \\ &= 1,50,000 - (\text{LA} / 1,00,000 = 1) = \text{Rs. 50,000} \\ \text{Debtors} &= \text{Average Collection Period} \times \text{Credit Sales} / 360 \\ &= 60 \times 0.8 \times 3,00,000 / 360 = \text{Rs. 40,000} \\ \text{Cash} &= \text{Current Assets} - \text{Debtors} - \text{Stock} \\ &= \text{Rs.1,50,000} - \text{Rs. 40,000} - \text{Rs. 50,000} \\ &= \text{Rs. 60,000} \\ \text{Fixed Assets} &= \text{Total Assets} - \text{Current Assets} \\ &= \text{Rs.10,00,000} - \text{Rs.1,50,000}\end{aligned}$$



= ₹ 8,50,000

Balance Sheet

| Liabilities | ₹ | Assets | ₹ |
|---------------------|-----------|--------------|-----------|
| Net Worth | 9,00,000 | Fixed Assets | 8,50,000 |
| Current Liabilities | 1,00,000 | Stock | 50,000 |
| | | Debtors | 40,000 |
| | | Cash | 60,000 |
| Total liabilities | 10,00,000 | Total Assets | 10,00,000 |

Question 30

Following are the data in respect of ABC Industries for the year ended 31 st March, 2021:

| | | |
|---------------------------------|---|-------------|
| Debt to Total assets ratio | : | 0.40 |
| Long-term debts to equity ratio | : | 30% |
| Gross profit margin on sales | : | 20% |
| Accounts receivables period | : | 36 days |
| Quick ratio | : | 0.9 |
| Inventory holding period | : | 55 days |
| Cost of goods sold | : | ₹ 64,00,000 |

| Liabilities | ₹ | Assets | ₹ |
|----------------------|-----------|---------------------|---|
| Equity Share Capital | 20,00,000 | Fixed assets | |
| Reserves & surplus | | Inventories | |
| Long-term debts | | Accounts receivable | |
| Accounts payable | | Cash | |
| Total | 50,00,000 | Total | |

Required:

Complete the Balance Sheet of ABC Industries as on 31st March, 2021. All calculations should be in nearest Rupee. Assume 360 days in a year. (PYP 10 Marks Dec '21)

Answer 30

$$(1) \text{ Total liability} = \text{Total Assets} =$$

'50,00,000 Debt to Total Asset Ratio

$$= 0.40$$

$$\frac{\text{Debt}}{\text{Total Assets}} = 0.40$$

$$\text{Or, } \frac{\text{Debt}}{50,00,000} = 0.40$$

$$\text{So, Debt} = 20,00,000$$

$$(2) \text{ Total Liabilities} = ₹ 50,00,000$$

$$\text{Equity share Capital} + \text{Reserves} + \text{Debt} = ₹$$

$$50,00,000 \text{ So, Reserves} = ₹ 50,00,000 - ₹ 20,00,000$$

$$= ₹ 30,00,000$$



So, Reserves & Surplus = ₹ 10,00,000

$$(3) \frac{\text{Long term Debt}}{\text{Equity Shareholders' Fund}} = 30\%$$

$$= \frac{\text{Long term Debt}}{(20,00,000 + 10,00,000)} = 30\%$$

Long Term Debt = ₹ 9,00,000

$$(4) \text{ So, Accounts Payable} = ₹ 20,00,000 - ₹ 9,00,000$$

Accounts Payable = ₹ 11,00,000

$$(5) \text{ Gross Profit to sales} = 20\%$$

$$\text{Cost of Goods Sold} = 80\% \text{ of Sales} = ₹ 64,00,000$$

$$\text{Sales} = 100/80 \times 64,00,000 = 80,00,000$$

$$(6) \text{ Inventory Turnover} = \frac{360}{55}$$

$$\frac{\text{COGS}}{\text{Closing Inventory}} = \frac{360}{55}$$

$$\frac{64,00,000}{\text{Closing inventory}} = \frac{360}{55}$$

Closing inventory = 9,77,778

$$(7) \text{ Accounts Receivable period} = 36 \text{ days}$$

$$\frac{\text{Accounts Receivable}}{\text{Credit Sales}} \times 360 = 36$$

$$\begin{aligned} \text{Accounts Receivable} &= 36/360 \times \text{credit sales} \\ &= 36 / 360 \times 80,00,000 \text{ (assumed all sales are on credit)} \end{aligned}$$

$$\text{Accounts Receivable} = ₹ 8,00,000$$

$$(8) \text{ Quick Ratio} = 0.9$$

$$\frac{\text{Quick Assets}}{\text{Current liabilities}} = 0.9$$

$$\frac{\text{Cash} + \text{Debtors}}{11,00,000} = 0.9$$

$$\text{Cash} + 8,00,000 = ₹ 9,90,000$$

Cash = ₹ 1,90,000

$$(9) \text{ Fixed Assets} = \text{Total Assets} - \text{Current Assets} = 50,00,000 - (9,77,778 + 8,00,000 + 1,90,000)$$

$$= 30,32,222$$

Balance Sheet of ABC Industries as on 31st March 2021

| Liabilities | (₹) | Assets | (₹) |
|------------------|-----------|----------------------|-----------|
| Share Capital | 20,00,000 | Fixed Assets | 30,32,222 |
| Reserved surplus | 10,00,000 | Current Assets: | |
| Long Term Debt | 9,00,000 | Inventory | 9,77,778 |
| Accounts Payable | 11,00,000 | Accounts Receivables | 8,00,000 |
| | | Cash | 1,90,000 |

| | | | |
|-------|-----------|-------|-----------|
| Total | 50,00,000 | Total | 50,00,000 |
|-------|-----------|-------|-----------|

(*Note: Equity shareholders' fund represent equity in 'Long term debts to equity ratio'. The question can be solved assuming only share capital as 'equity')

Question 31

Following information and ratios are given for W Limited for the year ended 31st March, 2022:

| | |
|--|------------|
| Equity Share Capital of ₹ 10 each | ₹ 10 lakhs |
| Reserves & Surplus to Shareholders' Fund | 0.50 |
| Sales / Shareholders' Fund | 1.50 |
| Current Ratio | 2.50 |
| Debtors Turnover Ratio | 6.00 |
| Stock Velocity | 2 Months |
| Gross Profit Ratio | 20% |
| Net Working Capital Turnover Ratio | 2.50 |

You are required to calculate:

- Shareholders' Fund
- Stock
- Debtors
- Current liabilities
- Cash Balance. (PYP 5 Marks May'22)

Answer 31

- (i) **Calculation of Shareholders' Fund:**

$$\frac{\text{Reserve \& Surplus}}{\text{Shareholders' Funds}} = 0.5$$

$$\frac{\text{Reserve \& Surplus}}{\text{Equity Share Capital + Reserve \& Surplus}} = 0.5$$

$$\frac{\text{Reserve \& Surplus}}{10,00,000 + \text{Reserve \& Surplus}} = 0.5$$

$$\text{Reserve \& Surplus} = 5,00,000 + 0.5 \text{ Reserve \& Surplus}$$

$$0.5 \text{ Reserve \& Surplus} = 5,00,000 \text{ Reserve \& Surplus} = 10,00,000$$

$$\text{Shareholders' funds} = 10,00,000 + 10,00,000$$

$$\text{Shareholders' funds} = ₹ 20,00,000$$

- (ii) **Calculation of Value of Stock:**

$$\frac{\text{Sales}}{\text{Shareholders' Funds}} =$$

$$\text{Sales} = 1.5 \times 20,00,000$$

$$\text{Sales} = 30,00,000$$

$$\text{Gross Profit} = 30,00,000 \times 20\% = 6,00,000$$

$$\text{Cost of Goods Sold} = 30,00,000 - 6,00,000$$

$$= ₹ 24,00,000$$

Stock velocity = 2 months

$$= \frac{\text{Average Stock}}{\text{Cost of Goods Sold}} \times 12 = 2$$

$$= \frac{\text{Average Stock}}{24,00,000} \times 12 = 2$$

$$\text{Average Stock} = 24,00,000 \times \frac{2}{12}$$

Average stock = ₹ 4,00,000

(iii) Calculation of Debtors: Debtors Turnover Ratio = 6

$$\therefore \frac{\text{Sales}}{\text{Average Debtors}} = 6$$
$$\therefore \frac{30,000}{\text{Average Debtors}} = 6$$

$$\therefore \frac{30,000}{\text{Average Debtors}} = 6$$

Average Debtors = ₹ 5,00,000

(iv) Calculation of Current Liabilities:

Net Working Capital Turnover ratio = 2.5

$$\frac{\text{Sales}}{\text{Current Assets} - \text{Current Liabilities}} = 2.5$$

$$\frac{30,000}{\text{Current Assets} - \text{Current Liabilities}} = 2.5$$

Current Assets – Current Liabilities = 12,00,000 (1)

Current Ratio = 2.5

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.5$$

Current Assets = 2.5 Current Liabilities (2)

From (1) & (2),

2.5 Current Liabilities – Current Liabilities = 12,00,000

1.5 Current Liabilities = 12,00,000

Current Liabilities = ₹ 8,00,000

(v) Calculation of Cash Balance:

Current Assets = 2.5 Current Liabilities

| | |
|---------------------------------|-------------|
| Current Assets = 2.5 (8,00,000) | = 20,00,000 |
| (-) Debtors | (5,00,000) |
| (-) Stock | (4,00,000) |
| Cash Balance | ₹ 11,00,000 |

Question 32

The following figures are related to the trading activities of M Ltd.

Total assets

₹ 10,00,000



| | |
|----------------------|-------------------------------|
| Debt to total assets | 50% |
| Interest cost | 10% per year |
| Direct Cost | 10 times of the interest cost |
| Operating Exp. | ₹ 1,00,000 |

The goods are sold to customers at a margin of 50% on the direct cost

Tax Rate is 30%

You are required to calculate

- (i) Net profit margin
- (ii) Net operating profit margin
- (iii) Return on assets
- (iv) Return on owner's equity (PYP 5 Marks Nov '22)

Answer 32

(i) Computation of Net Profit Margin

$$\text{Debt} = (10,00,000 \times 50\%) = ₹5,00,000$$

$$\text{Interest cost} = 5,00,000 \times \left(\frac{10}{100}\right) = 50,000$$

$$\text{Direct cost} = 50,000 \times 10 = ₹5,00,000$$

$$\text{Sales} = 5,00,000 \times 150\% = ₹7,50,000$$

(₹)

$$\text{Gross profit} = 7,50,000 - 5,00,000 = 2,50,000$$

$$\text{Less: Operating expenses} = 1,00,000$$

$$\therefore \text{EBIT} = 1,50,000$$

$$\text{Less: Interest} = 50,000$$

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$$\therefore \text{EBT} = 1,00,000$$

$$\text{Less: Tax @ 30\%} = 30,000$$

$$\therefore \text{PAT} = 70,000$$

$$\text{Net profit margin} = \left(\frac{70,000}{7,50,000}\right) \times 100 = 9.33 \%$$

(ii) Net Operating Profit margin

$$\text{Net operating profit margin} = \left(\frac{\text{EBIT}}{\text{Sales}}\right) \times 100$$

$$= \left(\frac{1,50,000}{7,50,000}\right) \times 100 = 20 \%$$

(iii) Return on Assets

$$\text{Return on Assets} = \left[\left(\frac{\text{PAT} + \text{Interest}}{\text{Total Assets}}\right)\right] \times 100$$

$$= \left[\left(\frac{1,20,000}{10,00,000}\right)\right] \times 100 = 12 \%$$



(OR)

$$\text{Return on Assets} = \frac{EBIT}{\text{Assets}} \times 100$$

$$= \left(\frac{1,50,000}{10,00,000} \right) \times 100 = 15 \%$$

(OR)

$$= \frac{70,000}{10,00,000} \times 100 = 7\%$$

(OR)

$$= \left[\frac{1,50,000(1-0.3)}{10,00,000} \right] \times 100 = 10.5\%$$

(iv) Return on owner's equity

$$\text{Return} = \frac{PAT}{\text{Owner's equity}} \times 100 = \frac{70,000}{5,00,000} \times 100 = 14\%$$

Question 33

Following information and ratios are given in respect of AQUA Ltd. for the year ended 31st March, 2023:

| | |
|--|------------|
| Current ratio | 4.0 |
| Acid test ratio | 2.5 |
| Inventory turnover ratio (based on sales) | 6 |
| Average collection period (days) | 70 |
| Earnings per share | ₹ 3.5 |
| Current liabilities | ₹ 3,10,000 |
| Total assets turnover ratio (based on sales) | 0.96 |
| Cash ratio | 0.43 |
| Proprietary ratio | 0.48 |
| Total equity dividend | ₹ 1,75,000 |
| Equity dividend coverage ratio | 1.60 |

Assume 360 days in a year.

You are required to complete Balance Sheet as on 31st March, 2023.

Balance Sheet as on 31st March, 2023.

| Liabilities | ₹ | Assets | ₹ |
|--------------------------------------|----------|------------------|-----|
| Equity share capital (₹10 per share) | XXX | Fixed assets | XXX |
| Reserves & surplus | XXX | Inventory | XXX |
| Long-term debt | XXX | Debtors | XXX |
| Current liabilities | 3,10,000 | Loans & advances | XXX |
| | | Cash & bank | XXX |
| Total | XXX | Total | XXX |

(PYP 10 Marks May '23)

Answer 33

(i) Current Ratio = 4

$$\frac{\text{current Assets}}{\text{Current Liabilities}} = 4$$



$$\therefore \frac{\text{current Assets}}{3,10,000} = 4$$

$$\therefore \text{Current Assets} = 12,40,000$$

(ii) Acid Test Ratio = 2.5

$$\frac{\text{current Assets} - \text{Inventory}}{\text{Current Liabilities}} = 2.5$$

$$\therefore \frac{12,40,000 - \text{Inventory}}{3,10,000} = 2.5$$

$$\therefore 12,40,000 - \text{Inventory} = ₹ 7,75,000$$

$$\text{Inventory} = ₹ 4,65,000$$

(iii) Inventory Turnover Ratio (on Sales) = 6

$$\frac{\text{Sales}}{\text{Inventory}} = 6$$

$$\frac{\text{Sales}}{4,65,000} = 6$$

$$\therefore \text{Sales} = ₹ 27,90,000$$

(iv) Debtors Collection Period = 70 days

$$\therefore (\text{Debtors} / \text{sales}) \times 360 = 70$$

$$\therefore (\text{Debtors} / 27,90,000) \times 360 = 70$$

$$\text{Debtors} = ₹ 5,42,500$$

(v) Total Assets Turnover Ratio (on Sales) = 0.96

$$\therefore \frac{\text{Sales}}{\text{Total Assets}} = 0.96$$

$$\therefore \frac{27,90,000}{\text{Total Assets}} = 0.96$$

$$\text{Total Assets} = ₹ 29,06,250$$

(vi) Fixed Assets (FA) = Total Assets – Current Assets

$$= 29,06,250 - 12,40,000$$

$$\text{Fixed Assets} = ₹ 16,66,250$$

(vii) Cash Ratio = $\frac{\text{Cash}}{\text{Current Liabilities}} = 0.43$

$$\therefore \frac{\text{Cash}}{3,10,000} = 0.43$$

$$\therefore \text{Cash} = ₹ 1,33,300$$

(viii) Proprietary Ratio = $\frac{\text{Proprietary Fund}}{\text{Total Assets}} = 0.48$

$$\therefore \frac{\text{Proprietary Fund}}{29,06,250} = 0.48$$

$$\therefore \text{Proprietary Fund} = ₹ 13,95,000$$

(ix) Equity Dividend Coverage Ratio = 1.6

$$\text{Or } \frac{EPS}{DPS} = \frac{3.5}{DPS}$$

$$\therefore DPS = 2.1875$$

$$DPS = \frac{\text{Total Dividend}}{\text{Number of Equity Shares}}$$

$$\therefore 2.1875 = \frac{1,75,000}{\text{Number of Equity Shares}}$$

$$\therefore \text{Number of Equity Shares} = 80,000$$

$$\therefore \text{Equity Share Capital} = 80,000 \times 10 = ₹ 8,00,000$$

$$\therefore \text{Reserves \& Surplus} = 13,95,000 - 8,00,000 = ₹ 5,95,000$$

(x) Loans and Advances = Current Assets - (Inventory + Receivables + Cash & Bank)

$$= ₹ 12,40,000 - (₹ 4,65,000 + 5,42,500 + 1,33,300) = ₹ 99,200$$

Balance Sheet as on 31st March 2023

| Liabilities | ₹ | Assets | ₹ |
|---------------------------------------|------------------|------------------|------------------|
| Equity Share Capital (₹ 10 per share) | 8,00,000 | Fixed Assets | 16,66,250 |
| Reserves & Surplus | 5,95,000 | Inventory | 4,65,000 |
| Long-term debt *(B/F) | 12,01,250 | Receivables | 5,42,500 |
| Current Liabilities | 3,10,000 | Loans & Advances | 99,200 |
| | | Cash & Bank | 1,33,300 |
| Total | 29,06,250 | Total | 29,06,250 |



Chapter 4 Cost of Capital

Question 1

G Limited has the following capital structure, which it considers to be optimal:

| Capital Structure | Weightage (in %) |
|-------------------|------------------|
| Debt | 25 |
| Preference Shares | 15 |
| Equity Shares | 60 |
| | 100 |

G Limited's expected net income this year is ₹ 34,285.72, its established dividend payout ratio is 30 per cent, its tax rate is 40 per cent, and investors expect earnings and dividends to grow at a constant rate of 9 per cent in the future. It paid a dividend of ₹ 3.60 per share last year, and its shares currently sells at a price of ₹ 54 per share.

G Limited requires additional funds which it can obtain in the following ways:

Preference Shares: New preference shares with a dividend of Rs.11 can be sold to the public at a price of Rs.95 per share.

Debt: Debt can be sold at an interest rate of 12 per cent. You are required to:

DETERMINE the cost of each capital structure component; and

COMPUTE the weighted average cost of capital (WACC) of G Limited. (MTP 10 Marks, March'18)

Answer 1

(i) Computation of Costs of Different Components of Capital:

(a) Equity Shares:

$$k_e = \frac{D_1}{P_0} + g = \frac{D_0(1+g)}{P_0} + g$$

$$= \frac{₹ 3.60 (1.09)}{₹ 54} + 0.09 = 0.0727 + 0.09 = 16.27\%$$

(b) Preference Shares:

$$K_p = \frac{\text{Preference Share Dividend}}{F_0}$$

$$= \frac{₹ 11}{₹ 95} = 11.58\%$$

(c) Debt at 12%

$$k_d (1 - t) = 12\% (1 - 0.4) = 12\% \times 0.6 = 7.20\%$$

(ii) Weighted Average Cost of Capital (WACC)

$$WACC = W_d K_d + W_p K_p + W_e K_e$$

$$WACC = 0.25 (7.2\%) + 0.15 (11.58\%) + 0.60 (16.27\%)$$

$$= 1.8 + 1.737 + 9.762 = 13.30\%$$

Question 2

PQR Ltd. has the following capital structure on October 31, 20X8:

| Sources of capital | (Rs.) |
|---|-----------|
| Equity Share Capital (2,00,000 Shares of Rs. 10 each) | 20,00,000 |
| Reserves & Surplus | 20,00,000 |
| 12% Preference Shares | 10,00,000 |
| 9% Debentures | 30,00,000 |



80,00,000

The market price of equity share is Rs. 30. It is expected that the company will pay next year a dividend of Rs. 3 per share, which will grow at 7% forever. Assume 40% income tax rate.

You are required to COMPUTE weighted average cost of capital using market value weights. (MTP 5 Marks, Aug'18, MTP 5 Marks Oct'18, RTP Nov '19)

Answer 2

Workings:

(i) Cost of Equity

$$= k_e = e = \frac{D_1}{P_0} + g = \frac{\text{Rs.3}}{\text{Rs.30}} + 0.07 = 0.17\%$$

(ii) Cost of Debentures (Kd) = $I(1 - t) = 0.09(1 - 0.4) = 0.054$ or 5.4%

Computation of Weighted Average Cost of Capital (WACC using market value weights)

| Source of capital | Market Value of capital (Rs.) | Weight | Cost of capital (%) | WACC (%) |
|--|-------------------------------|--------|---------------------|----------|
| 9% Debentures | 30,00,000 | 0.30 | 5.40 | 1.62 |
| 12% Preference Shares | 10,00,000 | 0.10 | 12.00 | 1.20 |
| Equity Share Capital (Rs.30 × 2,00,000 shares) | 60,00,000 | 0.60 | 17.00 | 10.20 |
| Total | 1,00,00,000 | 1.00 | | 13.02 |

Question 3

JKL Ltd. has the following book-value capital structure as on March 31, 20X8.

| | (Rs.) |
|--|-----------|
| Equity share capital (2,00,000 shares) | 40,00,000 |
| 11.5% Preference shares | 10,00,000 |
| 10% Debentures | 30,00,000 |
| | 80,00,000 |

The equity shares of the company are sold at Rs. 20. It is expected that the company will pay next year a dividend of Rs. 2 per equity share, which is expected to grow by 5% p.a. forever. Assume a 35% corporate tax rate.

Required:

(i) COMPUTE weighted average cost of capital (WACC) of the company based on the existing capital structure.

(ii) COMPUTE the new WACC, if the company raises an additional Rs. 20 lakhs debt by issuing 12% debentures. This would result in increasing the expected equity dividend to Rs. 2.40 and leave the growth rate unchanged, but the price of equity share will fall to Rs.16 per share. (MTP 10 Marks, Oct 18, Oct '23, RTP May 20) (Same concept different figures MTP 10 Marks Oct'20)

Answer 3

(i) Computation of Weighted Average Cost of Capital based on existing capital structure

| Source of Capital | Existing Capital structure (Rs.) | Weights (a) | After tax cost of capital (%) (b) | WACC (%) (a)×(b) |
|--|----------------------------------|-------------|-----------------------------------|------------------|
| Equity share capital (W.N.1) | 40,00,000 | 0.500 | 15.00 | 7.500 |
| 11.5% Preference share capital (W.N.2) | 10,00,000 | 0.125 | 11.50 | 1.437 |
| 10% Debentures (W.N.3) | 30,00,000 | 0.375 | 6.50 | 2.438 |
| | 80,00,000 | 1.000 | | 11.375 |

Working Notes (W.N.)

1. Cost of equity capital:

$$K_e = \frac{\text{Expected Dividend (D1)}}{\text{Current Market Price per Share (P0)}} + \text{Growth (g)}$$

$$= \frac{\text{Rs } 2}{\text{Rs } 20} + 0.05 = 0.15 \text{ or } 15\%$$

2. Cost of preference share capital: =

$$= \frac{\text{Annual preference share dividend (PD)}}{\text{Net proceeds in the issue of preference share (NP)}}$$

$$= \frac{\text{Rs. 1, 15, 000}}{\text{Rs. 1, 00, 000}}$$

3. Cost of 10% Debentures:

$$\frac{I(1-t)}{NP} = \frac{\text{Rs. 3,00,000 (1 - 0.35)}}{\text{Rs. 30,00,000}} = 0.065 \text{ or } 6.5\%$$

(ii) Computation of Weighted Average Cost of Capital based on new capital structure

| Source of Capital | New Capital structure (Rs.) | Weights (b) | After tax cost of capital (%) (a) | WACC (%) (a) × (b) |
|-------------------------------|-----------------------------|-------------|-----------------------------------|--------------------|
| Equity share capital (W.N. 4) | 40,00,000 | 0.40 | 20.00 | 8.00 |
| Preference share (W.N. 2) | 10,00,000 | 0.10 | 11.50 | 1.15 |
| 10% Debentures (W.N. 3) | 30,00,000 | 0.30 | 6.50 | 1.95 |
| 12% Debentures (W.N.5) | 20,00,000 | 0.20 | 7.80 | 1.56 |
| | 1,00,00,000 | 1.00 | | 12.66 |

Working Notes (W.N.):

4. Cost of equity capital:

$$K_e = \frac{\text{Expected Dividend (D1)}}{\text{Current Market Price per share (P0)}} + \text{Growth (g)}$$

$$\frac{\text{Rs. 2.40}}{\text{Rs. 16}} + 5\% = 20\%$$

5. Cost of 12% Debentures

$$K_d = \frac{2,40,000(1 - 0.35)}{\text{₹20,00,000}} = 0.078 \text{ or } 7.8\%$$

Question 4

DISCUSS the dividend-price approach to estimate cost of equity capital [MTP 2 Marks, March'19 & Oct '23]

Answer 4

In dividend price approach, cost of equity capital is computed by dividing the expected dividend by market price per share. This ratio expresses the cost of equity capital in relation to what yield the company should pay to attract investors. It is computed as:

$$K_e = \frac{D_1}{P_0}$$

Where,

D1 = Dividend per share in period P0 = Market price per share today.

Question 5

Annona Ltd is considering raising of funds of about Rs.250 lakhs by any of two alternative methods, viz., 14% institutional term loan and 13% non-convertible debentures. The term loan option would attract no major incidental cost and can be ignored. The debentures would have to be issued at a discount of 2.5%



and would involve cost of issue of 2% on face value.

ADVISE the company as to the better option based on the effective cost of capital in each case. Assume a tax rate of 50%. (MTP 5 Marks, April '19)

Answer 5

Calculation of Effective Cost of Capital

| Particulars | Option 1 14% institutional Term loan (Rs. in Lakhs) | Option 2 13% Non-convertible Debentures (Rs. in lakhs) |
|--|--|---|
| (A) Effective capital to be raised Face value | 250.00 | 250.00 |
| Less: Discount | Nil | (6.25) |
| | 250.00 | 243.75 |
| Less: Cost of issue | Nil | 5.00 |
| Effective amount of capital | 250.00 | 238.75 |
| (B) Annual interest charges on face value of Rs. 250 lakhs | 35.0 | 32.50 |
| Less: Tax benefit on interest @ 50% | 17.5 | 16.25 |
| | 17.5 | 16.25 |
| (C) Effective cost of capital after tax | $\frac{B}{A} \times 100$ = 7.0% | $\frac{16.25}{238.75} \times 100$ = 6.81% (approx.) |

So, the better option is raising of funds of Rs.250 lakhs by issue of 13% Non-convertible Debenture

Question 6

ABC Ltd. has the following capital structure which is considered to be optimum as on 31st March, 2019

| | (Rs.) |
|-------------------------------|-------------|
| 14% Debentures | 30,00,000 |
| 11% Preference shares | 10,00,000 |
| Equity Shares (10,000 shares) | 1,60,00,000 |
| | 2,00,00,000 |

The company share has a market price of Rs. 236. Next year dividend per share is 50% of year 2019 EPS. The following is the trend of EPS for the preceding 10 years which is expected to continue in future.

| Year | EPS (Rs.) | Year | EPS Rs.) |
|------|-----------|------|----------|
| 2010 | 10.00 | 2015 | 16.10 |
| 2011 | 11.00 | 2016 | 17.70 |
| 2012 | 12.10 | 2017 | 19.50 |
| 2013 | 13.30 | 2018 | 21.50 |
| 2014 | 14.60 | 2019 | 23.60 |

The company issued new debentures carrying 16% rate of interest and the current market price of debenture is Rs. 96.

Preference share Rs. 9.20 (with annual dividend of Rs. 1.1 per share) were also issued. The company is in 50% tax bracket.

(A) CALCULATE after tax:

- Cost of new debt
- Cost of new preference shares
- New equity share (consuming new equity from retained earnings)

(B) CALCULATE marginal cost of capital when no new shares are issued.

(C) COMPUTE the amount that can be spent for capital investment before new ordinary shares must be sold. Assuming that retained earnings for next year's investment are 50 percent of 2019.

(D) COMPUTE marginal cost of capital when the funds exceeds the amount calculated in (C), assuming



new equity is issued at Rs. 200 per share? [MTP 10 Marks, Oct'19, Old & New SM, RTP May '21]

Answer 6

(A) (i) Cost of new debt

$$K_d = \frac{I(1-t)}{P_0} = \frac{16(1-0.5)}{96} = 0.0833$$

(ii) Cost of new preference shares

$$K_p = \frac{PD}{P_0} = \frac{1.1}{9.2} = 0.12$$

(iii) Cost of new equity shares

$$K_e = \frac{D_1}{P_0} + g = \frac{11.80}{236} + 0.10 = 0.05 + 0.10 = 0.15$$

Calculation of D1

D1 = 50% of 2019 EPS = 50% of 23.60 = Rs. 11.80

(B) Calculation of marginal cost of capital

| Type of Capital | Proportion | Specific Cost | Product |
|--------------------------|------------|---------------|-----------------|
| (1) | (2) | (3) | (2) × (3) = (4) |
| Debenture | 0.15 | 0.0833 | 0.0125 |
| Preference Share | 0.05 | 0.12 | 0.0060 |
| Equity Share | 0.80 | 0.15 | 0.1200 |
| Marginal cost of capital | | | 0.1385 |

(C) The company can spend the following amount without increasing marginal cost of capital and without selling the new shares:

Retained earnings = (0.50) (236 × 10,000) = Rs. 11,80,000

The ordinary equity (Retained earnings in this case) is 80% of total capital 11,80,000 = 80% of Total Capital

Capital investment before issuing equity

$$\frac{\text{Rs. } 11,80,000}{0.80} = \text{Rs. } 14,75,000$$

(D) If the company spends in excess of Rs. 14,75,000 it will have to issue new shares.

The cost of new issue will be $\frac{\text{Rs. } 11.80}{200} + 0.10 = 0.159$

The marginal cost of capital will be:

| Type of Capital | Proportion | Specific Cost | Product |
|---------------------|------------|---------------|-----------------|
| (1) | (2) | (3) | (2) × (3) = (4) |
| Debentures | 0.15 | 0.0833 | 0.0125 |
| Preference Shares | 0.05 | 0.1200 | 0.0060 |
| Equity Shares (New) | 0.80 | 0.1590 | 0.1272 |
| | | | 0.1457 |



Question 7

ABC Limited has the following book value capital structure:

| | |
|---|---------------|
| Equity Share Capital (1 crore shares @ Rs.10 each) | Rs.1,000 lakh |
| Reserves and Surplus | Rs.2,250 lakh |
| 9% Preference Share Capital (5 lakh shares @ Rs.100 each) | Rs.500 lakh |
| 8.5% Debentures (1.5 lakh debentures @ Rs.1,000 each) | Rs.1,500 lakh |
| 12% Term Loans from Financial Institutions | Rs.500 lakh |

- The debentures of ABC Limited are redeemable at par after five years and are quoting at Rs.985 per debenture.
- The current market price per equity share is Rs.60. The prevailing default-risk free interest rate on 10-year GOI Treasury Bonds is 5.5%. The average market risk premium is 7%. The beta of the company is 1.85
- The preference shares of the company are redeemable at 10% premium after 5 years is currently selling at Rs.102 per share.
- The applicable income tax rate for the company is 35%.

Required:

CALCULATE weighted average cost of capital of the company using market value weights. (MTP 5 Marks, May'20)

Answer 7

Working Notes:

(1) Computation of cost of debentures (K_d):

$$K_d = \frac{\text{Rs.}85(1-0.35) + \frac{(1,000-985)}{5}}{\frac{(1,000-985)}{2}} = \frac{55.25+3}{992.5} = 0.0586 \text{ or } 5.86\%$$

(2) Computation of cost of term loans (K_T):

$$= r(1-t)$$

$$= 0.12(1-0.35) = 0.078 \text{ or } 7.8\%$$

$$= K_0 = \frac{\text{preferenc Divident} + (RV - NP)/n}{(RV + NP)/2}$$

$$= \frac{\text{Rs.}9 + \frac{(110-102)}{5}}{\frac{(110-102)}{2}} = \frac{9+1.6}{106}$$

$$= 0.1 \text{ or } 10\%$$

(3) Computation of cost of equity (K_e):

$$= R_f + \beta(R_m - R_f)$$

$$\text{Or,} \quad = \text{Risk free rate} + (\text{Beta} \times \text{Risk premium})$$

$$= 0.055 + (1.85 \times 0.07) = 0.1845 \text{ or } 18.45\%$$

Calculation of Weighted Average cost of capital Using market value weights

| Source of Capital | Market value of capital structure (Rs. in lakh) | Weights | After tax cost of capital (%) | WACC (%) |
|--|---|---------|-------------------------------|----------|
| Equity share capital (1 crore shares × Rs.60) | 6,000 | 0.71 | 18.45 | 13.09 |
| 9% Preference share capital (5 lakh shares × Rs.100) | 510 | 0.06 | 10.00 | 0.60 |



| | | | | |
|---|----------|-------|------|-------|
| Rs.102) | | | | |
| 8.5 % Debentures (1.5 lakh × Rs.985) | 1,477.5 | 0.17 | 5.86 | 0.99 |
| 12% Term loans | 500 | 0.06 | 7.80 | 0.47 |
| | 8,487.50 | 1.000 | | 15.15 |

Question 8

"Financing a business through borrowing is cheaper than using equity." Briefly EXPLAIN [MTP 2 Marks, May'20 & Sep '23].

Answer 8

Financing a business through borrowing is cheaper than using equity"

- Debt capital is cheaper than equity capital from the point of its cost and interest being deductible for income tax purpose, whereas no such deduction is allowed for dividends.
- Issue of new equity dilutes existing control pattern while borrowing does not result in dilution of control.
- In a period of rising prices, borrowing is advantageous. The fixed monetary outgo decreases in real terms as the price level increases.

Question 9

CALCULATE the WACC by using Market value weights. The capital structure of the company is as under:

| | (Rs.) |
|--------------------------------------|-----------|
| Debentures (Rs.100 per debenture) | 10,00,000 |
| Preference shares (Rs.100 per share) | 10,00,000 |
| Equity shares (Rs.10 per share) | 20,00,000 |
| | 40,00,000 |

The market prices of these securities are:

Debentures Rs. 115 per debenture

Preference shares Rs. 120 per preference share

Equity shares Rs. 265 each.

Additional information:

- Rs.100 per debenture redeemable at par, 10% coupon rate, 2% floatation cost, 10-year maturity.
 - Rs.100 per preference share redeemable at par, 5% coupon rate, 2% floatation cost and 10 - year maturity.
 - Equity shares have a floatation cost of Rs. 1 per share.
- The next year expected dividend is Rs. 5 with an annual growth of 15%. The firm has the practice of paying all earnings in the form of dividend.
- Corporate tax rate is 30%. Use YTM method to calculate cost of debentures and preference shares. (MTP 10 Marks, March'21, Old & New SM, RTP Nov '20)

Answer 9

(i) Cost of equity (K_e)

$$= \frac{D_1}{P_0 - F} + g = \frac{\text{Rs.5}}{\text{Rs.265} - \text{Rs.1}} + 0.15 = 0.1689 \text{ or } 16.89\%$$

(ii) Cost of Debt (K_d)

Calculation of NPV at discount rate of 5% and 7%

| Year | Cash flows (Rs.) | Discount factor @ 5% | Present Value | Discount factor @ 7% | Present Value (Rs.) |
|------|------------------|----------------------|---------------|----------------------|---------------------|
|------|------------------|----------------------|---------------|----------------------|---------------------|



| | | | | | |
|---------|-------|-------|---------|-------|---------|
| 0 | 112.7 | 1.000 | (112.7) | 1.000 | (112.7) |
| 1 to 10 | 7 | 7.722 | 54.05 | 7.024 | 49.17 |
| 10 | 100 | 0.614 | 61.40 | 0.508 | 50.80 |
| NPV | | | +2.75 | | -12.73 |

Calculation of IRR

$$IRR = 5\% + \frac{2.75}{2.75 - (-12.73)} (7\% - 5\%) = 5\% + \frac{2.75}{15.48} (7\% - 5\%) = 5.36\%$$

Cost of Debt (Kd) = 5.36%

(iii) Cost of Preference shares (Kp)

Calculation of NPV at discount rate of 2% and 5%

| Year | Cash flows (Rs.) | Discount factor @ 2% | Present Value | Discount factor @ 5% | Present Value (Rs.) |
|---------|------------------|----------------------|---------------|----------------------|---------------------|
| 0 | 117.6 | 1.000 | (117.6) | 1.000 | (117.6) |
| 1 to 10 | 5 | 8.983 | 44.92 | 7.722 | 38.61 |
| 10 | 100 | 0.820 | 82.00 | 0.614 | 61.40 |
| NPV | | | +9.32 | | -17.59 |

Calculation of IRR

$$IRR = 2\% + \frac{9.32}{9.32 - (-17.59)} (5\% - 2\%) = 2\% + \frac{9.32}{26.91} = 3.04\%$$

Cost of Preference Shares (Kp) = 3.04%

Calculation of WACC using market value weights

| Source of capital | Market Value | Weights | After tax cost of capital | WACC (Koi) |
|--|--------------|---------|---------------------------|-----------------|
| | (Rs.) | (a) | (b) | (c) = (a) × (b) |
| 10% Debentures (Rs.115 × 10,000) | 11,50,000 | 0.021 | 0.0536 | 0.00113 |
| 5% Preference shares (Rs.120 × 10,000) | 12,00,000 | 0.022 | 0.0304 | 0.00067 |
| Equity shares (Rs.265 × 2,00,000) | 5,30,00,000 | 0.957 | 0.1689 | 0.16164 |
| | 5,53,50,000 | 1.000 | | 0.16344 |

WACC (Ko) = 0.16344 or 16.344%

Question 10

Development Finance Corporation issued zero interest deep discount bonds of face value of Rs. 1,50,000 each issued at Rs. 3,750 & repayable after 25 years. COMPUTE the cost of debt if there is no corporate tax. (MTP 3 Marks April'21)

Answer 10

Here,

Redemption Value (RV) = Rs.1,50,000 Net Proceeds (NP) = Rs. 3,750 Interest = 0

Life of bond = 25 years

There is huge difference between RV and NP therefore in place of approximation method we should use trial & error method.

FV = PV × (1 + r)ⁿ

1,50,000 = 3,750 × (1 + r)²⁵

$$40 = (1 + r)^{25}$$

$$\text{Trial 1: } r = 15\%, (1.15)^{25} = 32.919$$

$$\text{Trial 2: } r = 16\%, (1.16)^{25} = 40.874$$

Here:

$$L = 15\%; H = 16\%$$

$$\text{NPVL} = 32.919 - 40 = -7.081$$

$$\text{NPVH} = 40.874 - 40 = +0.874$$

$$\text{IRR} = L + \frac{\text{NPV}_L}{\text{NPV}_L - \text{NPV}_H} (H - L)$$

$$= 15\% + \frac{-7.081}{-7.081 - (0.874)} \times (16\% - 15\%) = 15.89\%$$

Question 11

The following is the capital structure of Shard Ltd. as on 31.12.2020:

| | (₹) |
|---|-------------|
| Equity shares: 2,00,000 shares (of Rs.100 each) | 2,00,00,000 |
| 9% Preference Shares (of Rs.100 each) | 60,00,000 |
| 8% Debentures | 90,00,000 |
| | 3,50,00,000 |

The market price of the company's share is Rs.120 and it is expected that a dividend of Rs.12 per share would be declared for the year 2021. The dividend growth rate is 5% and the company is in the 30% tax bracket.

- CALCULATE the company's weighted average cost of capital.
- Further, in order to finance an expansion plan, the company intends to borrow a fund of ₹ 2 crores bearing 12% rate of interest. In this situation, WHAT will be the company's revised weighted average cost of capital? This financing decision is expected to increase dividend from Rs.12 to Rs.14 per share. However, the market price of equity share is expected to decline from Rs.120 to Rs.115 per share.

In case of both (i) and (ii) above, use market value weight while calculating weighted average cost of capital. [MTP 5 Marks, Oct'21]

Answer 11

- Computation of the weighted average cost of capital

| Source of finance (a) | Market Value of capital (₹) | Weight (b) | After tax Cost of capital (%) (c) | WACC (%) (d) = (b) × (c) |
|---|-----------------------------|---------------|--------------------------------------|-----------------------------|
| Equity share (Working note 1) [₹120 × 2,00,000 shares] | 2,40,00,000 | 0.6154 | 15 | 9.231 |
| 9% Preference share | 60,00,000 | 0.1538 | 9 | 1.3842 |
| 8% Debentures | 90,00,000 | 0.2308 | 5.60 | 1.2925 |
| | 3,90,00,000 | 1.0000 | | 11.9077 |

- Computation of Revised Weighted Average Cost of Capital

| Source of finance (a) | Market Value of capital (₹) | Weight (b) | After tax Cost of capital (%) (c) | WACC (%) (d) = (b) × (c) |
|--|-----------------------------|---------------|--------------------------------------|-----------------------------|
| Equity shares (Working note 2) [₹115 × 2,00,000 shares] | 2,30,00,000 | 0.3966 | 17.17 | 6.8096 |
| 9% Preference shares | 60,00,000 | 0.1034 | 9.00 | 0.9306 |



| | | | | |
|---------------|-------------|--------|------|---------|
| 8% Debentures | 90,00,000 | 0.1552 | 5.60 | 0.8691 |
| 12% Loan | 2,00,00,000 | 0.3448 | 8.40 | 2.8963 |
| | 5,80,00,000 | 1.0000 | | 11.5056 |

Working Notes:

- (1) Cost of Equity Shares
 $K_e = \{\text{Dividend Per Share (D1)} / \text{Market Price Share (P0)}\} + \text{Growth Rate}$
 $= 12/120 + 0.05$
 $= 0.15 \text{ or } 15\%$
- (2) Revised cost of equity shares (K_e) Revised $K_e = 14/115 + 0.05 = 0.1717 \text{ or } 17.17\%$

Question 12

XYZ Company's equity share is quoted in the market at ₹ 25 per share currently. The company pays a dividend of ₹ 5 per share and the investor's market expects a growth rate of 5% per year.

You are required to:

- (i) CALCULATE the company's cost of equity capital.
(ii) If the company issues 12% debentures of face value of Rs.100 each and realizes Rs.95 per debenture while the debentures are redeemable after 10 years at a premium of 12%, CALCULATE cost of debenture using YTM?

Assume tax rate to be 30%. [MTP 5 Marks , Nov'21 , March 22 & Sep '23]

Answer 12

- (i) Cost of Equity Capital (K_e)

$$\frac{\text{Expected dividend per share (D1)}}{\text{Market price per share (P0)}} = \text{Growth rate (g)}$$

$$= \frac{\text{Rs. } 5 \times 1.05}{\text{Rs. } 25} + 0.05 = 26\%$$

- (ii) Cost of Debenture (K_d):

Using Present Value method (or YTM)

Identification of relevant cash flows

| Year | Cash flows |
|---------|---|
| 0 | Current market price (P_0) = Rs.95 |
| 1 to 10 | Interest net of tax [$I(1-t)$] = 12% of Rs.100 (1 - 0.30) = Rs.8.40 |
| 10 | Redemption value (RV) = Rs.100 (1.12) = Rs.112 |

Calculation of Net Present Values (NPV) at two discount rates

| Year | Cash flows | Discount factor @ 9% (L) | Present Value | Discount factor @ 10% (H) | Present Value |
|---------|------------|--------------------------|---------------|---------------------------|---------------|
| 0 | (95) | 1.0000 | (95.00) | 1.0000 | (95.00) |
| 1 to 10 | 8.40 | 6.4176 | 53.91 | 6.1445 | 51.61 |
| 10 | 112 | 0.4224 | 47.31 | 0.3855 | 43.18 |
| NPV | | | +6.22 | | -0.21 |

Calculation of IRR=



$$\begin{aligned} \text{IRR} &= L + \frac{\text{NPV}_L}{\text{NPV}_L - \text{NPV}_H} (H - L) \\ &= 9\% + \frac{6.22}{6.22 - (-0.21)} (10\% - 9\%) = 9\% + \frac{6.22}{6.43} \\ &= \text{Therefore, } K_d = 9.97\% \end{aligned}$$

Question 13

The capital structure of RV Limited as on 31st March, 2022 as per its Balance Sheet is as follows:

| Particulars | ₹ |
|-------------------------------------|-----------|
| Equity shares of ₹ 10 each | 25,00,000 |
| 10% Preference shares of ₹ 100 each | 5,00,000 |
| Retained earnings | 5,00,000 |
| 13% debentures of ₹ 100 each | 20,00,000 |

The market price of equity shares is ₹ 50 per share. Expected dividend on equity shares is ₹ 3 per share. The dividend per share is expected to grow at the rate of 8%.

Preference shares are redeemable after eight years and the current market price is ₹ 80 per share.

Debentures are redeemable after five years and are currently selling at ₹ 90 per debenture. The tax rate applicable to the company is 35%. CALCULATE weighted average cost of capital using:

- Book value proportions
- Market value proportions (MTP 10 Marks April 22)

Answer 13

Working Notes:

- Cost of Equity (K_e)

$$\frac{D_1}{P} + g = \frac{\text{Rs. } 3}{\text{Rs. } 50} + 0.08 = 0.14 \text{ i.e. } 14\%$$

- Cost of preference Shares (K_p)

$$\frac{D + \frac{RV - NP}{n}}{\frac{RV + NP}{2}} = \frac{10 + \frac{100 - 80}{8}}{\frac{100 + 80}{2}} = \frac{12.5}{90} = 0.1389 = 13.89\%$$

- Cost of debenture (K_d)

$$\frac{I(1-t) + \frac{RV - NP}{n}}{\frac{RV + NP}{2}} = \frac{13(1-0.35) + \frac{100-90}{5}}{\frac{100+90}{2}} = \frac{8.45+2}{95} = 0.11 \text{ i.e. } 11\%$$

Or,

$$\left[\frac{I + \frac{RV - NP}{n}}{\frac{RV + NP}{2}} \right] (1-t) = \left[\frac{13 + \frac{100-90}{5}}{\frac{100+90}{2}} \right] (1-0.35) = 0.1026 \text{ i.e. } 10.26\%$$

Weighted Average cost of capital (Book Value)

| | Amount (₹) | Weight (W) | Cost (K) | W x K |
|-------------------|------------|------------|----------|--------|
| Equity shares | 25,00,000 | 0.4546 | 0.14 | 0.0636 |
| Preference shares | 5,00,000 | 0.0909 | 0.1389 | 0.0126 |
| Retained Earnings | 5,00,000 | 0.0909 | 0.14 | 0.0127 |



| | | | | |
|------------|-----------|--------|--------|--------|
| Debentures | 20,00,000 | 0.3636 | 0.1026 | 0.0373 |
| | 55,00,000 | | | 0.1262 |

Or (if K_d is 11%) the WACC = 0.1289

Thus, WACC (Book value based) = 12.62% or 12.89%

Weighted Average cost of capital (Market Value)

| | Amount (₹) | Weight (W) | Cost (K) | W x K |
|-------------------|-------------|------------|----------|--------|
| Equity shares | 1,25,00,000 | 0.85 | 0.14 | 0.119 |
| Preference shares | 4,00,000 | 0.028 | 0.1389 | 0.0039 |
| Debentures | 18,00,000 | 0.122 | 0.1026 | 0.0125 |
| | 1,47,00,000 | | | 0.1354 |

Or (if K_d is 11%) the WACC = 0.1363

Thus, WACC (Market value based) = 13.54% or 13.63%

Question 14

Answer the following:

The capital structure of a Company is given below:

| Source of capital | Book Value (₹) |
|--|----------------|
| Equity shares @ ₹ 100 each | 24,00,000 |
| 9% Cumulative preference shares @ ₹ 100 each | 4,00,000 |
| 11% Debentures | 12,00,000 |
| | 40,00,000 |

The company had paid equity dividend @ 25% for the last year which is likely to grow @ 5% every year. The current market price of the company's equity share is ₹ 200.

Considering corporate tax @ 30%, you are required to CALCULATE:

- Cost of capital for each source of capital.
- Weighted average cost of capital. (MTP 5 Marks Sep'22)

Answer 14

i. Calculation of Cost of Capital for each source of capital:

(a) Cost of Equity share capital:

$$K_e = \frac{D_0 (1+g)}{\text{Market Price per share}(P_0)} + g = \frac{25\% \times ₹100(1+0.05)}{₹200} + 0.05$$

(b) Cost of Preference share capital (K_p) = 9%

(c) Cost of Debentures (K_d) = $r(1-t)$

$$= 11\% (1 - 0.3) = 7.7\%$$

ii. Weighted Average Cost of Capital

| Source | Amount (₹) | Weights (a) | After tax Cost of Capital (%) (b) | WACC (%) (c) = (a) × (b) |
|---------------------|------------|----------------|---|-----------------------------|
| Equity share | 24,00,000 | 0.60 | 18.125 | 10.875 |
| 9% Preference share | 4,00,000 | 0.10 | 9.000 | 0.900 |



| | | | | |
|----------------|-----------|------|-------|--------|
| 11% Debentures | 12,00,000 | 0.30 | 7.700 | 2.310 |
| | 40,00,000 | 1.00 | | 14.085 |

Question 16

The financial advisor of Sun Ltd is confronted with following two alternative financing plans for raising ₹ 10 lakhs that is needed for plant expansion and modernization Alternative I: Issue 80% of funds with 14% Debenture [Face value (FV) ₹ 100] at par and redeem at a premium of 10% after 10 years and balance by issuing equity shares at 33 $\frac{1}{3}$ % premium.

Alternative II: Raise 10% of funds required by issuing 8% Irredeemable Debentures [Face value (FV) ₹ 100] at par and the remaining by issuing equity shares at current market price of ₹125. Currently, the firm has an Earnings per share (EPS) of ₹ 21 The modernization and expansion programme is expected to increase the firm's Earnings before Interest and Taxation (EBIT) by ₹ 200,000 annually.

The firm's condensed Balance Sheet for the current year is given below:

Balance Sheet as on 31.3.2022

| Liabilities | Amount (₹) | Assets | Amount (₹) |
|---------------------------------------|------------------|-------------------------|------------------|
| Current Liabilities | 5,00,000 | Current Assets | 16,00,000 |
| 10% Long Term Loan | 15,00,000 | Plant & Equipment (Net) | 34,00,000 |
| Reserves & Surplus | 10,00,000 | | |
| Equity Share Capital (FV: ₹ 100 each) | 20,00,000 | | |
| TOTAL | 50,00,000 | TOTAL | 50,00,000 |

However, the finance advisor is concerned about the effect that issuing of debt might have on the firm. The average debt ratio for firms in industry is 35%. He believes if this ratio is exceeded, the P/E ratio of the company will be 7 because of the potentially greater risk.

If the firm increases its equity capital by more than 10 %, he expects the P/E ratio of the company will increase to 8.5 irrespective of the debt ratio.

Assume Tax Rate of 25%. Assume target dividend pay-out under each alternative to be 60% for the next year and growth rate to be 10% for the purpose of calculating Cost of Equity

SUGGEST with reason which alternative is better on the basis of each of the below given criteria:

- Earnings per share (EPS) & Market Price per share (MPS)
- Financial Leverage
- Weighted Average Cost of Capital & Marginal Cost of Capital (using Book Value weights) (MTP 10 Marks Oct'22)

Answer 16

Calculation of Equity Share capital and Reserves and surplus:

Alternative 1:

$$\text{Equity Share capital} = ₹20,00,000 + \frac{₹2,00,000 \times 100}{133.3333} = ₹21,50,000$$

$$\text{Reserves} = ₹10,00,000 + \frac{₹2,00,000 \times 33.3333}{133.3333} = ₹10,50,000$$

Alternative 2:

$$\text{Equity Share capital} = ₹20,00,000 + \frac{₹9,00,000 \times 25}{125} = ₹11,80,000$$

Capital Structure Plans

| Capital | Amount in ₹ | |
|----------------------|---------------|---------------|
| | Alternative 1 | Alternative 2 |
| Equity Share capital | 21,50,000 | 27,20,000 |
| Reserves and surplus | 10,50,000 | 11,80,000 |
| 10% long term debt | 15,00,000 | 15,00,000 |



| | | |
|----------------------------|-----------|-----------|
| 14% Debentures | 8,00,000 | - |
| 8% Irredeemable Debentures | - | 1,00,000 |
| Total Capital Employed | 55,00,000 | 55,00,000 |

Computation of Present Earnings before interest and tax (EBIT)

| | |
|--|----------|
| EPS (₹) | 21 |
| No. of equity shares | 20,000 |
| Earnings for equity shareholders (I x II) (₹) | 4,20,000 |
| Profit Before Tax (III/75%) (₹) | 5,60,000 |
| Interest on long term loan (1500000 x 10%) (₹) | 1,50,000 |
| EBIT (IV + V) (₹) | 7,10,000 |

EBIT after expansion = ₹7,10,000 + ₹2,00,000 = ₹9,10,000

Evaluation of Financial Plans on the basis of EPS, MPS and Financial Leverage

Amount in ₹

| Particulars | Alternative I | Alternate II |
|---------------------------------------|---------------|--------------|
| EBIT | 9,10,000 | 9,10,000 |
| Less: Interest: 10% on long term loan | (1,50,000) | (1,50,000) |
| 14% on Debentures | (1,12,000) | Nil |
| 8% on Irredeemable Debentures | Nil. | (8000) |
| PBT | 6,48,000 | 7,52,000 |
| Less: Tax @25% | (1,62,000) | (1,88,000) |
| PAT | 4,86,000 | 5,64,000 |
| No. of equity shares | 21,500 | 27,200 |
| EPS | 22.60 | 20.74 |
| Applicable P/E ratio (Working Note 1) | 7 | 8.5 |
| MPS (EPS X P/E ratio) | 158.2 | 176.29 |
| Financial Leverage EBIT/PBT | 1.40 | 1.21 |

Working Note 1

| | Alternative I | Alternative II |
|---|---------------|----------------|
| Debt: | | |
| ₹15,00,000 + ₹8,00,000 | 23,00,000 | - |
| ₹15,00,000 + ₹1,00,000 | - | 16,00,000 |
| Total capital Employed (₹) | 55,00,000 | 55,00,000 |
| Debt Ratio (Debt/Capital employed) | =0.4182 | =0.2909 |
| | =41.82% | =29.09% |
| Change in Equity: ₹21,50,000-₹20,00,000 | 1,50,000 | |
| ₹27,20,000-₹20,00,000 | | 7,20,000 |
| Percentage change in equity | 7.5% | 36% |
| Applicable P/E ratio | 7 | 8.5 |

Calculation of Cost of equity and various type of debt

| | Alternative I | Alternative II |
|--------------------------|---------------|----------------|
| A) Cost of equity | | |
| EPS | 22.60 | 20.74 |
| DPS (EPS X 60%) | 13.56 | 12.44 |
| Growth (g) | 10% | 10% |



| | | |
|---------------------------|---|-----------------------------|
| Po (MPS) | 158.2 | 176.29 |
| $K_e = D_0 (1 + g) / P_0$ | $\frac{13.56(1.1)}{158.2}$ | $\frac{12.44(1.1)}{176.29}$ |
| | =9.43% | =7.76% |
| B) Cost of Debt: | | |
| 10% long term debt | 10% + (1-0.25) | 10% + (1-0.25) |
| | = 7.5% | = 7.5% |
| 14% redeemable debentures | $\frac{14(1 - 0.25) + (110 - 100/10)}{110 + 100/2}$ | nil |
| | = 10.5 + 1 / 10.5 | |
| | = 10.95% | |
| 8% irredeemable debenture | NA | 8000(1-0.25)/1,00,00 = 6% |

Calculation of Weighted Average cost of capital (WACC)

| | Alternative 1 | | | Alternative 2 | | |
|----------------------------|---------------|----------|-------|---------------|----------|-------|
| Capital | Weights | Cost (%) | WACC | Weights | Cost (%) | WACC |
| Equity Share Capital | 0.3909 | 9.43 | 3.69% | 0.4945 | 7.76 | 3.84% |
| Reserves and Surplus | 0.1909 | 9.43 | 1.80% | 0.2145 | 7.76 | 1.66% |
| 10% Long term Debt | 0.2727 | 7.50 | 2.05% | 0.2727 | 7.50 | 2.05% |
| 14% Debenture | 0.1455 | 10.95 | 1.59% | | | |
| 8% Irredeemable Debentures | - | | | 0.0182 | 6 | 0.11% |
| | | | 9.12% | | | 7.66% |

Calculation Marginal Cost of Capital (MACC)

| | Alternative 1 | | | Alternative 2 | | |
|----------------------------|------------------|----------|--------|-----------------|----------|-------|
| Capital | Amount(weight) | Cost (%) | MACC | Amount (weight) | Cost (%) | MACC |
| Equity Share Capital | ₹ 1,50,000(0.15) | 9.43 | 1.41% | ₹7,20,000(0.72) | 7.76 | 5.59% |
| Reserves and Surplus | ₹ 50,000(0.05) | 9.43 | 0.47% | ₹1,80,000(0.18) | 7.76 | 1.40% |
| 14% Debenture | ₹ 8,00,000(0.80) | 10.95 | 8.76% | - | | 0.00% |
| 8% Irredeemable Debentures | - | | | ₹1,00,000(0.10) | 6 | 0.60% |
| Total Capital Employed | ₹10,00,000 | | 10.65% | ₹10,00,000 | | 7.58% |

Summary of solution:

| | Alternate I | Alternate II |
|---|-------------|--------------|
| Earning per share (EPS) | 22.60 | 20.74 |
| Market price per share (MPS) | 158.20 | 176.29 |
| Financial leverage | 1.4043 | 1.2101 |
| Weighted Average cost of capital (WACC) | 9.12% | 7.66% |
| Marginal cost of capital (MACC) | 10.65% | 7.58% |

Alternative 1 of financing will be preferred under the criteria of EPS, whereas Alternative II of financing will be preferred under the criteria of MPS, Financial leverage, WACC and marginal cost of capital.

Question 17



The proportion and required return of debt and equity was recorded for a company with its increased financial leverage as below. (MTP 5 Marks, April '19)

| Debt (%) | Required return (Kd) (%) | Equity (%) | Required Return (Ke) (%) | Weighted Average Cost of Capital (WACC) (Ko)(%) |
|----------|--------------------------|------------|--------------------------|---|
| 0 | 5 | 100 | 15 | 15 |
| 20 | 6 | 80 | 16 | ? |
| 40 | 7 | 60 | 18 | ? |
| 60 | 10 | 40 | 23 | ? |
| 80 | 15 | 20 | 35 | ? |

You are required to complete the table and IDENTIFY which capital structure is most beneficial for this company. (Based on traditional theory, i.e., capital structure is relevant).

Answer 17

Computation of Weighted Average Cost of Capital (WACC) for each level of Debt-equity mix.

| Debt (%) | Required return (Kd)(%) | Equity (%) | Required return (Ke) (%) | Kd × Proportion of debt + Ke Proportion and equity | Weighted Average Cost of Capital (WACC)(Ko)(%) |
|----------|-------------------------|------------|--------------------------|--|--|
| 0 | 5 | 100 | 15 | 0%(5%)+100%(15%) | 15 |
| 20 | 6 | 80 | 16 | 20%(6%)+80%(16%) | 14 |
| 40 | 7 | 60 | 18 | 40%(7%)+60%(18%) | 13.6 |
| 60 | 10 | 40 | 23 | 60%(10%)+40%(23%) | 15.2 |
| 80 | 15 | 20 | 35 | 80%(15%)+20%(35%) | 19 |

The optimum mix is 40% debt and 60% equity, as this will lead to lowest WACC value i.e., 13.6%.

Question 18

Navya Limited wishes to raise additional capital of ₹10 lakhs for meeting its modernization plan. It has ₹ 3,00,000 in the form of retained earnings available for investments purposes. The following are the further details:

| | |
|----------------------------------|---------|
| Debt/ equity mix | 40%/60% |
| Cost of debt (before tax) | |
| Upto ₹ 1,80,000 | 10% |
| Beyond ₹ 1,80,000 | 16% |
| Earnings per share | ₹ 4 |
| Dividend pay out | ₹ 2 |
| Expected growth rate in dividend | 10% |
| Current market price per share | ₹ 44 |
| Tax rate | 50% |

Required:

- To DETERMINE the pattern for raising the additional finance.
- To CALCULATE the post-tax average cost of additional debt.
- To CALCULATE the cost of retained earnings and cost of equity, and
- To DETERMINE the overall weighted average cost of capital (after tax). (RTP May '18) (Same concept different figures Old & New SM)

Answer 18

(i) Pattern of Raising Additional Finance

$$\text{Equity} = 10,00,000 \times 60/100 = ₹ 6,00,000$$

$$\text{Debt} = 10,00,000 \times 40/100 = ₹ 4,00,000$$

Capital structure after Raising Additional Finance

| Sources of fund | Amount (₹) |
|--|------------|
| Shareholder's funds | |
| Equity capital (6,00,000 – 3,00,000) | 3,00,000 |
| Retained earnings | 3,00,000 |
| Debt at 10% p.a. | 1,80,000 |
| Debt at 16% p.a. (4,00,000 – 1,80,000) | 2,20,000 |
| Total funds | 10,00,000 |

(ii) Post-tax Average Cost of Additional Debt

$K_d = I(1 - t)$, where 'Kd' is cost of debt, 'I' is interest and 't' is tax rate.

$$\text{On ₹ 1,80,000} = 10\% (1 - 0.5) = 5\% \text{ or } 0.05$$

$$\text{On ₹ 2,20,000} = 16\% (1 - 0.5) = 8\% \text{ or } 0.08$$

Average Cost of Debt (Post tax) i.e.

$$k_d = \frac{(1,80,000 \times 0.05) + (2,20,000 \times 0.08)}{4,00,000} \times 100 = 6.65\%$$

(iii) Cost of Retained Earnings and Cost of Equity applying Dividend Growth Model

$$k_e = \frac{D_1}{P_0} + g \text{ or } \frac{D_0(1+g)}{P_0} + g$$

$$\text{Then, } k_e = \frac{2(1.1)}{44} + 0.10 = \frac{2.2}{44} + 0.10 = 0.15 \text{ or } 15\%$$

(iv) Overall Weighted Average Cost of Capital (WACC) (After Tax)

| Particulars | Amount (₹) | Weights | Cost of Capital | WACC |
|--------------------------------------|------------|---------|-----------------|-------|
| Equity (including retained earnings) | 6,00,000 | 0.60 | 15% | 9.00 |
| Debt | 4,00,000 | 0.40 | 6.65% | 2.66 |
| Total | 10,00,000 | 1.00 | | 11.66 |

Question 19

M/s. Navya Corporation has a capital structure of 40% debt and 60% equity. The company is presently considering several alternative investment proposals costing less than ₹ 20 lakhs. The corporation always raises the required funds without disturbing its present debt equity ratio. The cost of raising the debt and equity are as under:

| Project cost | Cost of debt | Cost of equity |
|-------------------------------------|--------------|----------------|
| Upto ₹ 2 lakhs | 10% | 12% |
| Above ₹ 2 lakhs & upto to ₹ 5 lakhs | 11% | 13% |
| Above ₹ 5 lakhs & upto ₹ 10 lakhs | 12% | 14% |
| Above ₹ 10 lakhs & upto ₹ 20 lakhs | 13% | 14.5% |

Assuming the tax rate at 50%, CALCULATE:

(i) Cost of capital of two projects X and Y whose fund requirements are ₹ 6.5 lakhs and ₹ 14 lakhs



respectively.

- (ii) If a project is expected to give after tax return of 10%, DETERMINE under what conditions it would be acceptable? (RTP Nov '18)

Answer 19

- (i) Statement of Weighted Average Cost of Capital

| Project cost | Financing | Proportion of capital Structure | After tax cost (1– Tax 50%) | Weighted average cost (%) |
|---------------------|-----------|---------------------------------|-----------------------------|---------------------------|
| Upto ₹ 2 Lakhs | Debt | 0.4 | 10% (1 – 0.5) | 0.4 × 5 = 2.0 |
| | | | = 5% | |
| | Equity | 0.6 | 12% | 0.6 × 12 = 7.2 |
| | | | | 9.2% |
| Above ₹ 2 lakhs | Debt | 0.4 | 11% (1 – 0.5) | 0.4 × 5.5 = 2.2 |
| & upto to ₹ 5 Lakhs | | | = 5.5% | |
| | Equity | 0.6 | 13% | 0.6 × 13 = 7.8 |
| | | | | 10.0% |
| Above ₹ 5 lakhs | Debt | 0.4 | 12% (1 – 0.5) | 0.4 × 6 = 2.4 |
| & upto ₹ 10 lakhs | | | = 6% | |
| | Equity | 0.6 | 14% | 0.6 × 14 = 8.4 |
| | | | | 10.8% |
| Above ₹ 10 lakhs | Debt | 0.4 | 13% (1 – 0.5) | 0.4 × 6.5 = 2.6 |
| & upto ₹ 20 lakhs | | | = 6.5% | |
| | Equity | 0.6 | 14.5% | 0.6 × 14.5 = 8.7 |
| | | | | 11.3% |

| Project | Fund requirement | Cost of capital |
|---------|------------------|------------------------------|
| X | ₹6.5 lakhs | 10.8% (from the above table) |
| Y | ₹14 lakhs | 11.3% (from the above table) |

- (ii) If a Project is expected to give after tax return of 10%, it would be acceptable provided its project cost does not exceed ₹ 5 lakhs or, after tax return should be more than or at least equal to the weighted average cost of capital.

Question 20

As a financial analyst of a large electronics company, you are required to DETERMINE the weighted average cost of capital of the company using (a) book value weights and (b) market value weights. The following information is available for your perusal.

The Company's present book value capital structure is:

| | (₹) |
|------------------------------------|------------------|
| Debentures (₹100 per debenture) | 8,00,000 |
| Preference shares (₹100 per share) | 2,00,000 |
| Equity shares (₹10 per share) | 10,00,000 |
| | <u>20,00,000</u> |

All these securities are traded in the capital markets. Recent prices are:

Debentures, ₹110 per debenture, Preference shares, ₹120 per share, and Equity shares, ₹ 22 per share

Anticipated external financing opportunities are:



- (i) ₹ 100 per debenture redeemable at par; 10 year maturity, 11 per cent coupon rate, 4 per cent flotation costs, sale price, ₹ 100
- (ii) ₹ 100 preference share redeemable at par; 10 year maturity, 12 per cent dividend rate, 5 per cent flotation costs, sale price, ₹100.
- (iii) Equity shares: ₹ 2 per share flotation costs, sale price = ₹ 22.

In addition, the dividend expected on the equity share at the end of the year is ₹ 2 per share, the anticipated growth rate in dividends is 7 per cent and the firm has the practice of paying all its earnings in the form of dividends. The corporate tax rate is 35 per cent. (RTP May '19)

Answer 20

Determination of specific costs:

$$(i) \quad \text{Cost Debt}(K_d) = \frac{\text{Interest}(1-t) + \frac{(RV-NP)}{N}}{\frac{(RV+NP)}{2}} = \frac{Rs.11(1-0.35) + \frac{(Rs.100-Rs.96)}{10 \text{ Years}}}{\frac{(Rs.100+Rs.96)}{2}}$$

$$= \frac{Rs.7.15 + Rs.0.4}{Rs.98} = 0.077 \text{ or } 7.70\%$$

$$(ii) \quad \text{Cost of Preference Shares}(K_p) = \frac{PD + \frac{(RV-NP)}{N}}{\frac{(RV+NP)}{2}} = \frac{Rs.12 + \frac{(Rs.100 - Rs.95)}{10 \text{ Years}}}{\frac{(Rs.100 + Rs.95)}{2}}$$

$$= \frac{Rs.12 + Rs.0.5}{Rs.97.5} = 0.1282 \text{ or } 12.82\%$$

$$(iii) \quad \text{Cost of Equity Shares}(K_e) = \frac{D_1}{P_0} + G = \frac{Rs.2}{Rs.22 - Rs.2} + 0.07 = 0.17 \text{ or } 17\%$$

I – Interest, t – Tax, RV- Redeemable value, NP- Net proceeds, N- No. of years, PD- Preference dividend, D1- Expected Dividend, P0- Price of share (net)

Using these specific costs we can calculate WACC on the basis of book value and market value weights as follows:

- (a) Weighted Average Cost of Capital (K_0) based on Book value weights

| Source of capital | Book value (₹) | Weights | Specific cost (%) | WACC (%) |
|--------------------|----------------|---------|-------------------|----------|
| Debentures | 8,00,000 | 0.40 | 7.70 | 3.08 |
| Preferences shares | 2,00,000 | 0.10 | 12.82 | 1.28 |
| Equity shares | 10,00,000 | 0.50 | 17.00 | 8.50 |
| | 20,00,000 | 1.00 | | 12.86 |

- (b) Weighted Average Cost of Capital (K_0) based on market value weights:

| Source of capital | Market value (₹) | Weights | Specific cost (%) | WACC (%) |
|--|------------------|---------|-------------------|----------|
| Debentures $\left(\frac{Rs. 8,00,000}{Rs. 100} \times Rs. 110 \right)$ | 8,80,000 | 0.265 | 7.70 | 2.04 |
| Preferences shares $\left(\frac{Rs. 2,00,000}{Rs. 100} \times Rs. 120 \right)$ | 2,40,000 | 0.072 | 12.82 | 0.92 |
| Equity shares $\left(\frac{Rs. 10,00,000}{Rs. 10} \times Rs. 22 \right)$ | 22,00,000 | 0.663 | 17.00 | 11.27 |



| | | | | |
|--|-----------|-------|--|-------|
| | | | | |
| | 33,20,000 | 1.000 | | 14.23 |

Question 21

Kalyanam Ltd. has an operating profit of ₹ 34,50,000 and has employed Debt which gives total Interest Charge of ₹ 7,50,000. The firm has an existing Cost of Equity and Cost of Debt as 16% and 8% respectively. The firm has a new proposal before it, which requires funds of ₹ 75 Lakhs and is expected to bring an additional profit of ₹ 14,25,000. To finance the proposal, the firm is expecting to issue an additional debt at 8% and will not be issuing any new equity shares in the market. Assume no tax culture.

You are required to CALCULATE the Weighted Average Cost of Capital (WACC) of Kalyanam Ltd.:

- Before the new Proposal
- After the new Proposal (RTP Nov '21, Old & New SM)

Answer 21

Workings:

$$\begin{aligned}
 \text{(a) Value of Debt} &= \frac{\text{Interest}}{\text{Cost of debt}(K_d)} \\
 &= \frac{\text{Rs.7,50,000}}{0.08} = \text{Rs. 93,75,000} \\
 \text{(b) Value of equity capital} &= \frac{\text{Operating Profit}-\text{Interest}}{\text{Cost of equity}(K_e)} \\
 &= \frac{\text{Rs.34,50,000}-\text{Rs.7,50,000}}{0.16} = \text{Rs. 1,68,75,000} \\
 \text{(c) New Cost of equity}(K_e) \text{ after proposal} &= \frac{\text{Increased Operating Profit}-\text{Interest on increased debt}}{\text{Equity Capital}} \\
 &= \frac{(\text{Rs.34,50,000}+\text{Rs.14,25,000})-(\text{Rs.7,50,000}+\text{Rs.6,00,000})}{\text{Rs.1,68,75,000}} \\
 &= \frac{\text{Rs.48,75,000}-\text{Rs.13,50,000}}{\text{Rs.1,68,75,000}} = \frac{\text{Rs.35,25,000}}{\text{Rs.1,68,75,000}} = 0.209 \text{ or } 20.9\%
 \end{aligned}$$

(i) Calculation of Weighted Average Cost of Capital (WACC) before the new proposal

| Sources | Amount (₹) | Weight | Cost of Capital | WACC |
|--------------|--------------------|----------|-----------------|--------------------------|
| Equity | 1,68,75,000 | 0.6429 | 0.160 | 0.1029 |
| Debt | 93,75,000 | 0.3571 | 0.080 | 0.0286 |
| Total | 2,62,50,000 | 1 | | 0.1315 or 13.15 % |

(ii) Calculation of Weighted Average Cost of Capital (WACC) after the new proposal

| Sources | Amount (₹) | Weight | Cost of Capital | WACC |
|--------------|--------------------|----------|-----------------|-----------------------|
| Equity | 1,68,75,000 | 0.5000 | 0.209 | 0.1045 |
| Debt | 1,68,75,000 | 0.5000 | 0.080 | 0.0400 |
| Total | 3,37,50,000 | 1 | | 0.1445 14.45 % |

Question 22



The information relating to book value (BV) and market value (MV) weights of Ex Limited is given below:

| Sources | Book Value (₹) | Market Value (₹) |
|-------------------|----------------|------------------|
| Equity shares | 2,40,00,000 | 4,00,00,000 |
| Retained earnings | 60,00,000 | - |
| Preference shares | 72,00,000 | 67,50,000 |
| Debentures | 18,00,000 | 20,80,000 |

Additional information:

- Equity shares are quoted at ₹ 130 per share and a new issue priced at ₹ 125 per share will be fully subscribed; flotation costs will be ₹ 5 per share on face value.
- During the previous 5 years, dividends have steadily increased from ₹ 10 to ₹ 16.105 per share. Dividend at the end of the current year is expected to be ₹ 17.716 per share.
- 15% Preference shares with face value of ₹ 100 would realise ₹ 105 per share.
- The company proposes to issue 11-year 15% debentures but the yield on debentures of similar maturity and risk class is 16%; flotation cost is 2% on face value.
- Corporate tax rate is 30%.

You are required to DETERMINE the weighted average cost of capital of Ex Limited using both the weights. (RTP May 22)(Same concept different figures Old & New SM)

Answer 22

$$(i) \text{ Cost of Equity } (K_e) = \frac{D_1}{P_0 - F} + g = \frac{Rs.17.716}{Rs.125 - Rs.5} + 0.10^*$$

$$K_e = 0.2476$$

* Calculation of g :

$$Rs. 10 (1+g)^5 = Rs. 16.105$$

$$Or, (1+g)^5 = \frac{16.105}{10} = 1.6105$$

Table (FVIF) Suggests that Rs. 1 Compounds to Rs. 1.6105 in years at the Compound rate of 10 percent . Therefore, g is 10 per cent.

$$(ii) \text{ Cost of Retained Earnings } (K_r) = \frac{D_1}{P_0} + g = \frac{Rs.17.716}{Rs.130} + 0.10 = 0.2363$$

$$(iii) \text{ Cost of Preference Shares } (K_p) = \frac{PD}{P_0} = \frac{Rs.15}{Rs.105} = 0.1429$$

$$(iv) \text{ Cost of Debentures } (K_d) = \frac{I(1-t) + \left(\frac{RV - NP}{n} \right)}{\frac{RV + NP}{2}}$$

$$= \frac{Rs.15(1-0.30) + \left(\frac{Rs.100 - Rs.91.75^*}{11 \text{ years}} \right)}{\frac{Rs.100 + Rs.91.75^*}{2}}$$

$$= \frac{Rs.15 \times 0.70 + Rs.0.75}{Rs.95.875} = \frac{Rs.11.25}{Rs.95.875} = 0.1173$$

*Since yield on similar type of debentures is 16 per cent, the company would be required to offer debentures at discount.

Market price of debentures (approximation method)

$$= ₹ 15 \div 0.16 = ₹ 93.75$$

Market value (P0) of debentures can also be found out using the present value method:

$$P0 = \text{Annual Interest} \times \text{PVIFA} (16\%, 11 \text{ years}) + \text{Redemption value} \times \text{PVIF} (16\%, 11 \text{ years})$$

$$P0 = ₹ 15 \times 5.0287 + ₹ 100 \times 0.1954 \quad P0 = ₹ 75.4305 + ₹ 19.54 = ₹ 94.9705$$



Net Proceeds = ₹ 94.9705 – 2% of ₹ 100 = ₹ 92.9705 Accordingly, the cost of debt can be calculated

Sale proceeds from debentures = ₹ 93.75 – ₹ 2 (i.e., floatation cost) = ₹91.75

Total Cost of capital [BV weights and MV weights] (Amount in (₹) lakh)

| Source of capital | Weights | | Specific Cost (K) | Total cost | |
|-------------------|---------|--------|-------------------|------------|----------|
| | BV | MV | | (BV × K) | (MV × K) |
| Equity Shares | 240 | 320** | 0.2476 | 59.4240 | 79.2320 |
| Retained Earnings | 60 | 80** | 0.2363 | 14.1780 | 18.9040 |
| Preference Shares | 72 | 67.50 | 0.1429 | 10.2888 | 9.6458 |
| Debentures | 18 | 20.80 | 0.1173 | 2.1114 | 2.4398 |
| Total | 390 | 488.30 | | 86.0022 | 110.2216 |

**Market Value of equity has been apportioned in the ratio of Book Value of equity and retained earnings i.e., 240:60 or 4:1.

Weighted Average Cost of Capital (WACC):

$$\text{Using Book Value} = \frac{\text{Rs.86.0022}}{\text{Rs.390}} = 0.2205 \text{ or } 22.05\%$$

$$\text{Using Market Value} = \frac{\text{Rs.110.2216}}{\text{Rs.488.30}} = 0.2257 \text{ or } 22.57\%$$

Question 23

Bounce Ltd. evaluates all its capital projects using discounting rate of 15%. Its capital structure consists of equity share capital, retained earnings, bank term loan and debentures redeemable at par. Rate of interest on bank term loan is 1.5 times that of debenture. Remaining tenure of debenture and bank loan is 3 years and 5 years respectively. Book value of equity share capital, retained earnings and bank loan is ₹ 10,00,000, ₹ 15,00,000 and ₹ 10,00,000 respectively. Debentures which are having book value of ₹ 15,00,000 are currently trading at ₹ 97 per debenture. The ongoing P/E multiple for the shares of the company stands at 5. You are required to CALCULATE the rate of interest on bank loan and debentures if tax rate applicable is 25%. (RTP Nov'22)

Answer 23

Let the rate of Interest on debenture be x

∴ Rate of Interest on loan = 1.5x

$$\begin{aligned} \therefore K_d \text{ on debentures} &= \frac{\text{Int}(1-t) \frac{RV-NP}{n}}{\frac{RV+NP}{n}} \\ &= \frac{100(1-0.25) \frac{100-97}{3}}{\frac{100+97}{2}} \\ &= \frac{75x+1}{98.5} \end{aligned}$$

∴ Kd on bank loan = 1.5x (1 – 0.25) = 1.125x

$$k_e = \frac{EPS}{MPS} = \frac{1}{MPS/EPS} = \frac{1}{P/E} = \frac{1}{5} = 0.2$$

Computation of WACC

| Capital | Amount (₹) | Weights | Cost | Product |
|---------|------------|---------|------|---------|
| Equity | 10,00,000 | 0.2 | 0.2 | 0.04 |



| | | | | |
|------------|-----------|-----|----------------|---|
| Reserves | 15,00,000 | 0.3 | 0.2 | 0.06 |
| Debentures | 15,00,000 | 0.3 | $(75x+1)/98.5$ | $(22.5x + 0.3)/98.5$ |
| Bank Loan | 10,00,000 | 0.2 | $1.125x$ | $0.225x$ |
| | 50,00,000 | 1 | | $0.1 + 0.225x + \frac{25 \times 3 + 1}{98.5}$ |

WACC = 15%

$$\therefore 0.1 + 0.225 \times \frac{22.5x}{98.5} + \frac{0.3}{98.5} = 0.15$$

$$\therefore 9.85 + 22.1625x + 22.5x + 0.3 = (0.15) (98.5)$$

$$\therefore 44.6625x = 14.775 - 9.85 - 0.3$$

$$\therefore 44.6625x = 4.625$$

$$\therefore x = \frac{4.625}{44.6625}$$

$$\therefore x = 10.36\% \cdot 5x$$

$$\therefore \text{Rate of interest on debenture} = x = 10.36\%$$

$$\text{Rate of interest on Bank loan} = 1.5x = (1.5) (10.36\%) = 15.54\%.$$

Question 24

Amrit Corporation has the following book value capital structure:

| | |
|---|---------------|
| Equity Capital (50 lakh shares of ₹ 10 each). | ₹ 5,00,00,000 |
| 15% Preference share (50,000 shares ₹ 100 each) | ₹ 50,00,000 |
| Retained earnings | ₹ 4,00,00,000 |
| Debentures 14% (2,50,000 debentures ₹ 100 each) | ₹ 2,50,00,000 |
| Term loan 13% | ₹ 4,00,00,000 |

The companies last year earnings per share was ₹ 5, and it maintains a dividend pay-out ratio of 60% and returns on equity is 10%. The market price per share is ₹ 20.8. Preference share redeemable after 10 years is currently selling for ₹ 90 per share. Debentures redeemable after 6 years are currently selling for ₹ 75 per debenture. The income tax rate is 40%.

- CALCULATE the Weighted Average Cost of Capital (WACC) using market value proportions.
- DETERMINE the Marginal Cost of Capital (MACC) if it needs ₹ 5,00,00,000 next year assuming the amount will be raised by 60% equity, 20% debt and 20% retained earnings. Equity issues will fetch a net price of ₹ 14 and cost of debt will be 13% before tax up to ₹ 40,00,000 and beyond ₹ 40,00,000 it will be 15% before tax. (RTP May 23)

Answer 24

(a) Calculation of Cost of Equity

$$(i) D_0 = ₹ 5 \times 60\%$$

$$D_0 = ₹ 3$$

$$g = b \times r$$

$$= (1 - 0.6) \times 10\% = 4\%$$

$$D_1 = D_0 \times (1 + g)$$

$$= 3 \times (1 + 4\%)$$

$$= 3 \times 1.04 = 3.12$$

$$K_e = \frac{D_1}{P_0} + g$$

$$K_e = \frac{3.12}{20.8} + 0.04$$

$$K_e = 19\%$$

(ii) Calculation of Cost of Preference Shares N = 10 years

$$NP = ₹ 90 \text{ PD} = ₹ 15 \text{ RV} = ₹ 100$$

$$K_p = \frac{PD + (RV - NP)/N}{(RV + NP)/2} \times 100$$

$$K_p = \frac{15 + (100 - 90)/10}{(100 + 90)/2} \times 100$$

$$K_p = 16/95 \times 100$$

$$K_p = 16.84\%$$

(iii) Calculation of Cost of Debentures N = 6 years

$$NP = ₹ 75 \text{ Interest} = ₹ 14 \text{ RV} = ₹ 100 \text{ T} = 40\%$$

$$K_d = \frac{int(1-t) + (RV - NP)/N}{(RV + NP)/2} \times 100$$

$$K_d = \frac{14(1-0.4) + (100 - 75)/6}{(100 + 75)/2} \times 100$$

$$K_d = \frac{8.4 - 4.17}{87.5} \times 100$$

$$K_d = 14.37\%$$

(iv) Cost of Term Loan

$$K_d = \text{Interest rate} (1-t)$$

$$K_d = 13\% (1-40\%) \quad K_d = 7.8\%$$

Calculation of Weighted Average Cost of Capital (WACC) (using market weights)

| Capital | Cost of Capital | Market Value | | Market Value Weights | Product (Cost x weights) |
|-------------------|-----------------|------------------|---------------|----------------------|--------------------------|
| Equity | 19.00% | 20.8 x 50,00,000 | ₹10,40,00,000 | 0.6218 | 11.81% |
| Preference Shares | 16.84% | 90 x 50,000 | ₹ 45,00,000 | 0.0269 | 0.45% |
| Debentures | 14.37% | 75 x 2,50,000 | ₹ 1,87,50,000 | 0.1121 | 1.61% |
| Term Loan | 7.80% | | ₹ 4,00,00,000 | 0.2392 | 1.87% |
| Total | | | ₹16,72,50,000 | 1 | 15.74% |

$$WACC = 15.74\%$$

(b) Calculation of Marginal Cost of Capital (MACC)

The required capital of ₹ 50,000,000 will be raised as follows: Equity = 60% of ₹ 50,000,000 = ₹ 30,000,000

Debt = 20% of ₹ 50,000,000 = ₹10,000,000

Retained Earnings = 20% of ₹ 50,000,000 = ₹ 10,000,000

$$\text{Marginal Cost of Equity} = \frac{3.12}{1.4} + 0.04$$

$$= 26.28\%$$

Marginal Cost of Debt



$$\begin{aligned}\text{Cost of Debt (before tax)} &= \frac{13\% \text{ of Rs.40,00,000} + 15\% \text{ of Rs.60,00,000}}{\text{Rs.1,00,00,000}} \\ &= \frac{\text{Rs.5,20,000} + \text{Rs.9,00,000}}{\text{Rs.1,00,00,000}} = 14.2\%\end{aligned}$$

$$\begin{aligned}\text{Cost of Debt (after tax)} &= 14.2\% (1-t) \\ &= 14.2\% (1-0.4) \\ &= 8.52\%\end{aligned}$$

Calculation of marginal cost of capital

| Capital | Cost of Capital | Value | Weights | Product (Cost x weights) |
|----------|-----------------|---------------|---------|--------------------------|
| Equity | 26.28% | ₹ 3,00,00,000 | 0.6 | 15.77% |
| Reserves | 26.28% | ₹ 1,00,00,000 | 0.2 | 5.26% |
| Debt | 8.52% | ₹ 1,00,00,000 | 0.2 | 1.70% |
| Total | | ₹ 5,00,00,000 | 1 | 22.73% |

Marginal Cost of Capital (MACC) = 22.73%

Question 25

Jason Limited is planning to raise additional finance of ₹ 20 lakhs for meeting its new project plans. It has ₹ 4,20,000 in the form of retained earnings available for investment purposes. Further details are as following:

| | |
|----------------------------------|-------------------|
| Debt / Equity Mix | 30 / 70 |
| Cost of Debt | |
| Upto ₹ 3,60,000 | 8 % (before tax) |
| Beyond ₹ 3,60,000 | 12 % (before tax) |
| Earnings per share | ₹ 4 |
| Dividend pay-out | 50% of earnings |
| Current Market Price per share | ₹ 44 |
| Expected Growth rate in Dividend | 10 % |
| Tax | 40% |

You are required:

- To determine the cost of retained earnings and cost of equity.
- To determine the post-tax average cost of additional debt.
- To determine the pattern for raising the additional finance, and
- Compute the overall weighted average after tax cost of additional finance. (RTP Nov '23)

Answer 25

(a) Cost of Equity / Retained Earnings (using dividend growth model)

$$K_e = \frac{D_1}{P_0}$$

$$\text{where } D_1 = D_0 (1 + g) = 2 (1 + .10) = 2.2$$

$$K_e = \frac{2.2}{44} + 0.10 = 0.15 \text{ or } 15\%$$



(b) Cost of Debt (Post Tax)

$$K_d = I (1-t)$$

$$\text{Upto } 3,60,000 \text{ } K_d = .08 (1-0.4) = 0.048$$

$$\text{Beyond } 3,60,000 = .12 (1-0.4) = 0.072$$

$$\text{Thus, post-tax cost of additional debt} = 0.048 \times 3,60,000 / 6,00,000 + 0.072 \times 2,40,000 / 6,00,000 = 0.0288 + 0.0288 = 0.0576 \text{ or } 5.76\%$$

(c) Pattern for Raising Additional Finance

$$\text{Debt} = 20,00,000 \times 30\% = 6,00,000$$

$$\text{Equity} = 20,00,000 \times 70\% = 14,00,000$$

$$\text{Out of this total equity amount of ₹ } 14,00,000 - \text{Equity Shares} = 14,00,000 - 4,20,000 = 9,80,000$$

$$\text{And Retained Earnings} = 4,20,000$$

(d) Overall Weighted Average after tax cost of additional finance

$$\text{WACC} = K_d \times \text{Debt Mix} + K_e \times \text{Equity Mix} = 0.0576 \times 30\% + 0.15 \times 70\% = 0.01728 + 0.105 = 0.1223 \text{ or } 12.23\% \text{ (approx.)}$$

Question 26

Following are the information of TT Ltd.:

| Particulars | |
|--|-------------|
| Earnings per share | Rs.10 |
| Dividend per share | Rs.6 |
| Expected growth rate in Dividend | 6% |
| Current market price per share | Rs.120 |
| Tax Rate | 30% |
| Requirement of Additional Finance | Rs.30 lakhs |
| Debt Equity Ratio (For additional finance) | 2:1 |
| Cost of Debt | |
| 0-5,00,000 | 10% |
| 5,00,001 - 10,00,000 | 9% |
| Above 10,00,000 | 8% |

Assuming that there is no Reserve and Surplus available in TT Ltd. You are required to:

Find the pattern of finance for additional requirement Calculate post tax average cost of additional debt Calculate cost of equity

Calculate the overall weighted average after tax cost of additional finance. (PYP 10 Marks, July'21)

Answer 26

(a) Pattern of raising additional finance

| | | |
|--------|---------------------|--------------|
| Equity | 1/3 of Rs.30,00,000 | Rs.10,00,000 |
| Debt | 2/3 of Rs.30,00,000 | Rs.20,00,000 |

The capital structure after raising additional finance:

| Particulars | (₹) |
|---------------------|-----------|
| Shareholder's Funds | |
| Equity Capital | 10,00,000 |



| | |
|---|-----------|
| Debt (Interest at 10% p.a.) | 5,00,000 |
| (Interest at 9% p.a.) | 5,00,000 |
| (Interest at 8% p.a.) (20,00,000–10,00,000) | 10,00,000 |
| Total Funds | 30,00,000 |

(b) Determination of post-tax average cost of additional debt

$$K_e = I (1 - t)$$

Where,

I = Interest Rate

t = Corporate tax-rate

On First ₹ 5,00,000 = 10% (1 – 0.3) = 7% or 0.07

On Next ₹ 5,00,000 = 9% (1 – 0.3) = 6.3% or 0.063

On Next Rs.10,00,000 = 8% (1 – 0.3) = 5.6% or 0.056

Average Cost of Debt

$$\frac{(\text{₹ } 5,00,000 \times 0.07) + (\text{₹ } 5,00,000 \times 0.063) + (\text{Rs. } 10,00,000 \times 0.056)}{20,00,000} \times 100 = 6.125\%$$

$$K_e = \frac{D_1}{P_0} + g$$

Where,

K_e = Cost of equity

$D_1 = D_0 (1 + g)$

D_0 = Dividend paid

g = Growth rate = 6%

P_0 = Current market price per share = Rs.120

$$K_e = \frac{\text{Rs. } 6(1+0.06)}{\text{Rs. } 120} + 0.06 = \frac{\text{Rs. } 6.36}{\text{Rs. } 120} + 0.06 = 0.13 \text{ or } 11.3\%$$

Computation of overall weighted average after tax cost of additional finance

| Particulars | (Rs) | eights | Cost of funds | Weighted Cost (%) |
|-------------|-----------|--------|---------------|-------------------|
| Equity | 10,00,000 | 1/3 | 11.3% | 3.767 |
| Debt | 20,00,000 | 2/3 | 6.125% | 4.083 |
| WACC | 30,00,000 | | | 7.85 |

(Note: In the above solution different interest rate have been considered for different slab of Debt)

Alternative Solution

(a) Pattern of raising additional finance

Equity 1/3 of Rs.30,00,000 = Rs.10,00,000

Debt 2/3 of Rs.30,00,000 = Rs.20,00,000

The capital structure after raising additional finance:

| Particulars | (₹) |
|----------------------------|------------------|
| Shareholders' Funds | |
| Equity Capital | 10,00,000 |
| Debt (Interest at 8% p.a.) | 20,00,000 |
| Total Funds | 30,00,000 |



(b) Determination of post-tax average cost of additional debt $K_d = I (1 - t)$

Where,

I = Interest Rate

t = Corporate tax-rate

$$K_d = 8\% (1 - 0.3) = 5.6\%$$

(c) Determination of cost of equity applying Dividend growth model:

$$\text{Then } k_e = \frac{D_1}{P_0} + g$$

Where,

K_e = Cost of equity

$$D_1 = D_0 (1 + g)$$

D_0 = Dividend paid

g = Growth rate = 6%

P_0 = Current market price per share = Rs.120

$$K_e = \frac{\text{Rs.}6(1+0.06)}{\text{Rs.}120} + 0.06 = \frac{\text{Rs.}6.36}{\text{Rs.}120} + 0.06 = 0.13 \text{ or } 11.3\%$$

(d) Computation of overall weighted average after tax cost of additional finance

| Particulars | (₹) | Weights | Cost of funds | Weighted Cost (%) |
|-------------|-----------|---------|---------------|-------------------|
| Equity | 10,00,000 | 1/3 | 11.3% | 3.767 |
| Debt | 20,00,000 | 2/3 | 5.6% | 3.733 |
| WACC | 30,00,000 | | | 7.50 |

(Note: In the above solution single interest rate have been considered for Debt)

Question 27

The Capital structure of PQR Ltd. is as follows:

| | ₹ |
|---|-----------|
| 10% Debenture | 3,00,000 |
| 12% Preference Shares | 2,50,000 |
| Equity Share (face value Rs.10 per share) | 5,00,000 |
| | 10,50,000 |

Additional Information:

- Rs.100 per debenture redeemable at par has 2% floatation cost & 10 years of maturity. The market price per debenture is Rs.110.
- Rs.100 per preference share redeemable at par has 3% floatation cost & 10 years of maturity. The market price per preference share is Rs.108.
- Equity share has Rs.4 floatation cost and market price per share of Rs.25. The next year expected dividend is Rs.2 per share with annual growth of 5%. The firm has a practice of paying all earnings in the form of dividends.
- Corporate Income Tax rate is 30%. Required:

Calculate Weighted Average Cost of Capital (WACC) using market value weights. (PYP 10 Marks, Jan'21)

Answer 27

Workings:

$$1. \text{ Cost of Equity } (K_e) = k_e = \frac{D_1}{P_0 - F} + g = \frac{\text{Rs.2}}{\text{Rs.25} - \text{Rs.4}} + 0.050 = 0.145 \text{ (approx.)}$$

$$2. \text{ Cost of Debt } (K_d) = \frac{I(1-t) + \frac{(RV-NP)}{n}}{\frac{(RV-NP)}{n}}$$

$$= \frac{10(1-0.03) + \frac{(100-98)}{10}}{\frac{(100-98)}{10}} = \frac{7+0.2}{99} = 0.073 \text{ (approx.)}$$

$$3. \text{ Cost of Preference Shares } (K_p) = \frac{PD + \frac{(RV-NP)}{n}}{\frac{(RV+NP)}{2}}$$

$$= \frac{12 + \frac{(100-97)}{10}}{\frac{(100-97)}{10}} = \frac{12+0.3}{98.5} = 0.125 \text{ (approx.)}$$

Calculation of WACC using market value weights

| Source of capital | Market Value | Weights | After tax cost of capital | WACC (Ko) |
|--|--------------|---------|---------------------------|-----------------|
| | (₹) | (a) | (b) | (c) = (a) × (b) |
| 10% Debentures (Rs.110 × 3,000) | 3,30,000 | 0.178 | 0.073 | 0.013 |
| 12% Preference shares (Rs.108 × 2,500) | 2,70,000 | 0.146 | 0.125 | 0.018 |
| Equity shares (Rs.25 × 50,000) | 12,50,000 | 0.676 | 0.145 | 0.098 |
| | 18,50,000 | 1.00 | | 0.129 |

$$\text{WACC } (K_o) = 0.129 \text{ or } 12.9\% \text{ (approx.)}$$

Question 28

TT Ltd. issued 20,000, 10% convertible debenture of Rs.100 each with a maturity period of 5 years. At maturity the debenture holders will have the option to convert debentures into equity shares of the company in ratio of 1:5 (5 shares for each debenture). The current market price of the equity share is Rs.20 each and historically the growth rate of the share is 4% per annum. Assuming tax rate is 25%. Compute the cost of 10% convertible debenture using Approximation Method and Internal Rate of Return Method.

PV Factor are as under:

| Year | 1 | 2 | 3 | 4 | 5 |
|-----------------|-------|-------|-------|-------|-------|
| PV Factor @ 10% | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 |
| PV Factor @ 15% | 0.870 | 0.756 | 0.658 | 0.572 | 0.497 |

(PYP 5 Marks, Nov'20)

Answer 28

Determination of Redemption value:

Higher of-

- The cash value of debentures = ₹100
- Value of equity shares = 5 shares × Rs.20 (1+0.04)⁵
= 5 shares × Rs.24.333



= ₹121.665 rounded to ₹121.67

₹121.67 will be taken as redemption value as it is higher than the cash option and attractive to the investors.

Calculation of Cost of 10% Convertible debenture

(i) Using Approximation Method:

Cost of Preference Shares

$$K_d = \frac{I(1-t) + \frac{(RV-NP)}{n}}{\frac{(RV+NP)}{2}} = \frac{10(1-0.25) + \frac{(121.67-100)}{5}}{\frac{(121.67+100)}{2}} = \frac{7.5+4.334}{110.835} = 10.676\%$$

(ii) Using Internal Rate of Return Method

| Year | Cash flows (₹) | Discount factor @ 10% | Present Value | Discount factor @ 15% | Present Value (₹) |
|--------|----------------|-----------------------|---------------|-----------------------|-------------------|
| 0 | 100 | 1.000 | (100.00) | 1.000 | (100.00) |
| 1 to 5 | 7.5 | 3.790 | 28.425 | 3.353 | 25.148 |
| 5 | 121.67 | 0.621 | 75.557 | 0.497 | 60.470 |
| NPV | | | +3.982 | | -14.382 |

$$IRR = L + \frac{NPV_L}{NPV_L - NPV_H} (H - L) = 10\% + \frac{3.982}{3.982 - 14.382} (15\% - 10\%)$$

= 0.11084 or 11.084% (approx.)

Question 29

A Company wants to raise additional finance of ₹ 5 crore in the next year. The company expects to retain Rs.1 crore earning next year. Further details are as follows:

- The amount will be raised by equity and debt in the ratio of 3: 1.
- The additional issue of equity shares will result in price per share being fixed at Rs.25.
- The debt capital raised by way of term loan will cost 10% for the first ₹ 75 lakh and 12% for the next ₹ 50 lakh.
- The net expected dividend on equity shares is Rs.2.00 per share. The dividend is expected to grow at the rate of 5%.
- Income tax rate is 25%.

You are required:

- To determine the amount of equity and debt for raising additional finance.
- To determine the post-tax average cost of additional debt.
- To determine the cost of retained earnings and cost of equity.
- To compute the overall weighted average cost of additional finance after tax. (PYP 10 Marks, Nov'19)

Answer 29

Determination of the amount of equity and debt for raising additional finance:

Pattern of raising additional finance

| | | |
|--------|------------------|-----------------|
| Equity | 3/4 of ₹ 5 Crore | = Rs.3.75 Crore |
| Debt | 1/4 of ₹ 5 Crore | = Rs.1.25 Crore |

The capital structure after raising additional finance:

| Particulars | (₹ In crore) |
|-------------|--------------|
|-------------|--------------|



| Shareholders' Funds | | |
|-----------------------------|---------------|------|
| Equity Capital | (3.75 – 1.00) | 2.75 |
| Retained earnings | | 1.00 |
| Debt (Interest at 10% p.a.) | | 0.75 |
| (Interest at 12% p.a.) | (1.25-0.75) | 0.50 |
| Total Funds | | 5.00 |

a. Determination of post-tax average cost of additional debt

$$K_d = I (1 - t)$$

Where,

I = Interest Rate

t = Corporate tax-rate

$$\text{On ₹ 75,00,000} = 10\% (1 - 0.25) = 7.5\% \text{ or } 0.075$$

$$\text{On ₹ 50,00,000} = 12\% (1 - 0.25) = 9\% \text{ or } 0.09$$

Average Cost of Debt

$$= \frac{(\text{₹ } 75,00,000 \times 0.075) + (\text{₹ } 50,00,000 \times 0.09)}{1,25,00,000} \times 100$$

$$= \frac{\text{₹ } 5,62,500 + \text{₹ } 4,50,000}{1,25,00,000} \times 100 = 8.10\%$$

b. Determination of cost of retained earnings and cost of equity (Applying Dividend growth model):

$$k_e = \frac{D_1}{p_0} + g$$

Where,

$$k_e = \text{Cost of equity } D_1 = D_0 (1 + g)$$

$$D_0 = \text{Dividend paid (i.e. ₹ 2)} \quad g = \text{Growth rate}$$

$$p_0 = \text{Current market price per share}$$

$$\text{Then, } k_e = \frac{\text{₹ } 2(1.05)}{\text{₹ } 25} + 0.05 = \frac{\text{₹ } 2.1}{\text{₹ } 25} + 0.05 = 0.084 + 0.05 = 0.134 = 13.4\%$$

Cost of retained earnings equals to cost of Equity i.e. 13.4%

c. Computation of overall weighted average after tax cost of additional finance

| Particular | (₹) | Weights | Cost of funds | Weighted Cost (%) |
|-------------------------------------|-------------|---------|---------------|-------------------|
| Equity(including retained earnings) | 3,75,00,000 | 3/4 | 13.4% | 10.05 |
| Debt | 1,25,00,000 | 1/4 | 8.1% | 2.025 |
| WACC | 5,00,00,000 | | | 12.075 |

Question 30

Explain the significance of Cost of Capital. (PYP 4 Marks, Nov'19)

Answer 30



Significance of the Cost of Capital: The cost of capital is important to arrive at correct amount and helps the management or an investor to take an appropriate decision. The correct cost of capital helps in the following decision making:

- (i) **Evaluation of investment options:** The estimated benefits (future cash flows) from available investment opportunities (business or project) are converted into the present value of benefits by discounting them with the relevant cost of capital. Here it is pertinent to mention that every investment option may have different cost of capital hence it is very important to use the cost of capital which is relevant to the options available. Here Internal Rate of Return (IRR) is treated as cost of capital for evaluation of two options (projects).
- (ii) **Performance Appraisal:** Cost of capital is used to appraise the performance of a particular project or business. The performance of a project or business is compared against the cost of capital which is known here as cut-off rate or hurdle rate.
- (iii) **Designing of optimum credit policy:** While appraising the credit period to be allowed to the customers, the cost of allowing credit period is compared against the benefit/ profit earned by providing credit to customer of segment of customers. Here cost of capital is used to arrive at the present value of cost and benefits received.

Question 31

Alpha Ltd. has furnished the following information:

| | |
|---------------------------|------|
| - Earning Per Share (EPS) | Rs.4 |
| - Dividend payout ratio | 25% |
| - Market price per share | ₹ 50 |
| - Rate of tax | 30% |
| - Growth rate of dividend | 10% |

The company wants to raise additional capital of Rs.10 lakhs including debt of Rs.4 lakhs. The cost of debt (before tax) is 10% up to Rs.2 lakhs and 15% beyond that. Compute the after tax cost of equity and debt and also weighted average cost of capital. (PYP 5 Marks, May'19)

Answer 31

i. (k_e)

$$k_e = \frac{D_0(1+g)}{P_0} + g = \frac{25\% \text{ of Rs.4}(1+0.10)}{\text{Rs.50}} + 0.10 = \frac{\text{Rs.1.10}}{\text{Rs.50}} + 0.10 = 0.122 \text{ or } 12.2\%$$

ii. Cost of Debt (k_d)

$$k_d = \frac{\text{Interest}}{\text{Net Proceeds}} \times 100 \times (1 - t)$$

Interest on first Rs.2,00,000 @ 10% = Rs. 20,000

Interest on next Rs.2,00,000 @ 15% = Rs. 30,000

$$k_d = \frac{50,000}{5,00,000} \times (1 - 0.3) = 0.0875 \text{ or } 8.75\%$$

iii. **Weighted Average Cost of Capital (WACC)**

| Source of capital | Amount (₹) | Weights | Cost of Capital (%) | WACC (%) |
|-------------------|------------|---------|---------------------|----------|
| Equity shares | 6,00,000 | 0.60 | 12.20 | 7.32 |
| Debt | 4,00,000 | 0.40 | 8.75 | 3.50 |
| Total | 10,00,000 | 1.00 | | 10.82 |

Alternatively Cost of Equity Share Capital (k_e) can be calculated as

$$k_e = \frac{D}{P_0} + g = \frac{25\% \text{ of Rs.4}}{\text{Rs.50}} + 0.10 = \frac{\text{Rs.1.00}}{\text{Rs.50}} + 0.10 = 0.12 \text{ or } 12.00\%$$

Accordingly

Weighted Average Cost of Capital (WACC)

| Source of capital | Amount (₹) | Weights | Cost of Capital (%) | WACC (%) |
|-------------------|------------|---------|---------------------|----------|
| Equity shares | 6,00,000 | 0.60 | 12.00 | 7.20 |
| Debt | 4,00,000 | 0.40 | 8.75 | 3.50 |

Question 32

Stop-go Ltd, an all equity financed company, is considering the repurchase of Rs.200 lakhs equity and to replace it with 15% debentures of the same amount. Current market Value of the company is Rs.1140 lakhs and it's cost of capital is 20%. It's Earnings before Interest and Taxes (EBIT) are expected to remain constant in future. Its entire earnings are distributed as dividend. Applicable tax rate is 30 per cent.

You are required to calculate the impact on the following on account of the change in the capital structure as per Modigliani and Miller (MM) Hypothesis:

- The market value of the company
- It's cost of capital, and
- It's cost of equity (PYP 5 Marks, May'18)

Answer 32

(a) Working Note

$$\frac{\text{Net income (NI) for equity-holders}}{k_e} = \text{Market Value of Equity}$$

$$\frac{\text{Net income (NI) for equity holders}}{0.20} = \text{Rs. 1,140 lakhs}$$

Therefore, Net Income to equity-holders = Rs.228 lakhs

$$\text{EBIT} = \text{Rs.228 lakhs} / 0.7 = \text{Rs.325.70 lakhs}$$

| | All Equity (₹ In lakhs) | Debt of Equity (₹ In lakhs) |
|------------------------------------|-------------------------|-----------------------------|
| EBIT | 325.70 | 325.70 |
| Interest on ₹200 lakhs @ 15% | -- | 30.00 |
| EBT | 325.70 | 295.70 |
| Tax @ 30 % | 97.70 | 88.70 |
| Income available to equity holders | 228 | 207 |

(i) Market value of levered firm = Value of unlevered firm + Tax Advantage

$$= \text{Rs. 1,140 lakhs} + (\text{₹200 lakhs} \times 0.3)$$

$$= \text{Rs. 1,200 lakhs}$$

The impact is that the market value of the company has increased by Rs.60 lakhs (Rs. 1,200 lakhs – Rs. 1,140 lakhs)

Calculation of Cost of Equity

$$k_e = (\text{Net Income to equity holders} / \text{Equity Value}) \times 100$$

$$= (207 \text{ lakhs} / 1200 \text{ lakhs} - 200 \text{ lakhs}) \times 100$$

$$= (207 / 1000) \times 100$$

$$= 20.7 \%$$

(ii) Cost of Capital



| Components | Amount (₹ In lakhs) | Cost of Capital % | Weight | WACC % |
|-------------|---------------------|----------------------|--------|--------|
| Equity Debt | 1000 | 20.7 | 83.33 | 17.25 |
| | 200 | (15% X 0.7) =10.5 | 16.67 | 1.75 |
| | 1200 | | | 19.00 |

The impact is that the WACC has fallen by 1% (20% - 19%) due to the benefit of tax relief on debt interest payment.

(iii) Cost of Equity is 20.7% [As calculated in point (I)]

The impact is that cost of equity has risen by 0.7% i.e. 20.7% - 20% due to the presence of financial risk.

Further, Cost of Capital and Cost of equity can also be calculated with the help of formulas as below, though there will be no change in final answers.

$$\text{Cost of Capital } (k_o) = k_{eu} (1-tL)$$

Where,

k_{eu} = Cost of equity in an unlevered company

t = Tax rate

$$L = \frac{\text{Debt}}{\text{Debt} + \text{Equity}}$$

$$k_o = 0.2 \times \left[1 + \frac{\text{Rs.200Lakh}}{\text{Rs.1,200Lakh}} \times 3 \right]$$

So, Cost of capital = 0.19 or 19%

$$\text{Cost of Equity } (k_e) = k_{eu} + (k_{eu} - k_d) \frac{\text{Debt } (1-t)}{\text{Debt} + \text{Equity}}$$

Where,

k_{eu} = Cost of equity in an unlevered company

k_d = Cost of debt

t = Tax rate

$$k_e = 0.20 + \left[(0.20 - 0.15) + \frac{\text{Rs.200Lakh} \times 0.7}{\text{Rs.1000Lakh}} \right]$$

$$k_e = 0.20 + 0.007 = 0.207 \text{ or } 20.7\%$$

So, Cost of Equity = 20.70%

Question 33

Book value of capital structure of B Ltd. is as follows:

| Sources | Amount |
|------------------------------------|-------------|
| 12%, 6,000 Debentures @ ₹ 100 each | ₹ 6,00,000 |
| Retained earnings | ₹ 4,50,000 |
| 4,500 Equity shares @ ₹ 100 each | ₹ 4,50,000 |
| | ₹ 15,00,000 |

Currently, the market value of debenture is ₹ 110 per debenture and equity share is ₹ 180 per share. The expected rate of return to equity shareholder is 24% p.a. Company is paying tax @ 30%. Calculate WACC on the basis of market value weights. (PYP 5 Marks Dec '21)

Answer 33



Calculation of Cost of Capital of debentures ignoring market value:

Cost of Debentures (k_d) = $12 (1 - .30) = 8.40\%$

Computation of Weighted Average Cost of Capital based on Market Value Weights

| Source of Capital | Market Value (₹) | Weights to Total Capital | After tax Cost of capital (%) | WACC (%) |
|-----------------------------------|------------------|--------------------------|-------------------------------|----------|
| Debentures (6,000 nos. × ₹ 110) | 6,60,000 | 0.45(approx.) | 8.40 | 3.78 |
| Equity Shares (4,500 nos. × ₹180) | 8,10,000 | 0.55(approx.) | 24.00 | 13.20 |
| | 14,70,000 | 1.00 | | 16.98 |

Note: Cost of Debenture and Cost of equity considered as given without considering market value. Cost of sources of capital can be computed based on the Market price and accordingly Weighted Average Cost of Capital can be calculated as below:

Calculation of Cost of Capital for each source of capital considering market value of capital:

(1) Cost of Equity share capital:

$$K_e = \frac{\text{Earnings}}{\text{Market Price per Share}} = \frac{24\% \times \text{Rs.}100}{\text{Rs.}180} = 13.333\%$$

(2) Cost of Debentures (K_d) = $\frac{I(1-t)}{NP} = \frac{\text{Rs.}12 (1-0.3)}{\text{Rs.}110} = 7.636\%$

Computation of Weighted Average Cost of Capital based on Market Value Weights

| Source of Capital | Market Value (₹) | Weights to Total Capital | After tax Cost of capital (%) | WACC (%) |
|------------------------------------|------------------|--------------------------|-------------------------------|-----------------|
| Debentures (6,000 nos. × ₹ 110) | 6,60,000 | 0.45(approx.) | 7.636 | 3.44 (approx.) |
| Equity Shares (4,500 nos. × ₹ 180) | 8,10,000 | 0.55(approx.) | 13.333 | 7.33 (approx.) |
| | 14,70,000 | 1.00 | | 10.77 (approx.) |

Question 34

A company issues:

- 15% convertible debentures of ₹ 100 each at par with a maturity period of 6 years. On maturity, each debenture will be converted into 2 equity shares of the company. The risk - free rate of return is 10%, market risk premium is 18% and beta of the company is 1.25. The company has paid dividend of ₹ 12.76 per share. Five year ago, it paid dividend of ₹ 10 per share. Flotation cost is 5% of issue amount.
- 5% preference shares of ₹ 100 each at premium of 10%. These shares are redeemable after 10 years at par. Flotation cost is 6% of issue amount.

Assuming corporate tax rate is 40%.

(i) Calculate the cost of convertible debentures using the approximation method.



(ii) Use YTM method to calculate cost of preference shares.

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| PVIF 0.03, t | 0.971 | 0.943 | 0.915 | 0.888 | 0.863 | 0.837 | 0.813 | 0.789 | 0.766 | 0.744 |
| PVIF 0.05, t | 0.952 | 0.907 | 0.864 | 0.823 | 0.784 | 0.746 | 0.711 | 0.677 | 0.645 | 0.614 |
| PVIFA 0.03, t | 0.971 | 1.913 | 2.829 | 3.717 | 4.580 | 5.417 | 6.230 | 7.020 | 7.786 | 8.530 |
| PVIFA 0.05, t | 0.952 | 1.859 | 2.723 | 3.546 | 4.329 | 5.076 | 5.786 | 6.463 | 7.108 | 7.722 |

| Interest rate | 1% | 2% | 3% | 4% | 5% | 6% | 7% | 8% | 9% |
|---------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| FVIF i, 5 | 1.051 | 1.104 | 1.159 | 1.217 | 1.276 | 1.338 | 1.403 | 1.469 | 1.539 |
| FVIF i, 6 | 1.062 | 1.126 | 1.194 | 1.265 | 1.340 | 1.419 | 1.501 | 1.587 | 1.677 |
| FVIF i, 7 | 1.072 | 1.149 | 1.230 | 1.316 | 1.407 | 1.504 | 1.606 | 1.714 | 1.828 |

(PYP 10 Marks May'22)

Answer 34

(i) Calculation of Cost of Convertible Debentures:

Given that, $R_f = 10\%$

$R_m - R_f = 18\%$

$B = 1.25$

$D_0 = 12.76$

$D_{-5} = 10$

Flotation Cost = 5%

Using CAPM,

$k_e = R_f + \beta (R_m - R_f)$

$= 10\% + 1.25 (18\%)$

$= 32.50\%$

Calculation of growth rate in dividend

$12.76 = 10 (1+g)^5$

$1.276 = (1+g)^5$

$(1+5\%)^5 = 1.276$ from FV Table

$g = 5\%$

Price of share after 6 years

$$P_1 = \frac{D_7}{k_e - g} = \frac{12.76(1.05)^2}{0.325 - 0.05}$$

$$P_6 = \frac{12.76 \times 1.407}{0.275}$$

$P_6 = 65.28$

Redemption Value of Debenture (RV) = $65.28 \times 2 = 130.56$ (RV)

NP = 95

$n = 6$

$$k_d = \frac{\frac{INT(1-t) \frac{RV-NP}{n}}{\frac{RV+NP}{2}}} \times 100$$

$$= \frac{\frac{15(1-0.4) \frac{130.56-95}{6}}{\frac{130.56+95}{2}}} \times 100$$

$$= \frac{9+5.93}{112.78} \times 100$$

$$k_d = 13.24\%$$

(ii) Calculation of Cost of Preference Shares:

Net Proceeds = 100 (1.1) - 6% of 100 (1.1)

$$= 110 - 6.60$$

$$= 103.40$$

Redemption Value = 100

| Year | Cash Flows (₹) | PVF @ 3% | PV (₹) | PVF @ 5% | PV (₹) |
|------|----------------|----------|--------|----------|--------|
| 0 | 103.40 | 1 | 103.40 | 1 | 103.40 |
| 1-10 | -5 | 8.530 | -42.65 | 7.722 | -38.61 |
| 10 | -100 | 0.744 | -74.40 | 0.614 | -61.40 |
| | | | -13.65 | | 3.39 |

$$k_p = 3\% + \frac{5\%-3\%}{[3.39 - (-13.65)]} \times 13.65$$

$$= 3\% + \frac{2\%}{17.4} \times 13.65$$

$$k_p = 4.6021\%$$

Question 35

The following is the extract of the Balance Sheet of M/s KD Ltd.:

| Particulars | Amount (₹) |
|--|------------|
| Ordinary shares (Face Value ₹ 10/- per share) | 5,00,000 |
| Share Premium | 1,00,000 |
| Retained Profits | 6,00,000 |
| 8% Preference Shares (Face Value ₹ 25/- per share) | 4,00,000 |
| 12% Debentures (Face value ₹ 100/- each) | 6,00,000 |
| | 22,00,000 |

The ordinary shares are currently priced at ₹ 39 ex-dividend and preference share is priced at ₹ 18 cum-dividend. The debentures are selling at 120 percent ex-interest. The applicable tax rate to KD Ltd. is 30 percent. KD Ltd.'s cost of equity has been estimated at 19 percent. Calculate the WACC (weighted average cost of capital) of KD Ltd. on the basis of market value. (PYP 5 Marks Nov '22)

Answer 35

Computation of WACC on the basis of market value

W.N. 1

Cum-dividend price of Preference shares = ₹ 18

Prakshal Shah | 8779794646

Less: Dividend (8/100) x 25

= ₹ 2



∴ Market Price of Preference shares = ₹ 16

$$K_p = \frac{2}{16} = 0.125 \text{ (or) } 12.5\%$$

$$\text{No. Of preference shares} = \left(\frac{4,00,000}{25} \right) = 16,000$$

W.N. 2

$$\text{Market price of Debentures} = \left(\frac{120}{100} \right) \times 100 = \text{Rs. } 120$$

$$K_d = \left[\frac{12(1-0.3)}{120} \right] = 0.07 \text{ (or) } 7\%$$

$$\text{No. of Debentures} = \left(\frac{6,00,000}{100} \right) = 6,000$$

W.N. 3

Market price of Equity Shares = Rs. 39

k_e (given) = 19% or 0.19

$$\text{No. of Equity Shares} = \frac{5,00,000}{10} = 50,000$$

| Sources | Market Value (₹) | Nos. | Total Market value (₹) | Weight | Cost of Capital | Product |
|-------------------|------------------|--------|------------------------|--------|-----------------|---------|
| Equity Shares | 39 | 50,000 | 19,50,000 | 0.6664 | 0.19 | 0.1266 |
| Preference Shares | 16 | 16,000 | 2,56,000 | 0.0875 | 0.125 | 0.0109 |
| Debentures | 120 | 6,000 | 7,20,000 | 0.2461 | 0.07 | 0.0172 |
| | | | | | WACC = | 0.1547 |

WACC = 0.1547 or 15.47%

Question 36

MR Ltd. is having the following capital structure, which is considered to be optimum as on 31.03.2022.

| | |
|--------------------------------------|-------------|
| Equity share capital (50,000 shares) | ₹ 8,00,000 |
| 12% Pref. share capital | ₹ 50,000 |
| 15% Debentures | ₹ 1,50,000 |
| | ₹ 10,00,000 |

The earnings per share (EPS) of the company were ₹ 2.50 in 2021 and the expected growth in equity dividend is 10% per year. The next year's dividend per share (DPS) is 50% of EPS of the year 2021. The current market price per share (MPS) is ₹ 25.00. The 15% new debentures can be issued by the company. The company's debentures are currently selling at ₹ 96 per debenture. The new 12% Pref. share can be sold at a net price of ₹ 91.50 (face value ₹ 100 each). The applicable tax rate is 30%.

You are required to calculate

- (a) After tax cost of
 - (i) New debt,
 - (ii) New pref. share capital and
 - (iii) Equity shares assuming that new equity shares come from retained earnings.
- (b) Marginal cost of capital,

How much can be spent for capital investment before sale of new equity shares assuming that retained earnings for next year investment is 50% of 2021? (6 Marks Nov '22)

Answer 36

(a)

(i) After tax Cost of new Debt:

$$K_d = I \frac{(1-t)}{P_1} = 15 \frac{(1-0.3)}{96}$$

$$= 0.1094 \text{ (or) } 10.94\%$$

(ii) After tax cost of new Preferences share Capital

$$K_p = \frac{PD}{P_0} + g = \left[\frac{(2.50 \times 50\%)}{25} \right] + 0.10$$

$$= 0.15 \text{ (or) } 15\%$$

(b) Marginal Cost of Capital

| Type of capital | Proportions | Specific cost | Product |
|----------------------------|-------------|---------------|---------|
| Equity Shares | 0.80 | 0.15 | 0.12 |
| Preference Shares | 0.05 | 0.1311 | 0.0066 |
| Debentures | 0.15 | 0.1094 | 0.0164 |
| ∴ Marginal cost of capital | | | 0.1430 |

(c) Amount that can be spend for capital investment

Retained earnings = 50% of EPS x No. of outstanding Equity shares

$$= 1.25 \times 50,000$$

$$= ₹ 62,500$$

Proportion of equity (Retained earnings here) capital is 80% of total capital.

Therefore, ₹ 62,500 is 80% of total capital.

$$\therefore \text{Amount of Capital Investment} = \frac{62,500}{0.80} = \text{Rs. } 78,125$$

Question 37

Capital structure of D Ltd. as on 31st March, 2023 is given below:

| Particulars | ₹ |
|--|-----------|
| Equity share capital (₹ 10 each) | 30,00,000 |
| 8% Preference share capital (₹ 100 each) | 10,00,000 |
| 12% Debentures (₹ 100 each) | 10,00,000 |

- Current market price of equity share is ₹ 80 per share. The company has paid dividend of ₹ 14.07 per share. Seven years ago, it paid dividend of ₹ 10 per share. Expected dividend is ₹ 16 per share.
- 8% Preference shares are redeemable at 6% premium after five years. Current market price per preference share is ₹ 104.
- 12% debentures are redeemable at 20% premium after 10 years. Flotation cost is ₹ 5 per debenture.
- The company is in 40% tax bracket.



- In order to finance an expansion plan, the company intends to borrow 15% Long-term loan of ₹ 30,00,000 from bank. This financial decision is expected to increase dividend on equity share from ₹ 16 per share to ₹ 18 per share. However, the market price of equity share is expected to decline from ₹ 80 to ₹ 72 per share, because investors' required rate of return is based on current market conditions.

Required:

- Determine the existing Weighted Average Cost of Capital (WACC) taking book value weights.
- Compute Weighted Average Cost of Capital (WACC) after the expansion plan taking book value weights. (PYP 10 Marks May '23)

| Interest Rate | 1% | 2% | 3% | 4% | 5% | 6% | 7% |
|---------------------|-------|-------|-------|-------|-------|-------|-------|
| FVIF _{i,5} | 1.051 | 1.104 | 1.159 | 1.217 | 1.276 | 1.338 | 1.403 |
| FVIF _{i,6} | 1.062 | 1.126 | 1.194 | 1.265 | 1.340 | 1.419 | 1.501 |
| FVIF _{i,7} | 1.072 | 1.149 | 1.230 | 1.316 | 1.407 | 1.504 | 1.606 |

Answer 37

- a) **Growth rate in Dividends**

$$14.07 = 10 \times \text{FVIF}(i, 7 \text{ years})$$

$$\text{FVIF}(i, 7 \text{ years}) = 1.407$$

$$\text{FVIF}(5\%, 7 \text{ years}) = 1.407$$

$$i = 5\%$$

$$\text{Growth rate in dividend} = 5\%$$

- b) **Cost of Equity**

$$K_e = \frac{D_1}{P_0} + g$$

$$K_e = \frac{16}{80} + 0.05$$

$$K_e = 25\%$$

- c) **Cost of Debt**

$$K_d = \frac{I(1-t) + \frac{(RV-NP)}{n}}{\frac{(RV-NP)}{2}}$$

$$K_p = \frac{12(1-0.4) + \frac{(120-95)}{10}}{\frac{(120+95)}{2}}$$

$$K_d = (7.2 + 2.5) / 107.5 = 9.02\%$$

$$K_d = 9.02\%$$

Calculation of existing Weighted Average Cost of Capital (WACC)

| Capital | Amount (₹) | Weights | Cost | WACC |
|--------------------------|------------|---------|------|--------|
| Equity Share Capital | 30,00,000 | 0.6 | 25% | 15.00% |
| Preference Share Capital | 10,00,000 | 0.2 | 8% | 1.60% |



| | | | | |
|-----------|-----------|-----|-------|--------|
| Debenture | 10,00,000 | 0.2 | 9.02% | 1.80% |
| | 50,00,000 | 1 | | 18.40% |

Alternative presentation

i) **Computation of existing WACC on book value weights**

| Source (1) | Book value (₹) (2) | Weight (3) | Cost of capital (%) (4) | Product (2) x (4) |
|-----------------------------|-----------------------|---------------|----------------------------|----------------------|
| Equity share capital | 30,00,000 | 0.60 | 25 | 7,50,000 |
| Preference share capital | 10,00,000 | 0.20 | 8 | 80,000 |
| Debentures | 10,00,000 | 0.20 | 9.02 | 90,200 |
| Total | 50,00,000 | 1.00 | | 9,20,200 |

$$\text{WACC} = (\text{Product} / \text{Total book value}) \times 100 = (9,20,200 / 50,00,000) \times 100 = 18.4\%$$

ii) **Cost of Long Term Debt = 15% (1-0.4) = 9%**

$$\text{Revised } K_e = \frac{18}{72} + 0.05 = 30\%$$

Calculation of WACC after expansion taking book value weights

| Capital | Amount | Weights | Cost | W.C |
|--------------------------|-----------|---------|-------|--------|
| Equity Share Capital | 30,00,000 | 0.3750 | 30% | 11.25% |
| Preference Share Capital | 10,00,000 | 0.1250 | 8% | 1.00% |
| Debenture | 10,00,000 | 0.1250 | 9.02% | 1.13% |
| Long Term Debt | 30,00,000 | 0.3750 | 9.00% | 3.38% |
| | 80,00,000 | 1.0000 | | 16.76% |

Alternative presentation

Computation of WACC on book value weights after expansion

| Source (1) | Book value (₹) (2) | Weight (3) | Cost of capital (%) (4) | Product (2) x (4) |
|--------------------------|-----------------------|---------------|----------------------------|----------------------|
| Equity share capital | 30,00,000 | 0.375 | 30 | 9,00,000 |
| Preference share capital | 10,00,000 | 0.125 | 8 | 80,000 |
| Debentures | 10,00,000 | 0.125 | 9.02 | 90,200 |
| Long term loan | 30,00,000 | 0.375 | 9 | 2,70,000 |
| Total | 80,00,000 | 1.00 | | 13,40,200 |

$$\text{WACC} = (\text{Product} / \text{Total book value}) \times 100 = (13,40,200 / 80,00,000) \times 100 = 16.76\%$$



Chapter 5

Financing Decisions-Capital Structure

Question 1

The Modern Chemicals Ltd. requires Rs.25,00,000 for a new plant. This plant is expected to yield earnings before interest and taxes of Rs. 5,00,000. While deciding about the financial plan, the company considers the objective of maximizing earnings per share. It has three alternatives to finance the project- by raising debt of Rs.2,50,000 or Rs.10,00,000 or Rs.15,00,000 and the balance, in each case, by issuing equity shares. The company's share is currently selling at Rs. 150, but is expected to decline to Rs.125 in case the funds are borrowed in excess of Rs.10,00,000. The funds can be borrowed at the rate of 10% up to Rs. 2,50,000, at 15% over Rs.2,50,000 and up to Rs.10,00,000 and at 20% over Rs.10,00,000. The tax rate applicable to the company is 50%.

DETERMINE, which form of financing should the company choose? (MTP 10 Marks, Aug'18)

Answer 1

Calculation of Earnings per share for three alternatives to finance the project

| Particulars | Alternatives | | |
|--|---|---|---|
| | I To raise debt of Rs. 2,50,000 and equity of Rs. 22,50,000 (Rs.) | II To raise debt of Rs. 10,00,000 and equity of Rs. 15,00,000 (Rs.) | III To raise debt of Rs. 15,00,000 and equity of Rs. 10,00,000 (Rs.) |
| Earnings before interest and tax | 5,00,000 | 5,00,000 | 5,00,000 |
| Less: Interest on debt at the rate of | 25,000 (10% on Rs.2,50,000) | 1,37,500 (10% on Rs.2,50,000) (15% on Rs. 7,50,000) | 2,37,500 (10% on Rs. 2,50,000) (15% on Rs.7,50,000) (20% on Rs.5,00,000) |
| Earnings before tax | 4,75,000 | 3,62,500 | 2,62,500 |
| Less: Tax @ 50% | 2,37,500 | 1,81,250 | 1,31,250 |
| Earnings after tax: (A) | 2,37,500 | 1,81,250 | 1,31,250 |
| Number of shares: (B) (Equity/Market price of Share) | 15,000 (Rs.22,50,000/Rs.150) | 10,000 (Rs.15,00,000/Rs.150) | 8,000 (Rs.10,00,000/Rs.125) |
| Earnings per share: [(A)/(B)] | 15.833 | 18.125 | 16.406 |

The company should raise Rs.10,00,000 from debt and Rs.15,00,000 by issuing equity shares, as it gives highest EPS.

Question 2

EXPLAIN the principles of "Trading on equity". (MTP 4 Marks, April'19, MTP 2 Marks April 21)

Answer 2

The term trading on equity means debts are contracted and loans are raised mainly on the basis of equity capital. Those who provide debt have a limited share in the firm's earning and hence want to be protected in terms of earnings and values represented by equity capital. Since fixed charges do not vary with firm's earnings before interest and tax, a magnified effect is produced on earning per share. Whether the leverage is favorable, in the sense, increase in earnings per share more proportionately to the increased earnings before interest and tax, depends on the profitability of investment proposal. If the rate of returns on investment exceeds their explicit cost, financial leverage is said to be positive.

Question 3

RPS Company presently has Rs. 36,00,000 in debt outstanding bearing an interest rate of 10 per cent. It wishes to finance a Rs. 40,00,000 expansion programmer and is considering three alternatives: additional debt at 12 per cent interest, preferred stock with an 11 per cent dividend, and the sale of common stock at Rs. 16 per share. The company presently has 8,00,000 shares of common stock outstanding and is in a 40

per cent tax bracket.

- (i) If earnings before interest and taxes are presently Rs. 15,00,000, CALCULATE earnings per share for the three alternatives, assuming no immediate increase in profitability?
- (ii) CALCULATE indifference point between debt and common stock. . [MTP 5 Marks, Oct'19, Old & New SM]

Answer 3

(I) (Rs. in thousands)

| | Debt | Preferred Stock | Common Stock |
|---|-------|-----------------|--------------|
| | Rs. | Rs. | Rs. |
| EBIT | 1,500 | 1,500 | 1,500 |
| Interest on existing debt | 360 | 360 | 360 |
| Interest on new debt | 480 | - | - |
| Profit before taxes | 660 | 1,140 | 1,140 |
| Taxes | 264 | 456 | 456 |
| Profit after taxes | 396 | 684 | 684 |
| Preferred stock dividend | - | 440 | - |
| Earnings available to common shareholders | 396 | 244 | 684 |
| Number of shares | 800 | 800 | 1,050 |
| Earnings per share | .495 | .305 | .651 |

(ii) Mathematically, the indifference point between debt and common stock is (Rs in thousands):

$$\frac{\text{EBIT}^* - \text{Rs.840}}{800} = \frac{\text{EBIT}^* - \text{Rs.360}}{1050}$$

$$\text{EBIT}^* (1,050) - \text{Rs. } 840(1,050) = \text{EBIT}^* (800) - \text{Rs. } 360(800) \quad 250\text{EBIT}^* = \text{Rs. } 5,94,000$$

$$\text{EBIT}^* = \text{Rs. } 2,376$$

Question 4

A Ltd. and B Ltd. are identical in every respect except capital structure. A Ltd. does not employ debts in its capital structure whereas B Ltd. employs 12% Debentures amounting to Rs.100 lakhs. Assuming that:

- (i) All assumptions of M-M model are met;
- (ii) Income-tax rate is 30%;
- (iii) EBIT is Rs. 25,00,000 and
- (iv) The Equity capitalization rate of 'A' Ltd. is 20%.

CALCULATE the value of both the companies and also find out the Weighted Average Cost of Capital for both the companies. [MTP 5 Marks, Oct'19]

Answer 4

i. Calculation of Value of 'A Ltd.' and 'B Ltd' according to MM Hypothesis

Market Value of 'A Ltd' (Unlevered)

$$V_u = \frac{\text{EBIT} (1 - t)}{k_e} = \frac{\text{Rs.25,00,000}(1 - 0.30)}{20\%} = \frac{\text{Rs.17,50,000}}{20\%} = \text{Rs. } 87,50,000$$

Market Value of 'B Ltd.' (Levered)

$$V_g = V_u + TB$$

$$= \text{Rs. } 87,50,000 + (\text{Rs.1,00,00,000} \times 0.30)$$

$$= \text{Rs. } 87,50,000 + \text{Rs.30,00,000} = \text{Rs.1,17,50,000}$$

ii. Computation of Weighted Average Cost of Capital (WACC)

$$\text{WACC of 'A Ltd.'} = 20\% \text{ (i.e. } k_e = k_o \text{)}$$



WACC of 'B Ltd.'

| | B Ltd. (Rs.) |
|--|---------------|
| EBIT | 25,00,000 |
| Interest to Debt holders | (12,00,000) |
| EBT | 13,00,000 |
| Taxes @ 30% | (3,90,000) |
| Income available to Equity Shareholders | 9,10,000 |
| Total Value of Firm | 1,17,50,000 |
| Less: Market Value of Debt | (1,00,00,000) |
| Market Value of Equity | 17,50,000 |
| Return on equity (Ke) = 9,10,000 / 17,50,000 | 0.52 |

Computation of WACC B. Ltd

| Component of Capital | Amount | Weight | Cost of Capital | WACC |
|----------------------|-------------|--------|-----------------|--------|
| Equity | 17,50,000 | 0.149 | 0.52 | 0.0775 |
| Debt | 1,00,00,000 | 0.851 | 0.084* | 0.0715 |
| Total | 1,17,50,000 | | | 0.1490 |

*Kd = 12% (1 - 0.3) = 12% × 0.7 = 8.4%

WACC = 14.90%

Question 5

A&R Ltd. is an all equity financed company with a market value of Rs. 25,000 lakhs and cost of equity (Ke) 18%. The company wants to buyback equity shares worth Rs. 5,000 lakhs by issuing and raising 10% debentures redeemable at 10% premium after 5 years. Rate of tax may be taken as 35%. Applying Modigliani-Miller (MM) (with taxes), you are required to CALCULATE after restructuring:

- Market value of A&R Ltd.
- Cost of Equity (Ke)
- Weighted average cost of capital (using market weights). (MTP 5 Marks, May'20)(Same concept different figures RTP Nov'18) (Includes concepts of Chp 4: Cost of Capital)

Answer 5

Value of a company (V) = Value of equity (S) + Value of debt (D)

A&R Ltd. is all equity financed company, its value would equal to value of equity

$$\text{Market value of equity} = \frac{\text{Net Income}}{(NI)K_E}$$

In the question, market value of equity is Rs. 25,000 lakhs and cost of equity (Ke) is 18%. The Net Income (NI) is calculated as follows:

$$\frac{\text{Net income (NI) for equity holders}}{K_E} = \text{Market Value of Equity}$$

$$\frac{\text{Net income (NI) for equity holders}}{0.18} = 25,000 \text{ lakh}$$

$$\text{Net income for equity holders} = 4,500 \text{ lakh}$$

Net Income (NI) is after tax income, the before tax income would be

$$\text{EBT} = \frac{45 \text{ Lakh}}{(1-0.35)} = 6,923.07 \text{ lakh.}$$

Since, A&R Ltd. is an all equity financed and there is no interest expense, so here EBT is equal to EBIT. After



issuing 10% debentures, the A&R Ltd would become a levered company.

(i) The value of A&R Ltd. after issuing debentures would be calculated as follows:

Value of a levered company (V_g)
 = Value of an unlevered company (V_u) + Tax benefit (TB)
 = Rs. 25,000 lakhs + (Rs. 5,000 lakhs \times 35%)
 = Rs. 25,000 + Rs. 1,750 = Rs. 26,750

(ii) Cost of Equity (K_e)

Total Value = Rs. 26,750 lakh
 Less: Value of Debt = Rs. 5,000 lakh
 Value of Equity = Rs. 21,750

$$\frac{4,175 \text{ Lakh}}{K_e = 21,750 \text{ Lakh}} = 0.1919 = 19.19\%$$

(iii) WACC (on market value weight)

| Components of Costs | Amount (lakh) | Cost of Capital (%) | Weight | WACC (%) |
|---------------------|---------------|---------------------|--------|----------|
| Equity | 21,750 | 19.19 | 0.81 | 15.54 |
| Debt | 5,000 | 8.10 | 0.19 | 1.54 |
| | 26,750 | | | 17.08 |

Workings Note:

(Rs. in lakh)

| | All Equity | Debt and Equity |
|---|------------|-----------------|
| EBIT (as calculated above) | 6,923.07 | 6,923.07 |
| Interest to debt-holders | - | 500.00 |
| EBT | 6,923.07 | 6,423.07 |
| Taxes (35%) | 2,423.07 | 2,248.07 |
| Income available to equity shareholders | 4,500.00 | 4,175.00 |
| Income to debt holders plus income available to equity shareholders | 4,500.00 | 4,675.00 |

$$\text{Cost of Debenture (Kd)} = \frac{\text{Rs.} 500(1-0.35) + \frac{(5,500-5,000)}{5}}{\frac{(5,500+5,000)}{2}}$$

$$\frac{\text{Rs.} 325 + 100}{5,525} = 0.081 \text{ or } 8.1\%$$

Question 6

EXPLAIN in brief the Pecking order theory. [MTP 4 Marks, May'20]

OR

'Pecking order theory' suggests manager to use various sources for raising of fund in certain order. BRIEF out that order. [MTP 2Marks, Nov'21]

Answer 6

This theory states that firms prefer to issue debt when they are positive about future earnings. Equity is issued when they are doubtful and internal finance is insufficient.

The pecking order theory argues that the capital structure decision is affected by manager's choice of a source of capital that gives higher priority to sources that reveal the least amount of information.

Pecking order theory suggests that managers may use various sources for raising of fund in the following order.

1. Managers first choice is to use internal finance
2. In absence of internal finance, they can use secured debt, unsecured debt, hybrid debt etc.



3. Managers may issue new equity shares as a last option. So briefly under this theory rules are

Rule 1: Use internal financing first.

Rule 2: Issue debt next

Rule 3: Issue of new equity shares at last

Question 7

EXPLAIN Over-capitalization. STATE its causes and consequences. [MTP 4Marks May'20, PYP 2 Marks Nov'22]

Answer 7

Over-capitalization and its Causes and Consequences

It is a situation where a firm has more capital than it needs or in other words assets are worth less than its issued share capital, and earnings are insufficient to pay dividend and interest.

Causes of Over Capitalization

Over-capitalization arises due to following reasons:

- (i) Raising more money through issue of shares or debentures than company can employ profitably.
- (ii) Borrowing huge amount at higher rate than rate at which company can earn.
- (iii) Excessive payment for the acquisition of fictitious assets such as goodwill etc.
- (iv) Improper provision for depreciation, replacement of assets and distribution of dividends at a higher rate.
- (v) Wrong estimation of earnings and capitalization.

Consequences of Over-Capitalization

Over-capitalization results in the following consequences:

- (i) Considerable reduction in the rate of dividend and interest payments.
- (ii) Reduction in the market price of shares.
- (iii) Resorting to "window dressing".
- (iv) Some companies may opt for reorganization. However, sometimes the matter gets worse and the company may go into liquidation.

Question 8

Sinha Steel Ltd. requires ₹ 30,00,000 for a new plant which expects to yield earnings before interest and taxes of ₹ 5,00,000. While deciding about the financial plan, the company considers the objective of maximizing earnings per share. It has three alternatives to finance the project as follows -

| Alternative | Debt | Equity Shares |
|-------------|--------------|---------------|
| 1 | Rs.2,50,000 | balance |
| 2 | Rs.10,00,000 | balance |
| 3 | Rs.15,00,000 | balance |

The company's share is currently selling at Rs.200, but is expected to decline to Rs.160 in case the funds are borrowed in excess of Rs.10,00,000.

Slab wise interest rate for fund borrowed are as follows -

| Fund Limit | Applicable Interest rate |
|---|--------------------------|
| up-to Rs.2,50,000 | 10% |
| over Rs.2,50,000 and up-to Rs.10,00,000 | 15% |
| over Rs.10,00,000 | 20% |

The tax rate applicable to the company is 50 percent.

ANALYSE which form of financing should the company choose? [MTP 10 Marks, Oct'20, PYP 5 Marks Nov '18, Old & New SM]

Answer 8

Alternative I = Raising Debt of Rs.2.5 lakh + Equity of Rs.27.5 lakh. Alternative II = Raising Debt of Rs.10 lakh + Equity of ₹20 lakh. Alternative III = Raising Debt of Rs.15 lakh + Equity of Rs.15 lakh.



Calculation of Earnings per share (EPS):
(Amount in ₹)

| Particulars | FINANCIAL ALTERNATIVES | | |
|------------------------------------|------------------------|----------------|-----------------|
| | Alternative I | Alternative II | Alternative III |
| Expected EBIT | 5,00,000 | 5,00,000 | 5,00,000 |
| Less: Interest (working note I) | (25,000) | (1,37,500) | (2,37,500) |
| Earnings before taxes | 4,75,000 | 3,62,500 | 2,62,500 |
| Less: Taxes @ 50% | (2,37,500) | (1,81,250) | (1,31,250) |
| Earnings after taxes (EAT) | 2,37,500 | 1,81,250 | 1,31,250 |
| Number of shares (working note ii) | 13,750 | 10,000 | 9,375 |
| Earnings per share (EPS) | 17.27 | 18.125 | 14.00 |

Financing Alternative II (i.e. Raising debt of ₹10 lakh and issue of equity share capital of Rs.20 lakh) is the option which maximizes the earnings per share.

Working Notes:

(i) Calculation of interest on Debt (Amount in ₹)

| | | | |
|-----------------|------------------|----------|----------|
| Alternative I | (2,50,000 × 10%) | | 25,000 |
| Alternative II | (2,50,000 × 10%) | 25,000 | |
| | (7,50,000 × 15%) | 1,12,500 | 1,37,500 |
| Alternative III | (2,50,000 × 10%) | 25,000 | |
| | (7,50,000 × 15%) | 1,12,500 | |
| | (5,00,000 × 20%) | 1,00,000 | 2,37,500 |

(ii) Number of equity shares to be issued

Alternative I = Rs.27,50,000/ ₹Rs.200 (Market Price of share)
= 13,750 shares

Alternative II = Rs.20,00,000/ Rs.200= 10,000 shares

Alternative III = Rs.15,00,000/ Rs. 160 = 9,375 shares

Question 9

HN Limited is considering total investment of Rs. 20 lakhs. You are required to **CALCULATE** the level of earnings before interest and tax (EBIT) at which the EPS indifference point between the following financing alternatives will occur:

- (i) Equity share capital of Rs. 12,00,000 and 14% debentures of Rs. 8,00,000.

Or

- (ii) Equity share capital of Rs. 8,00,000, 16% preference share capital of Rs. 4,00,000 and 14% debentures of Rs. 8,00,000.

Assume the corporate tax rate is 30% and par value of equity share is Rs.10 in each case. (MTP 5 Marks March '21, RTP May 20)

Answer 9

Computation of level of earnings before interest and tax (EBIT)

In case alternative (i) is accepted, then the EPS of the firm would be:

$$EPS_{Alternative(i)} = \frac{(EBIT - Interest)(1 - tax Rate)}{No. of equity Shares} = \frac{(EBIT - 0.14 \times 8,00,000)(1 - 0.3)}{1,20,000 \text{ shares}}$$



In case the alternative (ii) is accepted, then the EPS of the firm would be

$$EPS_{Alternative(ii)} = \frac{(EBIT - Interest)(1 - tax Rate) - PD}{No. of equity Shares}$$

$$\frac{(EBIT - 0.14 \times 8,00,000)(1 - 0.3) - 0.16 \times 4,00,000}{80,000 \text{ shares}}$$

In order to determine the indifference level of EBIT, the EPS under the two alternative plans should be equated as follows:

$$\frac{(EBIT - 0.14 \times 8,00,000)(1 - 0.3)}{1,20,000 \text{ shares}} = \frac{(EBIT - 0.14 \times 8,00,000)(1 - 0.3) - 0.16 \times 4,00,000}{80,000 \text{ shares}}$$

$$\begin{aligned} \text{Or } 1.40 \text{ EBIT} - \text{Rs. } 1,56,800 &= 2.10 \text{ EBIT} - \text{Rs. } 4,27,200 \\ \text{Or } 0.70 \text{ EBIT} &= \text{Rs. } 2,70,400 \\ \text{Or } \text{EBIT} &= 2,70,400 / 0.7 \\ \text{Or } \text{EBIT} &= \text{Rs. } 3,86,285.71 \text{ (approx.)} \end{aligned}$$

Question 10

Keep Ltd. and Lee Ltd. are identical in every respect except for capital structure. Keep Ltd. does not employ debt in its capital structure, whereas Lee Ltd. employs 12% debentures amounting to Rs. 20 lakhs.

Assuming that:

- All assumptions of MM model are met;
- The income tax rate is 30%;
- EBIT is Rs. 5,00,000 and
- The equity capitalization rate of Keep Ltd. is 25%. CALCULATE the average value of both the Companies. (MTP 5 Marks, April'21)

Answer 10

Keep Ltd. (pure Equity) i.e. unlevered company: $EAT = EBT (1 - t)$

$$= EBIT (1 - 0.3) = \text{Rs. } 5,00,000 \times 0.7 = \text{Rs. } 3,50,000$$

(Here, EBIT = EBT as there is no debt)

$$\text{Value of unlevered company Keep Ltd.} = \frac{EAT}{\text{Equity Capitalization rate}}$$

$$= \frac{\text{Rs. } 3,50,000}{25\%}$$

Lee Ltd. (Equity and Debt) i.e. levered company:

Value of levered company = Value of Equity + Value of Debt

$$= \text{Rs. } 14,00,000 + (\text{Rs. } 20,00,000 \times 0.3)$$

$$= \text{Rs. } 20,00,000$$

Question 11

Sophisticated Limited is considering three financing plans. The key information is as follows:

- Total investment amount to be raised Rs.4,00,000
- Plans of Financing Proportion:

| Plans | Equity | Debt | Preference Shares |
|-------|--------|------|-------------------|
| A | 100% | - | - |
| B | 50% | 50% | - |
| C | 50% | - | 50% |

- Cost of debt 10%
- Cost of preference shares 10%

- (d) Tax rate 30%
- (e) Equity shares of the face value of Rs.10 each will be issued at a premium of Rs.10 per share.
- (f) Expected EBIT is Rs.10,00,000.

You are required to DETERMINE for each plan: -

- (i) Earnings per share (EPS)
- (ii) The financial break-even point.
- (iii) Indicate if any of the plans dominate and compute the EBIT range among the plans for indifference. [MTP 10 Marks, Oct'21](Similar concepts with different amounts in MTP 10 Marks Mar 18 & Oct 18, RTP Nov '19, Old & New SM, PYP 10 Marks Nov'20)

Answer 11

Computation of Earnings per share (EPS)

| Plans | A | B | C |
|--|-------------------------------|-------------------------------|-------------------------------|
| Earnings before interest and tax (EBIT) | 10,00,000 | 10,00,000 | 10,00,000 |
| Less: Interest charges | --- | (20,000) (10% × ₹2 lakh) | --- |
| Earnings before tax (EBT) | 10,00,000 | 9,80,000 | 10,00,000 |
| Less: Tax (@ 30%) | (3,00,000) | (2,94,000) | (3,00,000) |
| Earnings after tax (EAT) | 7,00,000 | 6,86,000 | 7,00,000 |
| Less: Preference Dividend | --- | --- | (20,000) (10% × ₹2 lakh) |
| Earnings available for Equity shareholders (A) | 7,00,000 | 6,86,000 | 6,80,000 |
| No. of Equity shares (B) | 20,000 (Rs.4 lakh ÷ Rs.20) | 10,000 (Rs.2 lakh ÷ Rs.20) | 10,000 (Rs.2 lakh ÷ Rs.20) |
| EPS ₹ [(A) ÷ (B)] | 35 | 68.6 | 68 |

- (ii) Calculation of Financial Break-even point
- Financial break-even point is the earnings which are equal to the fixed finance charges and preference dividend.
- Plan A: Under this, plan there is no interest or preference dividend payment. Hence, the Financial Break-even point will be zero.
- Plan B: Under this plan, there is an interest payment of Rs.20,000 and no preference dividend. Hence, the Financial Break-even point will be Rs.20,000 (Interest charges).
- Plan C: Under this plan, there is no interest payment but an after tax preference dividend of Rs.20,000 is paid. Hence, the Financial Break- even point will be before tax earnings of Rs.28,571 (i.e. Rs.20,000 ÷ 0.7)
- (iii) Computation of indifference point between the plans.
- The indifference between two alternative methods of financing is calculated by applying the following formula.

$$\frac{(EBIT - I_1)(1 - T)}{E_1} = \frac{(EBIT - I_2)(1 - T)}{E_2}$$

EBIT = Earnings before interest and tax.

I₁ = Fixed charges (interest or pref. dividend) under Alternative 1

I₂ = Fixed charges (interest or pref. dividend) under Alternative 2

T = Tax rate



E1 = No. of equity shares in Alternative 1

E2 = No. of equity shares in Alternative 2

Now, we can calculate indifference point between different plans of financing.

(a) Indifference point where EBIT of Plan A and Plan B is equal.

$$\frac{(EBIT-0)(1-0.3)}{20,000} = \frac{(EBIT-20,000)(1-0.3)}{10,000}$$

$$0.7 \text{ EBIT } (10,000) = (0.7 \text{ EBIT} - 14,000) (20,000)$$

$$7,000 \text{ EBIT} = 14,000 \text{ EBIT} - 28 \text{ crores}$$

$$\text{EBIT} = 40,000$$

(b) Indifference point where EBIT of Plan A and Plan C is equal

$$\frac{(EBIT-0)(1-0.3)}{20,000} = \frac{(EBIT-20,000)(1-0.3)}{10,000}$$

$$0.7 \text{ EBIT } (10,000) = (0.7 \text{ EBIT} - 20,000) (20,000)$$

$$7,000 \text{ EBIT} = 14,000 \text{ EBIT} - 40 \text{ crores}$$

$$\text{EBIT} = 57,142.86$$

(c) Indifference point where EBIT of Plan B and Plan C are equal

$$\frac{(EBIT-20,000)(1-0.3)}{10,000} = \frac{(EBIT-0)(1-0.3)-20,000}{10,000}$$

$$(0.7 \text{ EBIT} - 14,000) (10,000) = (0.7 \text{ EBIT} - 20,000) (10,000)$$

$$7,000 \text{ EBIT} - 14 \text{ crore} = 7,000 \text{ EBIT} - 20 \text{ crore}$$

There is no indifference point between the financial plans B and C.

Question 12

ABC Limited is setting up a project with a capital outlay of ₹ 90,00,000. It has two alternatives in financing the project cost.

Alternative-I: 100% equity finance by issuing equity shares of Rs.10 each **Alternative-II:** Debt-equity ratio 2:1 (issuing equity shares of Rs.10 each)

The rate of interest payable on the debts is 18% p.a. The corporate tax rate is 30%. CALCULATE the indifference point between the two alternative methods of financing. [MTP 5 Marks Nov'21, Old & New SM]

Answer 12

Calculation of Indifference point between the two alternatives of financing.

Alternative-I by issue of 9,00,000 equity shares of ₹10 each amounting to ₹ 90 lakhs. No financial charges are involved.

Alternative-II by raising the funds in the following way: Debt = ₹ 60 lakhs

Equity = ₹ 30 lakhs (3,00,000 equity shares of Rs.10 each)

Interest payable on debt = $60,00,000 \times \frac{18}{100}$ = Rs.10,80,000

The difference point between the two alternatives is calculated by:

$$\frac{(EBT-I_1)(1-T)}{E_1} = \frac{(EBT-I_2)(1-T)}{E_2}$$

$$\frac{EBIT-0(1-0.30)}{9,00,000} = \frac{(EBIT-10,80,000)(1-0.30)}{3,00,000}$$

$$= \frac{(EBIT)(0.70)}{9,00,000} = \frac{(EBIT-10,80,000)(0.70)}{3,00,000}$$

$$= \frac{(EBIT)(0.70)}{3} = \frac{0.70(EBIT-10,80,000)}{1}$$



$$\begin{aligned} \text{EBIT} &= 3\text{EBT} - 32,40,000 \\ -2\text{EBT} &= -32,40,000 \\ \text{EBT} &= \frac{32,40,000}{2} \\ \text{EBIT} &= \text{Rs. } 16,20,000 \end{aligned}$$

Therefore, at EBIT of Rs.16,20,000, earnings per share for the two alternatives is equal.

Question 13

PRI Ltd. and SHA Ltd. are identical, however, their capital structure (in market-value terms) differs as follows:

| Company | Debt | Equity |
|----------|------|--------|
| PRI Ltd. | 60% | 40% |
| SHA Ltd. | 20% | 80% |

The borrowing rate for both companies is 8% in a no-tax world and capital markets are assumed to be perfect.

- (a) (i) If Mr. Rhi, owns 6% of the equity shares of PRI Ltd., DETERMINE his return if the Company has net operating income of ₹ 9,00,000 and the overall capitalization rate of the company (K_0) is 18%.
- (ii) CALCULATE the implied required rate of return on equity of PRI Ltd.
- (b) SHA Ltd. has the same net operating income as PRI Ltd.
- (i) CALCULATE the implied required equity return of SHA Ltd.
- (ii) ANALYSE why does it differ from that of PRI Ltd. [MTP 10 Marks March 22, PYP 10 Marks Jan '21, Old & New SM]

Answer 13

$$\text{Value of PRI Ltd.} = \frac{\text{NOI}}{K_0} = \frac{\text{Rs. } 9,00,000}{18\%} = \text{Rs. } 50,00,000$$

- (a) (i) Return on Shares of Mr. Rhi on PRI Ltd.

| Particulars | Amount (₹) |
|--|------------|
| Value of the company | 50,00,000 |
| Market value of debt (60% × ₹ 50,00,000) | 30,00,000 |
| Market value of shares (40% × ₹ 50,00,000) | 20,00,000 |
| Particulars | Amount (₹) |
| Net operating income | 9,00,000 |
| Interest on debt (8% × ₹ 30,00,000) | 2,40,000 |
| Earnings available to shareholders | 6,60,000 |
| Return on 6% shares (6% × ₹ 6,60,000) | 39,600 |

(ii) Implied required rate of return on equity of PRI Ltd. = $\frac{\text{Rs. } 6,60,000}{\text{Rs. } 20,00,000} = 33\%$

- (b) (i) Calculation of Implied rate of return of SHA Ltd.

| Particulars | Amount (₹) |
|--|------------|
| Total value of company | 50,00,000 |
| Market value of debt (20% × ₹ 50,00,000) | 10,00,000 |

| Market value of equity (80% × ₹ 50,00,000) | 40,00,000 |
|--|------------|
| Particulars | Amount (₹) |
| Net operating income | 9,00,000 |
| Interest on debt (8% × ₹ 10,00,000) | 80,000 |
| Earnings available to shareholders | 8,20,000 |

$$\text{Implied required rate of return on equity} = \frac{\text{Rs. } 8,20,000}{\text{Rs. } 40,00,000} = 20.5\%$$

- (ii) Implied required rate of return on equity of SHA Ltd. is lower than that of PRI Ltd. because SHA Ltd. uses less debt in its capital structure. As the equity capitalization is a linear function of the debt-to-equity ratio when we use the net operating income approach, the decline in required equity return offsets exactly the disadvantage of not employing so much in the way of “cheaper” debt funds.

Question 14

Following data is available in respect of two companies having same business risk: Capital employed = ₹ 4,00,000, EBIT = ₹ 60,000 and $K_e = 12.5\%$

| Sources | Levered Company (₹) | Unlevered Company (₹) |
|-------------|---------------------|-----------------------|
| Debt (@10%) | 2,00,000 | Nil |
| Equity | 2,00,000 | 4,00,000 |

An investor is holding 15% shares in levered company. CALCULATE the increase in annual earnings of investor if he switches his holding from Levered to Unlevered company. (MTP 5 Marks April 22, Old & New SM) (Same concept different figures MTP 5 Marks Oct'21)

Answer 14

Valuation of firms

| Particulars | Levered Firm (₹) | Unlevered Firm (₹) |
|--|------------------|--------------------|
| EBIT | 60,000 | 60,000 |
| Less: Interest on debt (10% × ₹ 2,00,000) | 20,000 | Nil |
| Earnings available to Equity shareholders | 40,000 | 60,000 |
| K_e | 12.5% | 12.5% |
| Value of Equity (S) (Earnings available to Equity shareholders/ K_e) | 3,20,000 | 4,80,000 |
| Debt (D) | 2,00,000 | Nil |
| Value of Firm (V) = S + D | 5,20,000 | 4,80,000 |

Value of Levered company is more than that of unlevered company. Therefore, investor will sell his shares in levered company and buy shares in unlevered company. To maintain the level of risk he will borrow proportionate amount and invest that amount also in shares of unlevered company.

| | |
|---|--------|
| Investment & Borrowings | (₹) |
| Sell shares in Levered company (₹ 3,20,000 × 15%) | 48,000 |
| Borrow money (₹ 2,00,000 × 15%) | 30,000 |
| Buy shares in Unlevered company | 78,000 |



| | |
|---|-------|
| Change in Return | (₹) |
| Income from shares in Unlevered company (₹ 78,000 x 12.5%) | 9,750 |
| Less: Interest on loan (₹ 30,000 x 10%) | 3,000 |
| Net Income from unlevered firm | 6,750 |
| Less: Income from Levered firm (₹ 48,000 x 12.5%) | 6,000 |
| Incremental Income due to arbitrage | 750 |

Question 15

Leo Ltd. has a net operating income of ₹ 21,60,000 and the total capitalisation of ₹ 120 lakhs. The company is evaluating the options to introduce debt financing in the capital structure and the following information is available at various levels of debt value.

| Debt value (₹) | Interest rate (%) | Equity Capitalisation rate (%) |
|----------------|-------------------|--------------------------------|
| 0 | N.A. | 12.00 |
| 10,00,000 | 7.00 | 12.50 |
| 20,00,000 | 7.00 | 13.00 |
| 30,00,000 | 7.50 | 13.50 |
| 40,00,000 | 7.50 | 14.00 |
| 50,00,000 | 8.00 | 15.00 |
| 60,00,000 | 8.50 | 16.00 |
| 70,00,000 | 9.00 | 17.00 |
| 80,00,000 | 10.00 | 20.00 |

You are required to COMPUTE the equity capitalization rate if MM approach is followed. Assume that the firm operates in zero tax regime and calculations to be based on book values. [MTP 8 Marks Sep'22, New SM]

Answer 15

As per MM approach, cost of the capital (K_0) remains constant, and cost of equity increases linearly with debt.

$$\text{Value of a Firm} = \frac{NOI}{k_e}$$

$$\therefore 1,20,00,000 = \frac{21,60,000}{K_0}$$

$$\therefore K_0 = \frac{21,60,000}{1,20,000} = 18\%$$

$$\text{Under MM approach } K_e = K_0 + \frac{D}{E} (K_0 - K_d)$$

Statement of equity capitalization under MM approach

| Debt Value (₹) | Equity Value (₹) | Debt/Equity | Kd (%) | Ko (%) | Ko-kd (%) | Ke = Ko+(Ko-Kd) (D/E) (%) |
|----------------|------------------|-------------|--------|--------|-----------|---------------------------|
| - | 1,20,00,000 | 0.0000 | NA | 18.00 | 18.00 | 18.00 |
| 10,00,000 | 1,10,00,000 | 0.0909 | 7.00 | 18.00 | 11.00 | 19.00 |
| 20,00,000 | 1,00,00,000 | 0.2000 | 7.00 | 18.00 | 11.00 | 20.20 |
| 30,00,000 | 90,00,000 | 0.3333 | 7.50 | 18.00 | 10.50 | 21.50 |
| 40,00,000 | 80,00,000 | 0.5000 | 7.50 | 18.00 | 10.50 | 23.25 |
| 50,00,000 | 70,00,000 | 0.7143 | 8.00 | 18.00 | 10.00 | 25.14 |
| 60,00,000 | 60,00,000 | 1.0000 | 8.50 | 18.00 | 9.50 | 27.50 |
| 70,00,000 | 50,00,000 | 1.4000 | 9.00 | 18.00 | 9.00 | 30.60 |



| | | | | | | |
|-----------|-----------|--------|-------|-------|------|-------|
| 80,00,000 | 40,00,000 | 2.0000 | 10.00 | 18.00 | 8.00 | 34.00 |
|-----------|-----------|--------|-------|-------|------|-------|

Question 16

BRIEF OUT the remedies for Over-Capitalisation. [MTP 2 Marks Sep'22]

Answer 16

Remedies for Over-Capitalisation: Following steps may be adopted to avoid the negative consequences of over-capitalisation-

- Company should go for thorough reorganization.
- Buyback of shares.
- Reduction in claims of debenture-holders and creditors.
- Value of shares may also be reduced. This will result in sufficient funds for the company to carry out replacement of assets.

Question 17

Axar Ltd. has a Sales of ₹ 68,00,000 with a Variable cost Ratio of 60%.

The company has fixed cost of ₹16,32,000. The capital of the company comprises of 12% long term debt, ₹1,00,000 Preference Shares of ₹ 10 each carrying dividend rate of 10% and 1,50,000 equity shares.

The tax rate applicable for the company is 30%.

At current sales level, DETERMINE the Interest, EPS and amount of debt for the firm if a 25% decline in Sales will wipe out all the EPS (MTP 5 Marks Oct'22, New SM)

Answer 17

Break Even Sales = ₹ 6800000×0.75 = ₹ 51,00,000

Income Statement

(Amount in ₹)

| | Original | Calculation of Interest at BEP (backward calculation) | Now at present level |
|-----------------------------------|-----------|---|-------------------------|
| Sales | 68,00,000 | 51,00,000 | 68,00,000 |
| Less: Variable Cost | 40,80,000 | 30,60,000 | 40,80,000 |
| Contribution | 27,20,000 | 20,40,000 | 27,20,000 |
| Less: Fixed Cost | 16,32,000 | 16,32,000 | 16,32,000 |
| EBIT | 10,88,000 | 4,08,000 | 10,88,000 |
| Less: Interest (EBIT-PBT) | ? | 3,93,714 | 3,93,714 |
| PBT | ? | 14,286(10,000/70%) | 6,94,286 |
| Less: Tax @ 30%(or PBT-PAT) | ? | 4,286 | 2,08,286 |
| PAT | ? | 10,000(Nil+10,000) | 4,86,000 |
| Less: Preference Dividend | 10,000 | 10,000 | 10,000 |
| Earnings for Equity share holders | ? | Nil (at BEP) | 4,76,000 |
| Number of Equity Shares | 1,50,000 | 1,50,000 | 1,50,000 |
| EPS | ? | - | 3.1733 |

So Interest=₹3,93,714, EPS=₹3.1733, Amount of debt=3,93,714/12%=₹ 32,80,950

Question 18

Aeron We Ltd. is considering two alternative financing plans as follows:

| Particulars | Plan – A (₹) | Plan – B (₹) |
|-------------|--------------|--------------|
|-------------|--------------|--------------|



| | | |
|---------------------------------|-------------|-------------|
| Equity shares of ₹ 100 each | 90,00,000 | 90,00,000 |
| Preference Shares of ₹ 100 each | - | 20,00,000 |
| 9% Debentures | 20,00,000 | - |
| | 1,10,00,000 | 1,10,00,000 |

The indifference point between the plans is ₹7,60,000. Corporate tax rate is 25%. CALCULATE the rate of dividend on preference shares. (MTP 5 Marks March '23, RTP Nov '20, Old & New SM)

Answer 18

Computation of Rate of Preference Dividend

$$\frac{(EBIT - \text{Interest})(1-t)}{\text{No. of Equity Shares } (N_1)} = \frac{(EBIT(1-t) - \text{Preference Dividend})}{\text{No. of Equity Shares } (N_2)}$$

$$\frac{(7,60,000 - 1,80,000)(1-0.25)}{90,000 \text{ Shares}} = \frac{7,60,000(1-0.25) - \text{Preference Dividend}}{90,000 \text{ Shares}}$$

$$\frac{4,35,000}{90,000 \text{ Shares}} = \frac{5,70,000 - \text{Preference Dividend}}{90,000 \text{ Shares}}$$

$$₹ 4,35,000$$

$$= ₹ 5,70,000 - \text{Preference Dividend}$$

$$₹ 5,70,000 - ₹ 4,35,000 = ₹ 1,35,000$$

$$\text{Rate of Dividend} = \frac{\text{Preference Dividend}}{\text{Preference Share Capital}} \times 100$$

$$= \frac{1,35,000}{20,00,000} \times 100 = 6.75\%$$

Question 19

Following data is available in respect of two companies having same business risk: Capital employed = ₹ 12,00,000, EBIT = ₹ 2,40,000 and $K_e = 15\%$

| Sources | Dumbo Ltd (₹) | Jumbo Ltd (₹) |
|-------------|---------------|---------------|
| Debt (@12%) | 4,00,000 | Nil |
| Equity | 8,00,000 | 12,00,000 |

An investor is holding 20% shares in the levered company. CALCULATE the increase in annual earnings of investor if arbitrage process is undertaken.

Also EXPLAIN the arbitrage process if $K_e = 20\%$ for Dumbo Ltd instead of 15%. (MTP 10 Marks, April '23)

Answer 19

(i) Valuation of firms

| Particulars | Dumbo Ltd (₹) | Jumbo Ltd (₹) |
|--|---------------|---------------|
| EBIT | 2,40,000 | 2,40,000 |
| Less: Interest on debt (12% × ₹ 4,00,000) | 48,000 | Nil |
| Earnings available to Equity shareholders | 1,92,000 | 2,40,000 |
| K_e | 15% | 15% |
| Value of Equity (S) (Earnings available to Equity shareholders/ K_e) | 12,80,000 | 16,00,000 |
| Debt (D) | 4,00,000 | Nil |
| Value of Firm (V) = S + D | 16,80,000 | 16,00,000 |

Value of Levered company is more than that of unlevered company. Therefore, investor will sell his shares in levered company and buy shares in unlevered company. To maintain the level of risk he will



borrow proportionate amount and invest that amount also in shares of unlevered company

(ii) Investment & Borrowings

₹

| | |
|--|----------|
| Sell shares in Levered company ($12,80,000 \times 20\%$) | 2,56,000 |
| Borrow money ($4,00,000 \times 20\%$) | 80,000 |
| Buy shares in Unlevered company | 3,36,000 |

(III) Change in Return

₹

| | |
|---|--------|
| Income from shares in Unlevered company ($2,40,000 \times 3,36,000/16,00,000$) | 50,400 |
| Less: Interest on loan ($80,000 \times 12\%$) | 9,600 |
| Net Income from unlevered firm | 40,800 |
| Less: Income from Levered firm ($1,92,000 \times 20\%$) | 38,400 |
| Incremental Income due to arbitrage | 2,400 |
| Arbitrage process if $K_e = 20\%$ | |

(I). Valuation of firms

| Particulars | Dumbo Ltd (₹) | Jumbo Ltd (₹) |
|--|---------------|---------------|
| EBIT | 2,40,000 | 2,40,000 |
| Less: Interest on debt ($12\% \times ₹ 4,00,000$) | 48,000 | Nil |
| Earnings available to Equity shareholders | 1,92,000 | 2,40,000 |
| K_e | 20% | 15% |
| Value of Equity (S) (Earnings available to Equity shareholders/ K_e) | 9,60,000 | 16,00,000 |
| Debt (D) | 4,00,000 | Nil |
| Value of Firm (V) = S + D | 13,80,000 | 16,00,000 |

Value of unlevered company is more than that of levered company. Therefore, investor will sell his shares in unlevered company and buy proportionate shares and debt in levered company i.e. 20% share.

(II). Investment & Borrowings

₹

| | |
|--|----------|
| Sell shares in unlevered company ($16,00,000 \times 20\%$) | 3,20,000 |
| Buy shares in levered company ($9,60,000 \times 20\%$) | 1,92,000 |
| Buy Debt of levered company | 1,28,000 |

(III). Change in Return

₹

| | |
|---|--------|
| Income from shares in levered company ($1,92,000 \times 20\%$) | 38,400 |
| Add: Interest on debt of levered ($1,28,000 \times 12\%$) | 15,360 |
| Net Income from levered firm | 53,760 |
| Less: Income from unlevered firm ($2,40,000 \times 20\%$) | 48,000 |



Incremental Income due to arbitrage

5,760

Question 20

Bhaskar Manufactures Ltd. have Equity Share Capital of ₹ 5,00,000 (face value ₹100) to meet the expenditure of an expansion programme, the company wishes to raise ₹ 3,00,000 and is having following four alternative sources to raise the funds:

Plan A: To have full money from equity shares.

Plan B: To have ₹ 1 lakhs from equity and ₹ 2 lakhs from borrowing from the financial institution @ 10% p.a.

Plan C: Full money from borrowing @ 10% p.a.

Plan D: ₹1 lakh in equity and ₹ 2 lakhs from preference shares at 8% p.a.

The company is expected to have an earning of ₹ 1,50,000. The corporate tax is 50%. Suggest a suitable plan of the above four plans to raise the required funds. (MTP 5 Marks Sep '23)

Answer 20

Statement showing the EPS under the four plans

| | Plan A | Plan B | Plan C | Plan D |
|--|------------|------------|------------|------------|
| Equity share capital | ₹ 8,00,000 | ₹ 6,00,000 | ₹ 5,00,000 | ₹ 6,00,000 |
| 8% Pref. Share capital | - | - | - | ₹ 2,00,000 |
| Borrowing @ 10% | - | ₹ 2,00,000 | ₹ 3,00,000 | - |
| | ₹ 8,00,000 | ₹ 8,00,000 | ₹ 8,00,000 | ₹ 8,00,000 |
| E.B.I.T | ₹ 1,50,000 | ₹ 1,50,000 | ₹ 1,50,000 | ₹ 1,50,000 |
| Less: Interest @ 10% | | ₹ 20,000 | ₹ 30,000 | |
| E.B.T | ₹ 1,50,000 | ₹ 1,30,000 | ₹ 1,20,000 | ₹ 1,50,000 |
| Less: Tax | ₹ 75,000 | ₹ 65,000 | ₹ 60,000 | ₹ 75,000 |
| Less: Pref Dividend | | | | ₹ 16,000 |
| Earnings available to equity share holders | ₹ 75,000 | ₹ 65,000 | ₹ 60,000 | ₹ 59,000 |
| No. of equity shares (₹100) | 8,000 | 6,000 | 5,000 | 6,000 |
| Earning per share | ₹ 9.38 | ₹ 10.83 | ₹ 12.00 | ₹ 9.83 |

Plan C given the highest EPS and therefore to be accepted.

Question 21

RML Limited needs ₹6,50,00,000 for the Expansion purposes. The following three plans are feasible:

- (I) The Company may issue 6,50,000 equity shares at ₹100 per share.
- (II) The Company may issue 4,00,000 equity shares at ₹100 per share and 2,50,000 debentures of ₹100 denomination bearing a 9% rate of interest.
- (III) The Company may issue 4,00,000 equity shares at ₹100 per share and 2,50,000 cumulative preference shares at ₹100 per share bearing a 9% rate of dividend.
 - (i) If the Company's earnings before interest and taxes are ₹15,62,500, ₹22,50,000, ₹62,50,000, ₹93,75,000 and ₹1,56,25,000, CALCULATE the earnings per share under each of three financial plans? Assume a Corporate Income tax rate of 25%.
 - (ii) WHICH alternative would you recommend and why? (MTP 10 Marks March '23, March '19 & Sep '23)

Answer 21

Computation of EPS under three-financial plans.

Plan I: Equity Financing



| | (₹) | (₹) | (₹) | (₹) | (₹) |
|----------------------|-----------|-----------|-----------|-----------|-------------|
| EBIT | 15,62,500 | 22,50,000 | 62,50,000 | 93,75,000 | 1,56,25,000 |
| Interest | 0 | 0 | 0 | 0 | 0 |
| EBT | 15,62,500 | 22,50,000 | 62,50,000 | 93,75,000 | 1,56,25,000 |
| Less: Tax @ 25% | 3,90,625 | 5,62,500 | 15,62,500 | 23,43,750 | 39,06,250 |
| PAT | 11,71,875 | 16,87,500 | 46,87,500 | 70,31,250 | 1,17,18,750 |
| No. of equity shares | 6,50,000 | 6,50,000 | 6,50,000 | 6,50,000 | 6,50,000 |
| EPS | 1.80 | 2.60 | 7.21 | 10.82 | 18.03 |

Plan II: Debt – Equity Mix

| | (₹) | (₹) | (₹) | (₹) | (₹) |
|----------------------|------------|-----------|-----------|-----------|-------------|
| EBIT | 15,62,500 | 22,50,000 | 62,50,000 | 93,75,000 | 1,56,25,000 |
| Less: Interest | 22,50,000 | 22,50,000 | 22,50,000 | 22,50,000 | 22,50,000 |
| EBT | (6,87,500) | 0 | 40,00,000 | 71,25,000 | 1,33,75,000 |
| Less: Tax @ 25% | 1,71,875* | 0 | 10,00,000 | 17,81,250 | 33,43,750 |
| PAT | (5,15,625) | 0 | 30,00,000 | 53,43,750 | 1,00,31,250 |
| No. of equity shares | 4,00,000 | 4,00,000 | 4,00,000 | 4,00,000 | 4,00,000 |
| EPS (₹) | (1.29) | 0.00 | 7.50 | 13.36 | 25.08 |

* The Company can set off losses against the overall business profit or may carry forward it to next financial years.

Plan III: Preference Shares – Equity Mix

| | (₹) | (₹) | (₹) | (₹) | (₹) |
|---------------------------|-------------|------------|-----------|-----------|-------------|
| EBIT | 15,62,500 | 22,50,000 | 62,50,000 | 93,75,000 | 1,56,25,000 |
| Less: Interest | 0 | 0 | 0 | 0 | 0 |
| EBT | 15,62,500 | 22,50,000 | 62,50,000 | 93,75,000 | 1,56,25,000 |
| Less: Tax @ 25% | 3,90,625 | 5,62,500 | 15,62,500 | 23,43,750 | 39,06,250 |
| PAT | 11,71,875 | 16,87,500 | 46,87,500 | 70,31,250 | 1,17,18,750 |
| Less: Pref. dividend * | 22,50,000 | 22,50,000 | 22,50,000 | 22,50,000 | 22,50,000 |
| PAT after Pref. dividend. | (10,78,125) | (5,62,500) | 24,37,500 | 47,81,250 | 94,68,750 |
| No. of Equity shares | 4,00,000 | 4,00,000 | 4,00,000 | 4,00,000 | 4,00,000 |
| EPS | (2.70) | (1.41) | 6.09 | 11.95 | 23.67 |

* In case of cumulative preference shares, the company has to pay cumulative dividend to preference shareholders.

- (ii) In case of lower EBIT Plan I i.e Equity Financing is better however in case of higher EBIT Plan II i.e Debt=Equity Mix is best.

Question 22

A Company earns a profit of Rs.6,00,000 per annum after meeting its interest liability of Rs.1,20,000 on 12% debentures. The Tax rate is 50%. The number of Equity Shares of Rs.10 each are 80,000 and the retained earnings amount to Rs.18,00,000. The company proposes to take up an expansion scheme for which a sum of Rs.8,00,000 is required. It is anticipated that after expansion, the company will be able to achieve the same return on investment as at present. The funds required for expansion can be raised either through debt at the rate of 12% or by issuing equity shares at par.

Required:

- (i) COMPUTE the Earnings per Share (EPS), if:

- The additional funds were raised as debt
- The additional funds were raised by issue of equity shares.
- (ii) **ADVISE** the company as to which source of finance is preferable. [MTP 10 Marks, March'19 & Oct '23]

Answer 22
Earnings before interest and tax (EBIT) after expansion scheme:

After expansion, capital employed = Rs.36,00,000 + Rs.8,00,000 = Rs.44,00,000

Desired EBIT = 20% × Rs.44,00,000 = Rs.8,80,000

(i) Computation of Earnings Per Share (EPS) under the following options:

| | Present situation | Expansion scheme Additional funds raised as | |
|---|-------------------|---|----------|
| | | Debt | Equity |
| | (Rs.) | (Rs.) | (Rs.) |
| Earnings before Interest and Tax (EBIT) | 7,20,000 | 8,80,000 | 8,80,000 |
| Less: Interest - Old capital | 1,20,000 | 1,20,000 | 1,20,000 |
| - New capital | -- | 96,000 (Rs.8,00,000 × 12%) | -- |
| Earnings before Tax (EBT) | 6,00,000 | 6,64,000 | 7,60,000 |
| Less: Tax (50% of EBT) | 3,00,000 | 3,32,000 | 3,80,000 |
| PAT | 3,00,000 | 3,32,000 | 3,80,000 |
| No. of shares outstanding | 80,000 | 80,000 | 1,60,000 |
| Earnings per Share (EPS) | | | |

- (ii) Advise to the Company:** When the expansion scheme is financed by additional debt, the EPS is higher. Hence, the company should finance the expansion scheme by raising debt.

Question 23

Company P and Q are identical in all respects including risk factors except for debt/equity, company P having issued 10% debentures of ₹ 18 lakhs while company Q is unlevered. Both the companies earn 20% before interest and taxes on their total assets of ₹ 30 lakhs. Assuming a tax rate of 50% and capitalization rate of 15% from an all-equity company.

Required:

CALCULATE the value of companies' P and Q using (i) Net Income Approach and (ii) Net Operating Income Approach. (RTP May '18)

Answer 23
(i) Valuation under Net Income Approach

| Particulars | P Amount (Rs.) | Q Amount (Rs.) |
|---|----------------------------------|----------------------------------|
| Earnings before Interest & Tax (EBIT) (20% of ₹ 30,00,000) | 6,00,000 | 6,00,000 |
| Less: Interest (10% of ₹ 18,00,000) | 1,80,000 | |
| Earnings before Tax (EBT) | 4,20,000 | 6,00,000 |
| Less: Tax @ 50% | 2,10,000 | 3,00,000 |
| Earnings after Tax (EAT) (available to equity holders) | 2,10,000 | 3,00,000 |
| Value of equity (capitalized @ 15%) | 14,00,000 (2,10,000 × 100/15) | 20,00,000 (3,00,000 × 100/15) |



| | | |
|--------------------------|-----------|-----------|
| Add: Total Value of debt | 18,00,000 | Nil |
| Total Value of Company | 32,00,000 | 20,00,000 |

(ii) Valuation of Companies under Net Operating Income Approach

| Particulars | P Amount (Rs.) | Q Amount (Rs.) |
|--|-------------------|-------------------|
| Capitalization of earnings at 15% | 20,00,000 | 20,00,000 |
| $\frac{\text{Rs. } 6,00,000(1 - 0.5)}{0.15}$ | | |
| Less: Value of debt {18,00,000 (1 – 0.5)} | 9,00,000 | Nil |
| Value of equity | 11,00,000 | 20,00,000 |
| Add: Total Value of debt | 18,00,000 | Nil |
| Total Value of Company | 29,00,000 | 20,00,000 |

Question 24

Akash Limited provides you the following information:

| | (₹) |
|-----------------------------------|------------|
| Profit (EBIT) | 2,80,000 |
| Less: Interest on Debenture @ 10% | (40,000) |
| EBT | 2,40,000 |
| Less Income Tax @ 50% | (1,20,000) |
| | 1,20,000 |
| No. of Equity Shares (₹ 10 each) | 30,000 |
| Earnings per share (EPS) | 4 |
| Price /EPS (PE) Ratio | 10 |

The company has reserves and surplus of ₹ 7,00,000 and required ₹ 4,00,000 further for modernization. Return on Capital Employed (ROCE) is constant. Debt (Debt/ Debt + Equity) Ratio higher than 40% will bring the P/E Ratio down to 8 and increase the interest rate on additional debts to 12%. You are required to ASCERTAIN the probable price of the share.

- If the additional capital are raised as debt; and
- If the amount is raised by issuing equity shares at ruling market price. (RTP May '19 & Nov '23)

Answer 24

Ascertainment of probable price of shares of Akash limited

| Particulars | Plan-I | Plan-II |
|--|-------------------------------------|--|
| | If ₹ 4,00,000 is raised as debt (₹) | If ₹ 4,00,000 is raised by issuing equity shares (₹) |
| Earnings Before Interest and Tax (EBIT) {20% of new capital i.e. 20% of (₹14,00,000 + ₹4,00,000)} (Refer working note1) | 3,60,000 | 3,60,000 |
| Less: Interest on old debentures (10% of ₹4,00,000) | (40,000) | (40,000) |

| | | |
|--|------------|------------|
| Less: Interest on new debt (12% of ₹4,00,000) | (48,000) | -- |
| Earnings Before Tax (EBT) | 2,72,000 | 3,20,000 |
| Less: Tax @ 50% | (1,36,000) | (1,60,000) |
| Earnings for equity shareholders (EAT) | 1,36,000 | 1,60,000 |
| No. of Equity Shares (refer working note 2) | 30,000 | 40,000 |
| Earnings per Share (EPS) | ₹ 4.53 | ₹ 4.00 |
| Price/ Earnings (P/E) Ratio (refer working note 3) | 8 | 10 |
| Probable Price Per Share (PE Ratio × EPS) | ₹ 36.24 | ₹ 40 |

Working Notes:
1. Calculation of existing Return of Capital Employed (ROCE):

| | (₹) |
|---|------------------|
| Equity Share capital (30,000 shares × ₹10) | 3,00,000 |
| 10% Debentures (Rs. 40,000 × 100/10) | 4,00,000 |
| Reserves and Surplus | 7,00,000 |
| Total Capital Employed | 14,00,000 |
| Earnings before interest and tax (EBIT) (given) | 2,80,000 |
| ROCE = $\frac{\text{Rs. } 2,80,000}{\text{Rs. } 14,00,000}$ | 20% |

2. Number of Equity Shares to be issued in Plan-II:

$$= \frac{\text{Rs. } 4,00,000}{\text{Rs. } 40} = 10,000 \text{ Shares}$$

Thus, after the issue total number of shares = 30,000 + 10,000 = 40,000 shares

3. Debt/Equity Ratio if ₹ 4,00,000 is raised as debt:

$$= \frac{\text{Rs. } 8,00,000}{\text{Rs. } 18,00,000} \times 100 = 44.44\%$$

As the debt equity ratio is more than 40% the P/E ratio will be brought down to 8 in Plan-I

Question 25

Zordon Ltd. has net operating income of ₹ 5,00,000 and total capitalization of ₹ 50,00,000 during the current year. The company is contemplating to introduce debt financing in capital structure and has various options for the same. The following information is available at different levels of debt value:

| Debt value (₹) | Interest rate (%) | Equity capitalization rate (%) |
|----------------|-------------------|--------------------------------|
| 0 | - | 10.00 |
| 5,00,000 | 6.0 | 10.50 |
| 10,00,000 | 6.0 | 11.00 |
| 15,00,000 | 6.2 | 11.30 |
| 20,00,000 | 7.0 | 12.40 |



| | | |
|-----------|-----|-------|
| 25,00,000 | 7.5 | 13.50 |
| 30,00,000 | 8.0 | 16.00 |

Assuming no tax and that the firm always maintains books at book values, you are REQUIRED to calculate:

- Amount of debt to be employed by firm as per traditional approach.
- Equity capitalization rate, if MM approach is followed. (RTP May '21)

Answer 25

Amount of debt to be employed by firm as per traditional approach

Calculation of Equity, W_d and W_e

| Total Capital (₹) | Debt (₹) | W_d | Equity value (₹) | W_e |
|-------------------|-----------|---------|------------------|---------|
| (a) | (b) | (b)/(a) | (c) = (a) - (b) | (c)/(a) |
| 50,00,000 | 0 | - | 50,00,000 | 1.0 |
| 50,00,000 | 5,00,000 | 0.1 | 45,00,000 | 0.9 |
| 50,00,000 | 10,00,000 | 0.2 | 40,00,000 | 0.8 |
| 50,00,000 | 15,00,000 | 0.3 | 35,00,000 | 0.7 |
| 50,00,000 | 20,00,000 | 0.4 | 30,00,000 | 0.6 |
| 50,00,000 | 25,00,000 | 0.5 | 25,00,000 | 0.5 |
| 50,00,000 | 30,00,000 | 0.6 | 20,00,000 | 0.4 |

Statement of Weighted Average Cost of Capital (WACC)

| K_e | W_e | K_d | W_d | $K_e W_e$ | $K_d W_d$ | K_o |
|-------|-------|-------|-------|-----------------|-----------------|-----------------|
| (1) | (2) | (3) | (4) | (5) = (1) x (2) | (6) = (3) x (4) | (7) = (5) + (6) |
| 0.100 | 1.0 | - | - | 0.100 | - | 0.100 |
| 0.105 | 0.9 | 0.060 | 0.1 | 0.095 | 0.006 | 0.101 |
| 0.110 | 0.8 | 0.060 | 0.2 | 0.088 | 0.012 | 0.100 |
| 0.113 | 0.7 | 0.062 | 0.3 | 0.079 | 0.019 | 0.098 |
| 0.124 | 0.6 | 0.070 | 0.4 | 0.074 | 0.028 | 0.102 |
| 0.135 | 0.5 | 0.075 | 0.5 | 0.068 | 0.038 | 0.106 |
| 0.160 | 0.4 | 0.080 | 0.6 | 0.064 | 0.048 | 0.112 |

So, amount of Debt to be employed = ₹ 15,00,000 as WACC is minimum at this level of debt i.e. 9.8%.

- (b) As per MM approach, cost of the capital (K_o) remains constant and cost of equity increases linearly with debt.

$$\text{Value of a firm} = \frac{\text{Net Operating Income (NOI)}}{K_o}$$

$$\text{Rs. } 50,00,000 = \frac{\text{Rs. } 5,00,000}{K_o}$$

$$K_o = \frac{\text{Rs. } 5,00,000}{\text{Rs. } 50,00,000} = 10\%$$

Statement of Equity Capitalization rate (k_e) under MM approach



| Debt (₹) | Equity (₹) | Debt/Equity | K_o | K_d | $K_o - K_d$ | K_e $= K_o + (K_o - K_d) \frac{\text{Debt}}{\text{Equity}}$ |
|-----------|------------|---------------|-------|-------|-----------------|--|
| (1) | (2) | (3) = (1)/(2) | (4) | (5) | (6) = (4) - (5) | (7) = (4) + (6) x (3) |
| 0 | 50,00,000 | 0 | 0.10 | - | 0.100 | 0.100 |
| 5,00,000 | 45,00,000 | 0.11 | 0.10 | 0.060 | 0.040 | 0.104 |
| 10,00,000 | 40,00,000 | 0.25 | 0.10 | 0.060 | 0.040 | 0.110 |
| 15,00,000 | 35,00,000 | 0.43 | 0.10 | 0.062 | 0.038 | 0.116 |
| 20,00,000 | 30,00,000 | 0.67 | 0.10 | 0.070 | 0.030 | 0.120 |
| 25,00,000 | 25,00,000 | 1.00 | 0.10 | 0.075 | 0.025 | 0.125 |
| 30,00,000 | 20,00,000 | 1.50 | 0.10 | 0.080 | 0.020 | 0.130 |

Question 26

Blue Ltd., an all equity financed company is considering the repurchase of ₹ 275 lakhs equity shares and to replace it with 15% debentures of the same amount. Current market value of the company is ₹ 1,750 lakhs with its cost of capital of 20%. The company's Earnings before Interest and Taxes (EBIT) are expected to remain constant in future years. The company also has a policy of distributing its entire earnings as dividend.

Assuming the corporate tax rate as 30%, you are required to CALCULATE the impact on the following on account of the change in the capital structure as per Modigliani and Miller (MM) Approach:

- Market value of the company
- Overall Cost of capital
- Cost of equity (RTP Nov '21, Old & New SM)

Answer 26

Workings:

$$\text{Market Value of Equity} = \frac{\text{Net income (NI) for equity holders}}{K_e}$$

$$₹ 1,750 \text{ lakhs} = \frac{\text{Net income (NI) for equity holders}}{0.20}$$

Net Income to equity holders/EAT = ₹ 350 lakhs

$$\text{Therefore, EBIT} = \frac{EAT}{(1-t)} = \frac{₹ 350 \text{ Lakhs}}{(1-0.3)} = ₹ 500 \text{ Lakhs}$$

Income Statement

| | All Equity (₹ In lakhs) | Equity & Debt (₹ In lakhs) |
|------------------------------------|----------------------------|-------------------------------|
| EBIT (as calculated above) | 500 | 500 |
| Interest on ₹ 275 lakhs @ 15% | - | 41.25 |
| EBT | - | 458.75 |
| Tax @ 30% | 500 | 137.63 |
| Income available to equity holders | 150 | 321.12 |
| | 350 | |

- Market value of the company

$$\begin{aligned}
 \text{Market value of levered firm} &= \text{Value of unlevered firm} + \text{Tax Advantage} \\
 &= ₹ 1,750 \text{ lakhs} + (₹ 275 \text{ lakhs} \times 0.3) \\
 &= ₹ 1,832.5 \text{ lakhs}
 \end{aligned}$$

$$\begin{aligned}
 \text{Change in market value of the company} &= ₹ 1,832.5 \text{ lakhs} - ₹ 1,750 \text{ lakhs} \\
 &= ₹ 82.50 \text{ lakhs}
 \end{aligned}$$

The impact is that the market value of the company has increased by ₹ 82.50 lakhs due to replacement of equity with debt.

(ii) Overall Cost of Capital

$$\begin{aligned}
 \text{Market Value of Equity} &= \text{Market value of levered firm} - \text{Equity repurchased} \\
 &= ₹ 1,832.50 \text{ lakhs} - ₹ 275 \text{ lakhs} = ₹ 1,557.50 \text{ lakhs}
 \end{aligned}$$

$$\begin{aligned}
 \text{Cost of Equity (Ke)} &= (\text{Net Income to equity holders} / \text{Market value of equity}) \times 100 \\
 &= (₹ 321.12 \text{ lakhs} / ₹ 1,557.50 \text{ lakhs}) \times 100 = 20.62\%
 \end{aligned}$$

$$\text{Cost of debt (Kd)} = I(1 - t) = 15(1 - 0.3) = 10.50\%$$

| Components | Amount (₹ In lakhs) | Cost of Capital % | Weight | WACC (Ko) % |
|------------|------------------------|----------------------|--------|----------------|
| Equity | 1,557.50 | 20.62 | 0.85 | 17.53 |
| Debt | 275.00 | 10.50 | 0.15 | 1.58 |
| | 1,832.50 | | 1 | 19.11 |

The impact is that the Overall Cost of Capital or Ko has fallen by 0.89% (20% - 19.11%) due to the benefit of tax relief on debt interest payment.

(iii) Cost of Equity

The impact is that cost of equity has risen by 0.62% (20.62% - 20%) due to the presence of financial risk i.e. introduction of debt in capital structure.

Note: Cost of Capital and Cost of equity can also be calculated with the help of following formulas, though there will be no change in the final answers.

$$\text{Cost of Capital (Ko)} = K_{eu} [1 - (t \times L)] \text{ Where,}$$

$$K_{eu} = \text{Cost of equity in an unlevered company}$$

$$t = \text{Tax rate} \quad L = \frac{\text{Debt}}{\text{Debt} + \text{Equity}}$$

$$\text{So, } K_0 = 0.20 \left[1 - \left(0.3 \times \frac{₹ 275 \text{ Lakhs}}{₹ 1,832.5 \text{ Lakhs}} \right) \right] = 0.191 \text{ or } 19.10\% \text{ (approx.)}$$

$$\text{Cost of Equity (Ke)} = K_{eu} + (K_{eu} - K_d) \frac{\text{Debt}(1-t)}{\text{Equity}}$$

$$K_{eu} = \text{Cost of equity in an unlevered company}$$

$$t = \text{Tax rate}$$

$$K_d = \text{Cost of debt}$$

$$\text{So, } K_e = 0.20 + \left((0.20 - 0.15) \times \frac{₹ 275 \text{ lakhs}(1-0.30)}{₹ 1,557.5 \text{ Lakhs}} \right) = 0.2062 \text{ or } 20.62\%$$

Question 27

The following data relates to two companies belonging to the same risk class:



| Particulars | Bee Ltd. | Cee Ltd. |
|-------------------------------|-------------|------------|
| 12% Debt | ₹ 27,00,000 | - |
| Equity Capitalization Rate | - | 18 |
| Expected Net Operating Income | ₹ 9,00,000 | ₹ 9,00,000 |
| You are required to: | | |

- (a) DETERMINE the total market value, Equity capitalization rate and weighted average cost of capital for each company assuming no taxes as per M.M. Approach.
- (b) DETERMINE the total market value, Equity capitalization rate and weighted average cost of capital for each company assuming 40% taxes as per M.M. Approach. (RTP May 22, PYP 10 Marks Nov '18)(Same concept different figures Old & New SM)

Answer 27

Assuming no tax as per MM Approach.

Calculation of Value of Firms 'Bee Ltd.' and 'Cee Ltd' according to MM Hypothesis Market Value of 'Cee Ltd' [Unlevered(u)]

Total Value of Unlevered Firm (V_u) = $[NOI/K_e] = 9,00,000/0.18 = ₹ 50,00,000$

K_e of Unlevered Firm (given) = 0.18

K_o of Unlevered Firm (Same as above = K_e as there is no debt) = 0.18

Market Value of 'Bee Ltd' [Levered Firm (l)]

Total Value of Levered Firm (VL) = $V_u + (\text{Debt} \times \text{Nil})$
 = ₹ 50,00,000 + (27,00,000 × nil)
 = ₹ 50,00,000

Computation of Equity Capitalization Rate and Weighted Average Cost of Capital (WACC)

| Particulars | Bee Ltd. |
|--|-----------|
| Net Operating Income (NOI) | 9,00,000 |
| Less: Interest on Debt (I) | 3,24,000 |
| Earnings of Equity Shareholders (NI) | 5,76,000 |
| Overall Capitalization Rate (K_o) | 0.18 |
| Total Value of Firm ($V = NOI/K_o$) | 50,00,000 |
| Less: Market Value of Debt | 27,00,000 |
| Market Value of Equity (S) | 23,00,000 |
| Equity Capitalization Rate [$K_e = NI/S$] | 0.2504 |
| Weighted Average Cost of Capital (K_o)* $K_o = (K_e \times S/V) + (K_d \times D/V)$ | 0.18 |

***Computation of WACC Bee Ltd**

| Component of Capital | Amount | Weight | Cost of Capital | WACC |
|----------------------|-----------|--------|-----------------|--------|
| Equity | 23,00,000 | 0.46 | 0.2504 | 0.1152 |
| Debt | 27,00,000 | 0.54 | 0.12* | 0.0648 |
| Total | 50,00,000 | | | 0.18 |

* $K_d = 12\%$ (since there is no tax) WACC = 18%

(b) Assuming 40% taxes as per MM Approach

Calculation of Value of Firms 'Bee Ltd.' and 'Cee Ltd' according to MM Hypothesis Market Value of 'Cee Ltd' [Unlevered(u)]



$$\text{Total Value of unlevered Firm (V}_u\text{)} = [\text{NOI} (1 - t) / K_e] = 9,00,000 (1 - 0.40) / 0.18$$

$$= ₹ 30,00,000$$

K_e of unlevered Firm (given) = 0.18

K_o of unlevered Firm (Same as above = k_e as there is no debt) = 0.18

Market Value of 'Bee Ltd' [Levered Firm (I)]

$$\begin{aligned} \text{Total Value of Levered Firm (V}_L\text{)} &= V_u + (\text{Debt} \times \text{Tax}) \\ &= ₹ 30,00,000 + (27,00,000 \times 0.4) \\ &= ₹ 40,80,000 \end{aligned}$$

Computation of Weighted Average Cost of Capital (WACC) of 'Cee Ltd.'

$$= 18\% \text{ (i.e. } K_e = K_o \text{)}$$

Computation of Equity Capitalization Rate and Weighted Average Cost of Capital (WACC) of Bee Ltd

| Particulars | Bee Ltd. (₹) |
|---|--------------|
| Net Operating Income (NOI) | 9,00,000 |
| Less: Interest on Debt (I) | 3,24,000 |
| Earnings Before Tax (EBT) | 5,76,000 |
| Less: Tax @ 40% | 2,30,400 |
| Earnings for equity shareholders (NI) | 3,45,600 |
| Total Value of Firm (V) as calculated above | 40,80,000 |
| Less: Market Value of Debt | 27,00,000 |
| Market Value of Equity (S) | 13,80,000 |
| Equity Capitalization Rate [$K_e = \text{NI}/S$] | 0.2504 |
| Weighted Average Cost of Capital (K_o)* $K_o = (K_e \times S/V) + (K_d \times D/V)$ | 13.23 |

*Computation of WACC Bee Ltd.

| Component of Capital | Amount | Weight | Cost of Capital | WACC |
|----------------------|-----------|--------|-----------------|--------|
| Equity | 13,80,000 | 0.338 | 0.2504 | 0.0846 |
| Debt | 27,00,000 | 0.662 | 0.072* | 0.0477 |
| Total | 40,80,000 | | | 0.1323 |

$$*K_d = 12\% (1 - 0.4) = 12\% \times 0.6 = 7.2\%$$

$$\text{WACC} = 13.23\%$$

Question 28

ABC Limited provides you the following information:

| | (₹) |
|----------------------------------|----------|
| Profit (EBIT) | 2,80,000 |
| Less: Intt. on Debt @10% | 40,000 |
| EBT | 2,40,000 |
| Less: Income Tax @ 50% | 1,20,000 |
| | 1,20,000 |
| No. of Equity Shares (₹ 10 each) | 30,000 |



| | |
|-------------------------------|----|
| Earnings per share (EPS) | 4 |
| Price / EPS (P/E) Ratio | 10 |
| Ruling Market price per share | 40 |

The company has undistributed reserves of ₹ 7,00,000 and needs ₹ 4,00,000 further for expansion. This investment is expected to earn the same rate as funds already invested. You are informed that a debt equity (debt/ debt +equity) ratio higher than 32% will push the P/E ratio down to 8 and raise the interest rate on additional borrowings (debentures) to 12%. You are required to ASCERTAIN the probable price of the share.

- (i) If the additional funds are raised as debt; and
- (ii) If the amount is raised by issuing equity shares at ruling market price of ₹ 40 per share. (RTP Nov'22)

Answer 28

Ascertainment of probable price of shares

| Particulars | Plan (i) (If ₹ 4,00,000 is raised as debt) (₹) | Plan (ii) (If ₹ 4,00,000 is raised by issuing equity shares) (₹) |
|---|--|--|
| Earnings Before Interest (EBIT) 20% on (14,00,000 + 4,00,000) | 3,60,000 | 3,60,000 |
| Less: Interest on old debentures @ 10% on 4,00,000 | 40,000 | 40,000 |
| | 3,20,000 | 3,20,000 |
| Less: Interest on New debt @ 12% on ₹ 4,00,000 | 48,000 | - |
| Earnings Before Tax (After interest) | 2,72,000 | 3,20,000 |
| Less: Tax @ 50% | 1,36,000 | 1,60,000 |
| Earnings for equity shareholders (EAIT) | 1,36,000 | 1,60,000 |
| Number of Equity Shares (in numbers) | 30,000 | 40,000 |
| Earnings per Share (EPS) | 4.53 | 4.00 |
| Price/ Earnings Ratio | 8 | 10 |
| Probable Price Per Share | 36.24 (8 x 4.53) | 40 (10 x 4) |

Working Notes:

| | (₹) |
|--|--|
| 1. Calculation of Present Rate of Earnings | |
| Equity Share capital (30,000 x ₹ 10) | 3,00,000 |
| 10% Debentures $\left[40,000 \times \frac{100}{10}\right]$ | 4,00,000 |
| Reserves (given) | 7,00,000 |
| | 14,00,000 |
| Earnings before interest and tax (EBIT) given | 2,80,000 |
| Rate of Present Earnings = $\left[\frac{2,80,000}{14,00,000} \times 100\right]$ | 20% |
| 2. Number of Equity Shares to be issued in Plan $\left[\frac{4,80,000}{40}\right]$ | 10,000 |
| Thus, after the issue total number of shares | 30,000 + 10,000 = 40,000 |
| 3. Debt/Equity Ratio if ₹ 4,00,000 is raised as debt: | $\left[\frac{8,00,000}{18,00,000} \times 100\right] =$ 44.44% |



As the debt equity ratio is more than 32% the P/E ratio shall be 8 in plan (i)

Question 29

Current Capital Structure of XYZ Ltd is as follows:

Equity Share Capital of 7 lakh shares of face value ₹ 20 each Reserves of ₹ 10,00,000 9% bonds of ₹ 3,00,00,000

11% preference capital: 3,00,000 shares of face value ₹ 50 each Additional Funds required for XYZ Ltd are ₹ 5,00,00,000.

XYZ Ltd is evaluating the following alternatives:

- I. Proposed alternative I: Raise the funds via 25% equity capital and 75% debt at 10%. PE ratio in such scenario would be 12.
- II. Proposed alternative II: Raise the funds via 50% equity capital and rest from 12% Preference capital .PE ratio in such scenario would be 11.

Any new equity capital would be issued at a face value of ₹ 20 each. Any new preferential capital would be issued at a face value of ₹ 20 each. Tax rate is 34%

DETERMINE the indifference point under both the alternatives. (RTP May 23)

Answer 29

| Current Capital Structure | | |
|------------------------------|----------------|---------------|
| Equity Share Capital | ₹ 20 x 7 lakhs | ₹ 1,40,00,000 |
| Reserves | | ₹ 10,00,000 |
| 9% Bonds | | ₹ 3,00,00,000 |
| 11% Preference Share Capital | ₹ 50 x 3 lakhs | ₹ 1,50,00,000 |
| Total Capital Employed | | ₹ 6,00,00,000 |

Proposed Capital Structure

| Capital | Working | Proposal I | Proposal II |
|-------------------------|----------------|---------------------|---------------------|
| Capital to be raised | | ₹5,00,00,000 | ₹5,00,00,000 |
| Equity | 50000000 x 25% | ₹ 1,25,00,000 | - |
| | 50000000 x 50% | - | ₹ 2,50,00,000 |
| Debt @ 10% | 50000000 x 75% | ₹ 3,75,00,000 | - |
| Preference Shares @ 12% | 50000000 x 50% | - | ₹ 2,50,00,000 |
| Combined Capital | | Amount (proposal 1) | Amount (proposal 2) |
| Equity | | ₹ 2,65,00,000 | ₹ 3,90,00,000 |
| Reserves | | ₹ 10,00,000 | ₹ 10,00,000 |
| 9% Bond | | ₹ 3,00,00,000 | ₹ 3,00,00,000 |
| 10% Debt | | ₹ 3,75,00,000 | - |
| 11% Preference Shares | | ₹ 1,50,00,000 | ₹ 1,50,00,000 |
| 12% Preference Shares | | - | ₹ 2,50,00,000 |
| | | ₹ 11,00,00,000 | ₹ 11,00,00,000 |

Interest for Proposal I = ₹ 3,00,00,000 x 9% + ₹ 3,75,00,000 x 10%

= ₹ 27,00,000 + ₹ 37,50,000

= ₹ 64,50,000

Preference Dividend for Proposal I = ₹ 1,50,00,000 x 11% = ₹ 16,50,000

Interest for Proposal II = ₹ 3,00,00,000 x 9% = ₹ 27,00,000

Preference Dividend for Proposal II = ₹ 1,50,00,000 x 11% + ₹ 2,50,00,000 x 12%
 = ₹ 16,50,000 + ₹ 30,00,000 = ₹ 46,50,000

Let the indifference Point be Rs. X

For Proposal I,

$$EPS = \frac{(X - Rs.64,50,000) \times 0.66 - Rs.16,50,000}{13,25,000} \quad (1)$$

For Proposal II,

$$EPS = \frac{(X - Rs.27,00,000) \times 0.66 - Rs.46,50,000}{19,50,000} \quad (2)$$

Equating (1) and (2),

$$EPS = \frac{(X - Rs.64,50,000) \times 0.66 - Rs.16,50,000}{13,25,000} = \frac{(X - Rs.27,00,000) \times 0.66 - Rs.46,50,000}{19,50,000}$$

$$\frac{0.66X - Rs.42,57,000 - Rs.16,50,000}{1,325} = \frac{0.66X - Rs.17,82,000 - Rs.46,50,000}{1,950}$$

$$\frac{0.66X - Rs.59,07,000}{53} = \frac{0.66X - Rs.64,32,000}{78}$$

$$51.48X - ₹ 46,07,46,000 = 37.98X - ₹ 34,08,96,000$$

$$16.5X = ₹ 11,98,50,000$$

$$\text{Indifference Point} = X = ₹ 72,63,636.36$$

Question 30

The details about two company's R Ltd. and S Ltd. having same operating risk are given below:

| Particulars | R Ltd. | S Ltd. |
|---------------------------------|-------------|-------------|
| Profit before interest and tax | Rs.10 lakhs | Rs.10 lakhs |
| Equity share capital Rs.10 each | Rs.17 lakhs | ₹ 50 lakhs |
| Long term borrowings @ 10% | Rs.33 lakhs | - |
| Cost of Equity (K_e) | 18% | 15% |

You are required to:

- Calculate the value of equity of both the companies on the basis of M.M. Approach without tax.
- Calculate the Total Value of both the companies on the basis of M.M. Approach without tax. (PYP 5 Marks, July'21)

Answer 30

1. Computation of value of equity on the basis of MM approach without tax

| Particulars | R Ltd. (Rs. in lakhs) | S Ltd. (Rs. in lakhs) |
|--|-----------------------|-----------------------|
| Profit before interest and taxes | 10 | 10 |
| Less: Interest on debt (10% × Rs.33,00,000) | 3.3 | - |
| Earnings available to Equity shareholders | 6.7 | 10 |
| K_e | 18% | 15% |
| Value of Equity (Earnings available to Equity shareholders/ K_e) | 37.222 | 66.667 |

2. Computation of total value on the basis of MM approach without tax



| Particulars | R Ltd. (Rs. in lakhs) | S Ltd. (Rs. in lakhs) |
|---|-----------------------|-----------------------|
| Value of Equity (S) (as calculated above) | 37.222 | 66.667 |
| Debt (D) | 33 | - |
| Value of Firm (V) = S + D | 70.222 | 66.667 |

Question 31

RM Steels Limited requires Rs.10,00,000 for construction of a new plant. It is considering three financial plans:

- The company may issue 1,00,000 ordinary shares at Rs.10 per share;
- The company may issue 50,000 ordinary shares at Rs.10 per share and 5000 debentures of Rs.100 denominations bearing an 8 per cent rate of interest; and
- The company may issue 50,000 ordinary shares at Rs.10 per share and 5,000 preference shares at Rs.100 per share bearing an 8 per cent rate of dividend.
- If RM Steels Limited's earnings before interest and taxes are Rs.20,000; Rs.40,000; Rs.80,000; Rs.1,20,000 and Rs.2,00,000, you are required to compute the earnings per share under each of the three financial plans?
- Which alternative would you recommend for RM Steels and why? Tax rate is 50%. (PYP 10 Marks, May'19) (Same concept different figures MTP 10 Marks, March'19)

Answer 31

(i) Computation of EPS under three-financial plans Plan I: Equity Financing

| | (Rs.) | (Rs.) | (Rs.) | (Rs.) | (Rs.) |
|----------------------|----------|----------|----------|----------|----------|
| EBIT | 20,000 | 40,000 | 80,000 | 1,20,000 | 2,00,000 |
| Interest | 0 | 0 | 0 | 0 | 0 |
| EBT | 20,000 | 40,000 | 80,000 | 1,20,000 | 2,00,000 |
| Less: Tax @ 50% | 10,000 | 20,000 | 40,000 | 60,000 | 1,00,000 |
| PAT | 10,000 | 20,000 | 40,000 | 60,000 | 1,00,000 |
| No. of equity shares | 1,00,000 | 1,00,000 | 1,00,000 | 1,00,000 | 1,00,000 |
| EPS | 0.10 | 0.20 | 0.40 | 0.60 | 1 |

Plan II: Debt – Equity Mix

| | (Rs.) | (Rs.) | (Rs.) | (Rs.) | (Rs.) |
|----------------------|------------|--------|--------|----------|----------|
| EBIT | 20,000 | 40,000 | 80,000 | 1,20,000 | 2,00,000 |
| Less: Interest | 40,000 | 40,000 | 40,000 | 40,000 | 40,000 |
| EBT | (20,000) | 0 | 40,000 | 80,000 | 1,60,000 |
| Less: Tax @ 50% | 10,000* | 0 | 20,000 | 40,000 | 80,000 |
| PAT | (10,000) | 0 | 20,000 | 40,000 | 80,000 |
| No. of equity shares | 50,000 | 50,000 | 50,000 | 50,000 | 50,000 |
| EPS | (Rs. 0.20) | 0 | 0.40 | 0.80 | 1.60 |

*The Company can set off losses against the overall business profit or may carry forward it to next financial years.

Plan III: Preference Shares – Equity Mix

| | (Rs.) | (Rs.) | (Rs.) | (Rs) | (Rs.) |
|--|-------|-------|-------|------|-------|
|--|-------|-------|-------|------|-------|



| | | | | | |
|---------------------------|----------|----------|--------|----------|----------|
| EBIT | 20,000 | 40,000 | 80,000 | 1,20,000 | 2,00,000 |
| Less: Interest | 0 | 0 | 0 | 0 | 0 |
| EBT | 20,000 | 40,000 | 80,000 | 1,20,000 | 2,00,000 |
| Less: Tax @ 50% | 10,000 | 20,000 | 40,000 | 60,000 | 1,00,000 |
| PAT | 10,000 | 20,000 | 40,000 | 60,000 | 1,00,000 |
| Less: Pref. dividend | 40,000* | 40,000* | 40,000 | 40,000 | 40,000 |
| PAT after Pref. dividend. | (30,000) | (20,000) | 0 | 20,000 | 60,000 |
| No. of Equity shares | 50,000 | 50,000 | 50,000 | 50,000 | 50,000 |
| EPS | (0.60) | (0.40) | 0 | 0.40 | 1.20 |

* In case of cumulative preference shares, the company has to pay cumulative dividend to preference shareholders, when company earns sufficient profits.

- (ii) From the above EPS computations tables under the three financial plans we can see that when EBIT is Rs.80,000 or more, Plan II: Debt-Equity mix is preferable over the Plan I and Plan III, as rate of EPS is more under this plan. On the other hand, an EBIT of less than Rs.80,000, Plan I: Equity Financing has higher EPS than Plan II and Plan III. Plan III Preference Share Equity mix is not acceptable at any level of EBIT, as EPS under this plan is lower.

The choice of the financing plan will depend on the performance of the company and other macro-economic conditions. If the company is expected to have higher operating profit Plan II: Debt – Equity Mix is preferable. Moreover, debt financing gives more benefit due to availability of tax shield.

Question 32

Sun Ltd. is considering two financing plans. Details of which are as under:

- (i) Fund's requirement – Rs.100 Lakhs

- (ii) Financial Plan

| Plan | Equity | Debt |
|------|--------|------|
| I | 100% | - |
| II | 25% | 75% |

- (iii) Cost of debt – 12% p.a.

- (iv) Tax Rate – 30%

- (v) Equity Share Rs.10 each, issued at a premium of Rs.15 per share

- (vi) Expected Earnings before Interest and Taxes (EBIT) Rs.40 Lakhs

You are required to compute:

- (i) EPS in each of the plan

- (ii) The Financial Break Even Point

- (iii) Indifference point between Plan I and II (PYP 5 Marks, May'18)

Answer 32

- (i) Computation of Earnings Per Share (EPS)

| Plans | I (Rs.Rs.) | II (Rs.) |
|--|-------------|------------|
| Earnings before interest & tax (EBIT) | 40,00,000 | 40,00,000 |
| Less: Interest charges (12% of ₹75 lakh) | -- | (9,00,000) |
| Earnings before tax (EBT) | 40,00,000 | 31,00,000 |
| Less: Tax @ 30% | (12,00,000) | (9,30,000) |



| | | |
|----------------------------------|-----------|-----------|
| Earnings after tax (EAT) | 28,00,000 | 21,70,000 |
| No. of equity shares (@ ₹10+₹15) | 4,00,000 | 1,00,000 |
| E.P.S (Rs.) | 7.00 | 21.70 |

(ii) Computation of Financial Break-even Points

Plan 'I' = 0 – Under this plan there is no interest payment, hence the financial break- even point will be zero.

Plan 'II' = ₹ 9,00,000 - Under this plan there is an interest payment of ₹9,00,000, hence the financial break -even point will be ₹9 lakhs

(iii) Computation of Indifference Point between Plan I and Plan II:

Indifference point is a point where EBIT of Plan-I and Plan-II are equal. This can be calculated by applying the following formula:

$$\{(EBIT - I_1) (1 - T)\} / E_1 = \{(EBIT - I_2) (1 - T)\} / E_2$$

$$SO = \frac{EBIT(1-0.3)}{4,00,000 \text{ Shares}} = \frac{(EBIT - ₹9,00,000)(1-0.3)}{1,00,000 \text{ Shares}}$$

$$\text{Or, } 2.8 \text{ EBIT} - 25,20,000 = 0.7 \text{ EBIT or, } 2.1 \text{ EBIT} = 25,20,000$$

$$\text{EBIT} = 12,00,000$$

Question 33

Earnings before interest and tax of a company are ₹ 4,50,000. Currently the company has 80,000 Equity shares of ₹ 10 each, retained earnings of ₹ 12,00,000. It pays annual interest of ₹ 1,20,000 on 12% Debentures. The company proposes to take up an expansion scheme for which it needs additional fund of ₹ 6,00,000. It is anticipated that after expansion, the company will be able to achieve the same return on investment as at present.

It can raise fund either through debts at rate of 12% p.a. or by issuing Equity shares at par. Tax rate is 40%.

Required:

Compute the earning per share if:

- The additional funds were raised through debts.
- The additional funds were raised by issue of Equity shares.

Advise whether the company should go for expansion plan and which sources of finance should be preferred. (PYP 10 Marks Dec '21)

Answer 33

Working Notes:

(1) Capital employed before expansion plan:

| | (₹) |
|--------------------------------------|------------------|
| Equity shares (₹ 10 × 80,000 shares) | 8,00,000 |
| Debentures {(₹ 1,20,000/12) × 100} | 10,00,000 |
| Retained earnings | 12,00,000 |
| Total capital employed | 30,00,000 |

(2) Earnings before interest and tax (EBIT) = 4,50,000

(3) Return on Capital Employed (ROCE):

$$ROCE = \frac{EBIT}{\text{Capital employed}} \times 100 = \frac{Rs.4,50,000}{Rs.30,00,000} \times 100 = 15\%$$

(4) Earnings before interest and tax (EBIT) after expansion scheme:

After expansion, capital employed = ₹ 30,00,000 + ₹ 6,00,000 = ₹ 36,00,000

Desired EBIT = 15% X ₹ 36,00,000 = ₹ 5,40,000

(i) & (ii) Computation of Earnings Per Share (EPS) under the following options:

| | Present situation | Expansion scheme | |
|---|---|--|--|
| | | Additional funds raised as | |
| | | Debt (i) | Equity (ii) |
| | (₹) | (₹) | (₹) |
| Earnings before Interest and Tax (EBIT) | 4,50,000 | 5,40,000 | 5,40,000 |
| Less: Interest - Old Debt | 1,20,000 | 1,20,000 | 1,20,000 |
| - New Debt | -- | 72,000 (₹ 6,00,000 X 12%) | -- |
| Earnings before Tax (EBT) | 3,30,000 | 3,48,000 | 4,20,000 |
| Less: Tax (40% of EBT) | 1,32,000 | 1,39,200 | 1,68,000 |
| PAT/EAT | 1,98,000 | 2,08,800 | 2,52,000 |
| No. of shares outstanding | 80,000 | 80,000 | 1,40,000 |
| Earnings per Share (EPS) | $2.475 \left(\frac{Rs.1,98,000}{80,000} \right)$ | $2.610 \left(\frac{Rs. 2,08,800}{80,000} \right)$ | $1.800 \left(\frac{Rs. 2,52,000}{80,000} \right)$ |

Advise to the Company: When the expansion scheme is financed by additional debt, the EPS is higher. Hence, the company should finance the expansion scheme by raising debt.

Question 34

The particulars relating to Raj Ltd. for the year ended 31 st March, 2022 are given as follows:

| | |
|-----------------------------------|-------------|
| Output (units at normal capacity) | 1,00,000 |
| Selling price per unit | ₹ 40 |
| Variable cost per unit | ₹ 20 |
| Fixed cost | ₹ 10,00,000 |

The capital structure of the company as on 31st March, 2022 is as follows:

| Particulars | Amount in ₹ |
|---|-------------|
| Equity share capital (1,00,000 shares of ₹ 10 each) | 10,00,000 |
| Reserves and surplus | 5,00,000 |
| Current liabilities | 5,00,000 |
| Total | 20,00,000 |

Raj Ltd. has decided to undertake an expansion project to use the market potential that will involve ₹ 20 lakhs. The company expects an increase in output by 50%. Fixed cost will be increased by ₹ 5,00,000 and variable cost per unit will be decreased by 15%. The additional output can be sold at the existing selling price without any adverse impact on the market.

The following alternative schemes for financing the proposed expansion program are planned:



| | | (Amount in ₹) |
|-------------|-----------|---------------|
| Alternative | Debt | Equity Shares |
| 1 | 5,00,000 | Balance |
| 2 | 10,00,000 | Balance |
| 3 | 14,00,000 | Balance |

Current market price per share is ₹ 200.

Slab wise interest rate for fund borrowed is as follows:

| Fund limit | Applicable interest rate |
|---------------------------------------|--------------------------|
| Up-to ₹ 5,00,000 | 10% |
| Over ₹ 5,00,000 and up-to ₹ 10,00,000 | 15% |
| Over ₹ 10,00,000 | 20% |

Find out which of the above-mentioned alternatives would you recommend for Raj Ltd. with reference to the EPS, assuming a corporate tax rate is 40%? (PYP 10 Marks May'22)

Answer 34

Alternative 1 = Raising Debt of ₹ 5 lakh + Equity of ₹ 15 lakh Alternative 2

=Raising Debt of ₹ 10 lakh + Equity of ₹ 10 lakh Alternative 3=Raising Debt of ₹ 14 lakh + Equity of ₹ 6 lakh Calculation of Earnings per share (EPS)

| Particulars | FINANCIAL ALTERNATIVES | | |
|------------------------------|------------------------|---------------|---------------|
| | Alternative 1 | Alternative 2 | Alternative 3 |
| | (₹) | (₹) | (₹) |
| Expected EBIT [W. N. (a)] | 19,50,000 | 19,50,000 | 19,50,000 |
| Less: Interest [W. N. (b)] | (50,000) | (1,25,000) | (2,05,000) |
| Earnings before taxes (EBT) | 19,00,000 | 18,25,000 | 17,45,000 |
| Less: Taxes @ 40% | 7,60,000 | 7,30,000 | 6,98,000 |
| Earnings after taxes (EAT) | 11,40,000 | 10,95,000 | 10,47,000 |
| Number of shares [W. N. (d)] | 1,07,500 | 1,05,000 | 1,03,000 |
| Earnings per share (EPS) | 10.60 | 10.43 | 10.17 |

Conclusion: Alternative 1 (i.e. Raising Debt of ₹ 5 lakh and Equity of ₹ 15 lakh) is recommended which maximizes the earnings per share.

Working Notes (W.N.):

(a) Calculation of Earnings before Interest and Tax (EBIT)

| Particulars | |
|---|-------------|
| Output (1,00,000 + 50%) (A) | 1,50,000 |
| Selling price per unit | ₹ 40 |
| Less: Variable cost per unit (₹ 20 – 15%) | ₹ 17 |
| Contribution per unit (B) | ₹ 23 |
| Total contribution (A x B) | ₹ 34,50,000 |
| Less: Fixed Cost (₹ 10,00,000 + ₹ 5,00,000) | ₹ 15,00,000 |
| EBIT | ₹ 19,50,000 |

Calculation of interest on Debt



| Alternative | | (₹) | Total (₹) |
|-------------|--------------------|--------|-----------|
| 1 | (₹ 5,00,000 x 10%) | | 50,000 |
| 2 | (₹ 5,00,000 x 10%) | 50,000 | 1,25,000 |
| | (₹ 5,00,000 x 15%) | 75,000 | |
| 3 | (₹ 5,00,000 x 10%) | 50,000 | 2,05,000 |
| | (₹ 5,00,000 x 15%) | 75,000 | |
| | (₹ 4,00,000 x 20%) | 80,000 | |

(b) Number of equity shares to be issued

$$\text{Alternative 1} = \frac{\text{₹ } (20,00,000 - 5,00,000)}{\text{₹ } 200 \text{ (Market price of share)}} = \frac{\text{₹ } 15,00,000}{\text{₹ } 200} = 7,500 \text{ shares}$$

$$\text{Alternative 2} = \frac{\text{₹ } (20,00,000 - 10,00,000)}{\text{₹ } 200 \text{ (Market price of share)}} = \frac{\text{₹ } 10,00,000}{\text{₹ } 200} = 5,000 \text{ shares}$$

$$\text{Alternative 3} = \frac{\text{₹ } (20,00,000 - 14,00,000)}{\text{₹ } 200 \text{ (Market price of share)}} = \frac{\text{₹ } 6,00,000}{\text{₹ } 200} = 3,000 \text{ shares}$$

(c) Calculation of total equity shares after expansion program

| | Alternative 1 | Alternative 2 | Alternative 3 |
|-------------------------------------|---------------|---------------|---------------|
| | 1,00,000 | 1,00,000 | 1,00,000 |
| Add: issued under expansion program | 7,500 | 5,000 | 3,000 |
| Total no. of equity shares | 1,07,500 | 1,05,000 | 1,03,000 |

Question 35

The following are the costs and values for the firms A and B according to the traditional approach.

| | Firm A | Firm B |
|--------------------------------------|--------|--------|
| Total value of firm, V (in ₹) | 50,000 | 60,000 |
| Market value of debt, D (in ₹) | 0 | 30,000 |
| Market value of equity, E (in ₹) | 50,000 | 30,000 |
| Expected net operating income (in ₹) | 5,000 | 5,000 |
| Cost of debt (in ₹) | 0 | 1,800 |
| Net Income (in ₹) | 5,000 | 3,200 |
| Cost of equity, $K_e = NI/V$ | 10.00% | 10.70% |

(i) Compute the Equilibrium value for Firm A and B in accordance with the M-M approach. Assume that (a) taxes do not exist and (b) the equilibrium value of K_e is 9.09%.

(ii) Compute Value of Equity and Cost of Equity for both the firms. (PYP 4 Marks Nov '22)

Answer 35

(i) Computation of Equilibrium value of Firms A & B under MM Approach:

As per MM approach K_o is equal to K_{eu}

$$\therefore K_o = K_{eu} (1 - t) = 9.09 (1 - 0) = 9.09$$

| Particulars | A | B |
|----------------|------|------|
| EBIT (NOI) (₹) | 5000 | 5000 |

| | | |
|--------------------------------------|---------------------------------|---------|
| KO (%) | 9.09 | 9.09 |
| Equilibrium value (₹) (NOI/Ko) X 100 | 55005.5 | 55005.5 |
| $\frac{5,000}{9.09} \times 100$ | $\frac{5,000}{9.09} \times 100$ | |

(ii) Computation of value of equity and cost of equity of Firms A & B

| Particulars | A | B |
|-----------------------|----------|----------|
| Equilibrium value (₹) | 55,005.5 | 55,005.5 |
| Less: Value of Debt | - | 30,000 |
| Value of Equity | 55,005.5 | 25,005.5 |

Cost of Equity of Firm A (unlevered) = 9.09

Cost of Debt of Firm B (K_d) (levered) = $(1800/30000) \times 100 = 6\%$

Cost of Equity of Firm B (Levered) = $K_o + (K_o - K_d) \times (\text{Debt} / \text{Equity})$

$$= 9.09 + (9.09 - 6) \times (30000/25005.5)$$

$$= 9.09 + 3.09 \times 1.2 = 9.09 + 3.71 = 12.80\%$$

(OR)

Cost of Equity of Firm B (Levered) = $\left(\frac{NI}{\text{Value of Equity}} \right) \times 100$

$$= \left(\frac{3200}{25005.5} \right) \times 100 = 12.8\%$$

Question 36

What are the important factors considered for deciding the source and quantum of capital? (PYP 2 Marks Nov '22, Old & New SM)

Answer 36

The source and quantum of capital is decided keeping in mind the following factors:

- Control: Capital structure should be designed in such a manner that existing shareholders continue to hold majority stake
- Risk: Capital structure should be designed in such a manner that financial risk of a company does not increase beyond tolerable limit.
- Cost: Overall cost of capital remains minimum.

Question 37

The following information pertains to CIZA Ltd.:

| | ₹ |
|--|-----------|
| Capital Structure: | |
| Equity share capital (₹ 10 each) | 8,00,000 |
| Retained earnings | 20,00,000 |
| 9% Preference share capital (₹ 100 each) | 12,00,000 |
| 12% Long-term loan | 10,00,000 |
| Interest coverage ratio | 8 |



| | |
|------------------------|-----|
| Income tax rate | 30% |
| Price – earnings ratio | 25 |

The company is proposed to take up an expansion plan, which requires an additional investment of ₹ 34,50,000. Due to this proposed expansion, earnings before interest and taxes of the company will increase by ₹ 6,15,000 per annum. The additional fund can be raised in following manner:

- By issue of equity shares at present market price, or
- By borrowing 16% Long-term loans from bank.

You are informed that Debt-equity ratio (Debt/ Shareholders' fund) in the range of 50% to 80% will bring down the price-earnings ratio to 22 whereas; Debt-equity ratio over 80% will bring down the price-earnings ratio to 18.

Required:

Advise which option is most suitable to raise additional capital so that the Market Price per Share (MPS) is maximized. (PYP 10 Marks May '23)

Answer 37

Working notes:

- (i) Interest Coverage ratio = 8

$$\frac{EBIT}{Interest} = 8$$

$$\frac{EBIT}{1,20,000} = 8$$

So, EBIT = ₹ 9,60,000

- (ii) Proposed Earnings Before Interest & Tax = 9,60,000 + 6,15,000 = ₹ 15,75,000

Option 1: Equity option

Debt = ₹ 10,00,000

Shareholders Fund = 8,00,000+20,00,000+12,00,000+34,50,000 = ₹ 74,50,000

$$\text{Debt Equity ratio(Debt/Shareholders fund)} = \frac{10,00,000}{74,50,000} = 13.42\%$$

P/E ratio in this case will be 25 times

Option 2: Debt option

Debt = 10,00,000+34,50,000 = ₹ 44,50,000

Shareholders Fund = 8,00,000+20,00,000+12,00,000 = ₹ 40,00,000

$$\text{Debt Equity ratio(Debt/Shareholders fund)} = \frac{44,50,000}{40,00,000} = 111.25\%$$

Debt equity ratio has crossed the limit of 80% hence PE ratio in this case will remain at 18 times.

Number of Equity Shares to be issued = ₹ 34,50,000/ ₹ 150 = 23,000

- (iii) Calculation of Earnings per Share and Market Price per share

| Particulars | ₹ |
|--|----------|
| Current Earnings Before Interest & Tax | 9,60,000 |
| Less: Interest | 1,20,000 |

| | |
|--------------------------------------|----------|
| Earnings Before Tax | 8,40,000 |
| Less: Taxes | 2,52,000 |
| Earnings After Tax | 5,88,000 |
| Less: Preference Dividend (@9%) | 1,08,000 |
| Net earnings for Equity shareholders | 4,80,000 |
| Number of equity shares | 80,000 |
| Earnings Per Share | 6 |
| Price-earnings ratio | 25 |
| Market Price per share | 150 |

Calculation of EPS and MPS under two financial options

| Particulars | Financial Options | |
|--|---|---|
| | Option I Equity Shares Issued (₹) | Option II 16% Long Term Debt Raised (₹) |
| Earnings before interest and Tax (EBIT) | 15,75,000 | 15,75,000 |
| Less: Interest on old debentures @ 12% | 1,20,000 | 1,20,000 |
| Less: Interest on additional loan (new) @ 16% on ₹ 34,50,000 | NIL | 5,52,000 |
| Earnings before tax | 14,55,000 | 9,03,000 |
| Less: Taxes @ 30% | 4,36,500 | 2,70,900 |
| (EAT/Profit after tax) | 10,18,500 | 6,32,100 |
| Less: Preference Dividend (@9%) | 1,08,000 | 1,08,000 |
| Net Earnings available to Equity shareholders | 9,10,500 | 5,24,100 |
| Number of Equity Shares | 1,03,000 | 80,000 |
| Earnings per Share (EPS) | 8.84 | 6.55 |
| Price/ Earnings ratio | 25 | 18 |
| Market price per share (MPS) | 221 | 117.9 |

Advise: Equity option has higher Market Price per Share therefore company should raise additional fund through equity option.

Question 38

Briefly explain concept of "Trading on Equity" in financial leverage analysis. (PYP 2 Marks May '23)

Answer 38

Financial Leverage as 'Trading on Equity':

Financial leverage indicates the use of funds with fixed cost like long term debts and preference share capital along with equity share capital which is known as trading on equity. The basic aim of financial leverage is to increase the earnings available to equity shareholders using fixed cost fund. A firm is known to have a positive/favourable leverage when its earnings are more than the cost of debt. If earnings are equal to or less than cost of debt, it will be a negative/unfavourable leverage. When the quantity of fixed cost fund is relatively high in comparison to equity capital it is said that the firm is 'trading on equity'.



Chapter 6 Financing Decisions-Leverages

Question 1: illustration

Following are the selected financial information of A Ltd. and B Ltd. for the year ended March 31st, 2021:

| | A Ltd. | B Ltd. |
|---------------------|----------|------------|
| Variable Cost Ratio | 60% | 50% |
| Interest | ₹ 20,000 | ₹ 1,00,000 |
| Operating Leverage | 5 | 2 |
| Financial Leverage | 3 | 2 |
| Tax Rate | 30% | 30% |

You are required to FIND out:

- EBIT
- Sales
- Fixed Cost
- Identify the company which is better placed with reasons based on leverages. (Old & New SM)(MTP 10 Marks Sep '23)

Answer 1

Company A

$$(i) \text{ Financial Leverage} = \frac{EBIT}{EBT \text{ i.e. } ebit - INTREST}$$

$$\text{So, } 3 = \frac{EBIT}{EBIT - 20,000}$$

$$\text{Or, } 3 (EBIT - 20,000) = EBIT$$

$$\text{Or, } 2 EBIT = 60,000$$

$$\text{Or, } EBIT = 30,000$$

$$(ii) \text{ Operating Leverage} = \frac{\text{Contribution}}{EBIT} \quad \text{Or, } 5 = \frac{\text{contribution}}{Rs. 30,000}$$

$$\text{Or, } \text{Contribution} = ₹ 1,50,000$$

$$\text{Sale} = \frac{\text{Contribution}}{P/V \text{ Ratio } (1 - \text{variable cost ratio})} = \frac{₹ 1,50,000}{40\%} = ₹ 3,75,000$$

$$(iii) \text{ Fixed Cost} = \text{Contribution} - EBIT \\ = ₹ 1,50,000 - 30,000$$

$$\text{Or, Fixed cost} = ₹ 1,20,000$$

Company B

$$i. \text{ Financial Leverage} = \frac{EBIT}{EBT \text{ i.e. } ebit - INTREST}$$

$$\text{So, } 2 = \frac{EBIT}{EBIT - 1,00,000}$$

$$\text{Or, } 2 (EBIT - 1,00,000) = EBIT$$

$$\text{Or, } 2 EBIT - 2,00,000 = EBIT$$

$$\text{Or, } EBIT = ₹ 2,00,000$$



$$\text{ii. Operating Leverage} = \frac{\text{Contribution}}{\text{EBIT}} \quad \text{Or, } 5 = \frac{\text{contribution}}{\text{Rs.2,00,000}}$$

$$\text{Or, Contribution} = ₹ 4,00,000$$

$$\text{Sale} = \frac{\text{Contribution}}{\text{P/V Ratio (1-variable cost ratio)}} = \frac{₹ 4,00,000}{50\%} = ₹ 8,00,000$$

$$\text{iii. Fixed Cost} = \text{Contribution} - \text{EBIT}$$

$$= ₹ 4,00,000 - ₹ 2,00,000$$

$$\text{Or, Fixed cost} = ₹ 2,00,000$$

Income Statements of Company A and Company B

| | Company A (₹) | Company B (₹) |
|---|---------------|---------------|
| Sales | 3,75,000 | 8,00,000 |
| Less: Variable cost | 2,25,000 | 4,00,000 |
| Contribution | 1,50,000 | 4,00,000 |
| Less: Fixed Cost | 1,20,000 | 2,00,000 |
| Earnings before interest and tax (EBIT) | 30,000 | 2,00,000 |
| Less: Interest | 20,000 | 1,00,000 |
| Earnings before tax (EBT) | 10,000 | 1,00,000 |
| Less: Tax @ 30% | 3,000 | 30,000 |
| Earnings after tax (EAT) | 7,000 | 70,000 |

Comment based on Leverage

Comment based on leverage – Company B is better than company A of the following reasons:

- Capacity of Company B to meet interest liability is better than that of companies A (from EBIT/Interest ratio)

$$\left[A \frac{30,000}{20,000} = 1.5, B \frac{2,00,000}{1,00,000} = 2 \right]$$

- Company B has the least financial risk as the total risk (business and financial) of company B is lower (combined leverage of Company A – 15 and Company B- 4)

Question 2

The following information is related to YZ Company Ltd. for the year ended 31st March, 20X8:

| | |
|-------------------------------------|--------------|
| Equity share capital (of ₹ 10 each) | ₹ 50 lakhs |
| 12% Bonds of ₹ 1,000 each | ₹ 37 lakhs |
| Sales | ₹ 84 lakhs |
| Fixed cost (excluding interest) | ₹ 6.96 lakhs |
| Financial leverage | 1.49 |
| Profit-volume Ratio | 27.55% |
| Income Tax Applicable | 40% |

You are required to CALCULATE:

- Operating Leverage;
- Combined leverage; and
- Earnings per share.

(Show calculations up to two decimal points) (MTP 5 Marks Mar'18, Old & New SM, RTP May '20)(Same concept different figures MTP 8 Marks Oct'22)

Answer 2

Computation of Profits after Tax (PAT)

| Particulars | Amount (₹) |
|-------------|------------|
|-------------|------------|



| | |
|--|------------|
| Sales | 84,00,000 |
| Contribution (Sales × P/V ratio) | 23,14,200 |
| Less: Fixed cost (excluding Interest) | (6,96,000) |
| EBIT (Earnings before interest and tax) | 16,18,200 |
| Less: Interest on debentures (12% ₹ ₹37 lakhs) | (4,44,000) |
| Less: Other fixed Interest (balancing figure) | (88,160)* |
| EBT (Earnings before tax) | 10,86,040 |
| Less: Tax @ 40% | 4,34,416 |
| PAT (Profit after tax) | 6,51,624 |

(i) Operating Leverage := $\frac{\text{Contribution}}{\text{EBIT}} = \frac{23,14,200}{16,18,200} = 1.43$

(ii) Combined Leverage := Operating Leverage × Financial Leverage
= 1.43 × 1.49 = 2.13

Or,

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

Or, Combined Leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{\text{Rs.23,14,200}}{\text{Rs.10,86,040}} = 2.13$

Financial Leverage = $\frac{\text{EBIT}}{\text{EBT}} = \frac{\text{Rs.16,18,200}}{\text{Rs.10,86,040}} = 1.49$

So, EBT = $\frac{\text{Rs.16,18,200}}{1.49} = ₹10,86,040$

Accordingly, other fixed interest

(iii) Earnings per share (EPS) := $\frac{\text{PAT}}{\text{No. of shares outstanding}} = \frac{\text{Rs.6,51,624}}{5,00,000 \text{ Equity Shares}} = \text{Rs. 1.30}$

Question 3

From the following, PREPARE Income Statement of Company A and B.

| Company | A | B |
|--|--------------------|-----------|
| Financial leverage | 3:1 | 4:1 |
| Interest | Rs.20,000 | Rs.30,000 |
| Operating leverage | 4:1 | 5:1 |
| Variable Cost as a Percentage to Sales | 66 $\frac{2}{3}$ % | 75% |
| Income tax Rate | 45% | 45% |

(MTP 10 Marks, Aug'18)

Answer 3

Working Notes: Company A

Financial leverage = $\frac{\text{EBT}}{\text{EBT} - \text{Interest}} = \frac{3}{1}$ OR EBT = 3 × EBT (1)

Again EBIT – Interest = EBT
Or, EBIT - 20,000 = EBT (2)

Taking (1) and (2) we get

3 EBT - 20,000 = EBT
Or, 2 EBT = 20,000 or EBT = Rs.10,000
Hence EBIT = 3 EBT = Rs.30,000

Again, we have operating leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{4}{1}$

Again, we have operating leverage

EBIT = Rs. 30,000, hence we get

Contribution = 4 × EBIT = Rs.1,20,000

Now variable cost = 66 $\frac{2}{3}$ % on sales



Contribution = $100 - 66\frac{2}{3}\%$ i.e. $33\frac{1}{3}\%$

Hence, sales = $\frac{1,20,000}{33\frac{1}{3}\%} = \text{Rs. } 3,60,000$

Same way EBIT, EBT, contribution and sales for company B can be worked out.
Company B

Financial leverage = $\frac{\text{EBIT}}{\text{EBT}} = \frac{4}{1}$ or EBIT = 4 EBT (3)

Again EBIT – Interest = EBT or EBIT – 30,000 = EBT (4)

Taking (3) and (4) we get, 4EBT – 30,000 = EBT

Or, 3EBT = 30,000 Or, EBT = 10,000 Hence, EBIT = 4 × EBT = 40,000

Again, we have operating leverage = $\frac{\text{Contribution}}{\text{EBIT}}$

EBIT = 40,000; Hence we get contribution = 5 × EBIT = 2,00,000

Now variable cost = 75% on sales

Contribution = 100 – 75% i.e. 25% on sales

Hence Sales = $\frac{2,00,000}{25\%} = \text{Rs. } 8,00,000$

Income Statement

| | A (Rs.) | B (Rs.) |
|-----------------------------|----------|----------|
| Sales | 3,60,000 | 8,00,000 |
| Less: Variable Cost | 2,40,000 | 6,00,000 |
| Contribution | 1,20,000 | 2,00,000 |
| Less: Fixed Cost (bal. Fig) | 90,000 | 1,60,000 |
| EBIT | 30,000 | 40,000 |
| Less: Interest | 20,000 | 30,000 |
| EBT | 10,000 | 10,000 |
| Less: Tax 45% | 4,500 | 4,500 |
| EAT | 5,500 | 5,500 |

Question 4

NSG Ltd. has a sale of Rs.75,00,000, variable cost of Rs.42,00,000 and fixed cost of Rs.6,00,000. The Present capital structure of NSG is as follows:

| | |
|---------------|-----------------|
| Equity Shares | Rs. 55,00,000 |
| Debt (12%) | Rs. 45,00,000 |
| Total | Rs. 1,00,00,000 |

- DETERMINE the ROCE of NSG Ltd.
- Does NSG have a favourable financial leverage? ANALYSE.
- If the industry average of asset turnover is 3, does it have a high or low asset leverage?

DETERMINE

- COMPUTE the leverages of NSG?
- DETERMINE, at what level of sales, will the EBT be zero? (MTP 5 Marks ,Oct'18)

Answer 4

i) $\text{ROCE} = \frac{\text{EBIT}}{\text{Capital employed}} = \frac{\text{Rs } 27,00,000}{\text{Rs. } 1,00,00,000} \times 100 = 27\%$

Workings:

| (I) Calculation of EBT: | Rs. |
|--|-----------|
| Sales | 75,00,000 |
| Less: Variable costs | 42,00,000 |
| Contribution | 33,00,000 |
| Less: Fixed costs | 6,00,000 |
| EBIT | 27,00,000 |
| Less: Interest (12 % of Rs. 45,00,000) | 5,40,000 |
| EBT | 21,60,000 |

Capital employed = Debt + Equity Shares = Rs. 1,00,00,000.

Since ROCE (27%) is higher than the interest payable on debt (12%). NSG has a favourable financial leverage.

Capital employed = Total assets = Rs. 1,00,00,000 Net sales = Rs.75,00,000

Therefore, turnover ratio = $\frac{\text{Rs. 75,00,000}}{\text{Rs. 1,00,00,000}} = 0.75$

The industry average is 3 against NSG's ratio of 0.75. Hence NSG Ltd. has very low asset leverage.

Operating leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{\text{Rs. 33,00,000}}{\text{Rs. 27,00,000}} = 1.22$

Financial Leverage = $\frac{\text{EBIT}}{\text{EBT}} = \frac{\text{Rs. 27,00,000}}{\text{Rs. 21,60,000}} = 1.25$

Combined leverage = $\frac{\text{Contribution}}{\text{EBT}} = \frac{\text{Rs. 33,00,000}}{\text{Rs. 21,60,000}} = 1.53$

OR

DCL = DOL × DFL = 1.22 × 1.25 = 1.53

For EBT to become zero, a 100% reduction in the EBT is required. As the combined leverage is 1.53, sales have to drop approx. by $100/1.53 = 65.36\%$. Hence, the new sales will be:

Rs. 75,00,000 × (1 – 0.6536) = Rs. 25,98,000 (approx.)

Question 5

EXPLAIN the difference between Business risk and Financial risk [MTP 4 Marks, March'19 & Sep '23]

Answer 5

Business Risk and Financial Risk

Business risk refers to the risk associated with the firm's operations. It is an unavoidable risk because of the environment in which the firm has to operate and the business risk is represented by the variability of earnings before interest and tax (EBIT). The variability in turn is influenced by revenues and expenses. Revenues and expenses are affected by demand of firm's products, variations in prices and proportion of fixed cost in total cost.

Whereas, Financial risk refers to the additional risk placed on firm's shareholders as a result of debt use in financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity. Financial risk can be measured by ratios such as firm's financial leverage multiplier, total debt to assets ratio etc.

Question 6

The capital structure of Anshu Ltd. as at 31.3.2019 consisted of ordinary share capital of Rs. 5,00,000 (face value Rs. 100 each) and 10% debentures of Rs. 5,00,000 (Rs. 100 each). In the year ended with March 2019, sales decreased from 60,000 units to 50,000 units. During this year and in the previous year, the selling price was Rs. 12 per unit; variable cost stood at Rs. 8 per unit and fixed expenses were at Rs. 1,00,000 p.a. The income tax rate was 30%.



You are required to CALCULATE the following:

- The percentage of decrease in earnings per share.
- The degree of operating leverage at 60,000 units and 50,000 units.
- The degree of financial leverage at 60,000 units and 50,000 units. (MTP 6 Marks ,April '19)

Answer 6

| Sales in units | 60,000 Rs. | 50,000 Rs. |
|------------------------|---------------|---------------|
| Sales Value | 7,20,000 | 6,00,000 |
| Variable Cost | (4,80,000) | (4,00,000) |
| Contribution | 2,40,000 | 2,00,000 |
| Fixed expenses | 1,00,000 | 1,00,000 |
| EBIT | 1,40,000 | 1,00,000 |
| Debenture Interest | (50,000) | (50,000) |
| EBT | 90,000 | 50,000 |
| Tax @ 30% | (27,000) | (15,000) |
| Profit after tax (PAT) | 63,000 | 35,000 |

(i) Earning per share (EPS) = $\frac{63,000}{5000}$ = Rs.12.6

$\frac{35,000}{5,000}$ = Rs.7

= Decrease in EPS = 12.6 – 7 = 5.6

% decrease in EPS = $\frac{5.6}{12.6} \times 100$ = 44.44%

(ii) operating leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{2,40,000}{1,40,000} = \frac{2,00,000}{1,00,000} = 1.71$

(iii) Financial Leverage = $\frac{\text{EBIT}}{\text{EBT}} = \frac{1,40,000}{90,000} = \frac{1,00,000}{50,000} = 1.56$

Question 7

BLLP. has the following balance sheet and Income statement information:

Balance Sheet as on March 31st 2019

| Liabilities | (Rs.) | Assets | (Rs.) |
|-------------------|-------------|-------------------|-------------|
| Partners' Capital | 80,00,000 | Net Fixed Assets | 1,00,00,000 |
| Term Loan | 60,00,000 | Inventories | 45,00,000 |
| Retained Earnings | 35,00,000 | Trade Receivables | 40,50,000 |
| Trade Payables | 15,00,000 | Cash & Bank | 4,50,000 |
| | 1,90,00,000 | | 1,90,00,000 |

Income Statement for the year ending March 31st 2019

| | (Rs.) |
|--|-----------|
| Sales | 34,00,000 |
| Operating expenses (including Rs. 6,00,000 depreciation) | 12,00,000 |
| EBIT | 22,00,000 |
| Less: Interest | 6,00,000 |

| | |
|---------------------|-----------|
| Earnings before tax | 16,00,000 |
| Less: Taxes | 5,60,000 |
| Net Earnings (EAT) | 10,40,000 |

COMPUTE the degree of operating, financial and combined leverages at the current sales level, if all operating expenses, other than depreciation, are variable costs.[MTP 3 Marks Oct'19]

Answer 7

Computation of Degree of Operating (DOL), Financial (DFL) and Combined leverages (DCL).

$$DOL = \frac{Rs.34,00,000 - Rs.6,00,000}{Rs.22,00,000} = 1.27$$

$$DFL = \frac{Rs.22,00,000}{Rs.16,00,000} = 1.38$$

$$DCL = DOL \times DFL = 1.27 \times 1.38 = 1.75$$

Question 8

The data relating to two companies are as given below:

| | Company A | Company B |
|--------------------------|----------------|----------------|
| Equity Capital | Rs.6,00,00,000 | Rs.3,50,00,000 |
| 15% Debentures | Rs.40,00,000 | Rs.65,00,000 |
| Output (units) per annum | 6,00,000 | 1,50,000 |
| Selling price/ unit | Rs.60 | Rs.500 |
| Fixed Costs per annum | Rs.70,00,000 | Rs.1,40,00,000 |
| Variable Cost per unit | Rs.30 | Rs.275 |

You are required to CALCULATE the Operating leverage, Financial leverage and Combined leverage of the two Companies.(MTP 5 Marks 'May'20)

Answer 8

Computation of Operating leverage, Financial leverage and Combined leverage of two companies

| | Company A | Company B |
|--|---|--|
| Output units per annum | 6,00,000 | 1,50,000 |
| | (Rs.) | (Rs.) |
| Selling price / unit | 60 | 500 |
| Sales revenue | 3,60,00,000 (6,00,000 units X Rs.60) | 7,50,00,000 (1,50,000 units X Rs.500) |
| Less: Variable costs | 1,80,00,000 (6,00,000 units X Rs.30) | 4,12,50,000 (1,50,000 units X Rs.275) |
| Contribution (C) | 1,80,00,000 | 3,37,50,000 |
| Less: Fixed costs | 70,00,000 | 1,40,00,000 |
| EBIT (Earnings before Interest and tax) | 1,10,00,000 | 1,97,50,000 |
| Less: Interest @ 15% on debentures | 6,00,000 | 9,75,000 |
| PBT | 1,04,00,000 | 1,87,75,000 |
| Operating Leverage = Contribution / EBIT | 1.64 (Rs.1,80,00,000 ÷ 1,10,00,000) | 1.71 (Rs.3,37,50,000 ÷ Rs. 1,97,50,000) |

| | | |
|--------------------------------------|---|---|
| Financial Leverage = EBIT/ PBT | 1.06 (Rs.1,10,00,000 ÷ Rs.1,04,00,000) | 1.05 (Rs.1,97,50,000 ÷ Rs. 1,87,75,000) |
| Combined Leverage = DOL X DFL | 1.74 (1.64 X 1.06) | 1.80 (1.71 X 1.05) |

Question 9

Following Balance Sheet and Income Statement have been obtained from the books of accounts of Benaca Pvt. Ltd.

Balance Sheet as on March 31st 2020

| Liabilities | Amount (₹) | Assets | Amount (₹) |
|--------------------------------|-------------|------------------|-------------|
| Equity Capital (₹10 per share) | 80,00,000 | Net Fixed Assets | 1,00,00,000 |
| 10% Debt | 60,00,000 | Current Assets | 90,00,000 |
| Retained Earnings | 35,00,000 | | |
| Current Liabilities | 15,00,000 | | |
| | 1,90,00,000 | | 1,90,00,000 |

Income Statement for the year ending March 31st 2020

| Particulars | Amount (₹) |
|--|-------------|
| Sales | 34,00,000 |
| Less: Operating expenses (including ₹ 6,00,000 depreciation) | (12,00,000) |
| EBIT | 22,00,000 |
| Less: Interest | (6,00,000) |
| Earnings before tax | 16,00,000 |

The tax rate applicable to the company is 35 percent.

- DETERMINE the degree of operating, financial and combined leverages at the current sales level, if all operating expenses, other than depreciation, are variable costs.
- If total assets remain at the same level, but sales (i) increase by 20 percent and (ii) decrease by 20 percent, COMPUTE the earnings per share at the new sales level? [MTP 8 Marks, Oct'20, Old & New SM)

Answer 9

- Degree of operating, financial and combined leverages at the current sales level-

$$\text{DOL} = \frac{\text{Contribution}}{\text{EBIT}}$$

$$= \frac{\text{Rs.}34,00,000 - \text{Rs.}6,00,000}{\text{RS.}22,00,000} = 1.27$$

$$\text{DFL} = \frac{\text{EBIT}}{\text{EBT}} = \frac{\text{Rs.}22,00,000}{\text{RS.}16,00,000} = 1.375$$

$$\text{DCL} = \text{DOL} \times \text{DFL} = 1.27 \times 1.38 = 1.75$$

- Earnings per share at the new sales level
(Amount in ₹)

| Particulars | Increase by 20% | Decrease by 20% |
|------------------------------------|-----------------|-----------------|
| Sales level | 40,80,000 | 27,20,000 |
| Less: Variable expenses | 7,20,000 | 4,80,000 |
| Less: Fixed cost | 6,00,000 | 6,00,000 |
| Earnings before interest and taxes | 27,60,000 | 16,40,000 |



| | | |
|----------------------------|-----------|-----------|
| Less: Interest | 6,00,000 | 6,00,000 |
| Earnings before taxes | 21,60,000 | 10,40,000 |
| Less: Taxes @35% | 7,56,000 | 3,64,000 |
| Earnings after taxes (EAT) | 14,04,000 | 6,76,000 |
| Number of equity shares | 8,00,000 | 8,00,000 |
| EPS | 1.76 | 0.85 |

Working Notes:

Variable Costs = ₹ 6,00,000 (total cost - depreciation)

Variable Costs at:

- (i) Sales level, ₹ 40,80,000 = ₹ 7,20,000 (increase by 20%)
- (ii) Sales level, ₹ 27,20,000 = ₹ 4,80,000 (decrease by 20%)

Question 10

Following information are related to four firms of the same industry:

| Firm | Change in Revenue | Change in Operating Income | Change in Earning Share |
|------|-------------------|----------------------------|-------------------------|
| P | 25% | 23% | 30% |
| Q | 27% | 30% | 26% |
| R | 24% | 36% | 20% |
| S | 20% | 30% | 20% |

For all the firms, FIND OUT:

- (i) Degree of operating leverage, and
- (ii) Degree of combined leverage. (MTP 5 Marks , March 21, Old & New SM)

Answer 10

Calculation of Degree of Operating leverage and Degree of Combined leverage

| Firm | Degree of Operating Leverage (DOL) = % change in Operating Income % change in Revenue | Degree of Combined Leverage (DCL) = % change in EPS % change in Revenue |
|------|---|---|
| P | $\frac{23\%}{25\%} = 0.92$ | $\frac{30\%}{35\%} = 1.2$ |
| Q | $\frac{30\%}{27\%} = 1.11$ | $\frac{26\%}{27\%} = 0.96$ |
| R | $\frac{36\%}{24\%} = 1.50$ | $\frac{20\%}{24\%} = 0.83$ |
| S | $\frac{30\%}{20\%} = 1.50$ | $\frac{20\%}{20\%} = 1.00$ |

Question 11

Following data of MT Ltd. under Situations 1, 2 and 3 and Financial Plan A and B is given:



| | |
|-------------------------------------|-------|
| Actual Production and Sales (units) | 2,400 |
| Selling price per unit (Rs.) | 30 |
| Variable cost per unit (Rs.) | 20 |
| Fixed Costs (Rs.): Situation 1 | 3,000 |
| Situation 2 | 6,000 |
| Situation 3 | 9,000 |

Capital Structure :

| Particulars | Financial Plan | |
|--------------|-------------------|------------------|
| | A | B |
| Equity Debt | Rs. 15,000 | Rs. 22,500 |
| Cost of Debt | Rs. 15,000 12% | Rs. 7,500 12% |

Required:

- CALCULATE the operating leverage and financial leverage.
- FIND out the combinations of operating and financial leverage which give the highest value and the least value.(MTP 10 Marks, April'21)

Answer 11

(i) Operating Leverage

| | Situation 1 | Situation 2 | Situation 3 |
|--|--|--|--|
| | (Rs.) | (Rs.) | (Rs.) |
| Sales (S) | | | |
| 2,400 units @ Rs. 30 per unit | 72,000 | 72,000 | 72,000 |
| Less: Variable Cost (VC) @ Rs. 20 per unit | 48,000 | 48,000 | 48,000 |
| Contribution (C) | 24,000 | 24,000 | 24,000 |
| Less: Fixed Cost (FC) | 3,000 | 6,000 | 9,000 |
| EBIT | 21,000 | 18,000 | 15,000 |
| Operating Leverage = $\frac{C}{EBIT}$ | $\frac{Rs. 24,000}{Rs. 21,000}$ =1.14 | $\frac{Rs. 24,000}{Rs. 18,000}$ =1.33 | $\frac{Rs. 24,000}{Rs. 15,000}$ =1.60 |

Financial Leverage

| | Financial Plan | |
|--|---|--|
| | A (Rs.) | B (Rs.) |
| Situation 1 | | |
| EBIT | 21,000 | 21,000 |
| Less: Interest on debt (Rs. 15,000 x 12%);(Rs. 7,500 x 12%) | 1,800 | 900 |
| EBT | 19,200 | 20,100 |
| Financial Leverage = EBIT / EBT | $\frac{Rs. 21,000}{Rs. 19,200}$ = 1.09 | $\frac{Rs. 21,000}{Rs. 20,100}$ =1.04 |
| Situation 2 | | |
| EBIT | 18,000 | 18,000 |
| Less: Interest on debt | 1,800 | 900 |
| EBT | 16,200 | 17,100 |
| Financial Leverage = EBIT / EBT | $\frac{Rs. 18,000}{Rs. 16,200}$ =1.11 | $\frac{Rs. 18,000}{Rs. 17,100}$ =1.05 |

| | | |
|---|---|---|
| Situation 3 | | |
| EBIT | 15,000 | 15,000 |
| Less: Interest on debt | 1,800 | 900 |
| EBT | 13,200 | 14,100 |
| Financial Leverage = $\frac{EBIT}{EBT}$ | $\frac{Rs. 15,000}{Rs. 13,200}$ = 1.14 | $\frac{Rs. 15,000}{Rs. 14,100}$ = 1.06 |

Combined Leverages

CL = OL x FL

| | Financial Plan | |
|-----------------|--------------------|--------------------|
| | A (Rs.) | B (Rs.) |
| (a) Situation 1 | 1.14 x 1.09 = 1.24 | 1.14 x 1.04 = 1.19 |
| (b) Situation 2 | 1.33 x 1.11 = 1.48 | 1.33 x 1.05 = 1.40 |
| (c) Situation 3 | 1.60 x 1.14 = 1.82 | 1.60 x 1.06 = 1.70 |

The above calculations suggest that the highest value is in Situation 3 financed by Financial Plan A and the lowest value is in the Situation 1 financed by Financial I Plan B.

Question 12

The following details of PQR Limited for the year ended 31st March, 2021 are given below:

| | |
|-----------------------------------|---------------|
| Operating leverage | 1.4 |
| Combined leverage | 2.8 |
| Fixed Cost (Excluding interest) | ₹ 2.10 lakhs |
| Sales | ₹ 40.00 lakhs |
| 10% Debentures of ₹ 100 each | ₹ 25.00 lakhs |
| Equity Share Capital of ₹ 10 each | ₹ 20.00 lakhs |
| Income tax rate | 30 per cent |

REQUIRED:

- Calculate Financial leverage
- Calculate P/V ratio and Earning per Share (EPS)
- If the company belongs to an industry, whose assets turnover is 1.6, does it have a high or low assets turnover?
- At what level of sales, the Earning before Tax (EBT) of the company will be equal to zero? In the question, assume that 10% Debentures and Share Capital consists of total liabilities [MTP 8 Marks, Oct'21] (Same concept different figures Old & New SM)

Answer 12

(i) Financial leverage

Combined Leverage = Operating Leverage x Financial Leverage

So, financial leverage = Combined Leverage/Operating Leverage

$$= 2.8/1.4 = 2$$

(ii) P/V Ratio and EPS

Operating Leverage = $\frac{\text{Contribution}}{\text{Contribution} - \text{Fixed Cost}}$

$$1.4 = \frac{\text{Contribution}}{\text{Contribution} - 2,10,000}$$

$$1.4 \text{ Contribution} - 2,94,000 = \text{Contribution}$$

$$0.4 \text{ Contribution} = 2,94,000 \text{ Contribution} = 7,35,000$$

$$\text{Now, P/V Ratio} = \frac{\text{Contribution}}{\text{Sales}} \times 100 = \frac{7,35,000}{40,00,00} \times 100 = 18.375\%$$

$$EPS = \frac{\text{Profit after tax (PAT)}}{\text{No. of equity shares}}$$

- (iii) **Earning before tax (EBT)** = Contribution – Fixed Cost – Interest
 = 7,35,000 – 2,10,000 – 2,50,000
 = 2,75,000
 Profit after tax = EBT – Tax @ 30%
 = 2,75,000 – 82,500
 = 1,92,500
 $EPS = \frac{1,92,500}{20,00,00} = 0.9625$

Asset Turnover

Total Assets = Equity Share Capital + Debentures = ₹ 20 lakhs + ₹ 25 lakhs = ₹ 45 lakhs

$$\text{Asset Turnover} = \frac{\text{Sales}}{\text{Total Assets}} = \frac{40,00,000}{45,00,000} = 0.89$$

0.89 < 1.6, means lower than industry turnover.

- (iv) EBT zero means 100% reduction in EBT. Since combined leverage is 2.8, sales have to be dropped by 100/2.8 = 35.71%. Hence new sales will be
 40,00,000 × (100% - 35.71%) = 25,71,600

Question 13

The capital structure of Roshan Ltd. for the year ended 31st March, 2022 consisted as follows:

| Particulars | Amount (₹' 000) |
|--|-----------------|
| Equity share capital (face value ₹ 100 each) | 1,50,000 |
| 10% debentures (₹ 100 each) | 1,50,000 |

During the year 2021-22, sales of the company decreased to 15,00,000 units as compared to 18,00,000 units in the previous year. However, the selling price stood at ₹ 120 per unit and variable cost at ₹ 80 per unit for both the years. The fixed expenses were at ₹ 3 crore p.a. and the income tax rate is 30%.

You are required to CALCULATE the following:

- The degree of financial leverage at 18,00,000 units and 15,00,000 units.
- The degree of operating leverage at 18,00,000 units and 15,00,000 units.
- The percentage change in EPS. (MTP 5 Marks March 22 & Oct '23)(Similar concept to 5 Marks Nov 21, Old & New SM, RTP Nov '20)

Answer 13

Income Statement with required calculations

| Particulars | Previous Year | Current Year |
|--------------------|---------------|--------------|
| Sales (in units) | 18,00,000 | 15,00,000 |
| No. of shares | 15,00,000 | 15,00,000 |
| | (₹' 000) | (₹' 000) |
| Sales Value | 2,16,000 | 1,80,000 |
| Variable Cost | (1,44,000) | (1,20,000) |
| Contribution | 72,000 | 60,000 |
| Fixed expenses | (30,000) | (30,000) |
| EBIT | 42,000 | 30,000 |
| Debenture Interest | (15,000) | (15,000) |



| | | |
|---|---|---|
| EBT | 27,000 | 15,000 |
| Tax @ 30% | (8,100) | (4,500) |
| Profit after tax (PAT) | 18,900 | 10,500 |
| (i) Financial Leverage $= \frac{EBIT}{EBT}$ | $= \frac{Rs.42,000}{Rs.27,000}$ $= 1.56$ | $\frac{Rs. 30,000}{Rs 15,000}$ $= 2$ |
| (ii) Operating leverage $= \frac{Contribution}{EBIT}$ | $\frac{Rs. 72,000}{Rs 42,000}$ $= 1.71$ | $\frac{Rs. 60,000}{Rs 30,000}$ $= 2$ |
| (iii) Earnings per share (EPS) $= \frac{PAT}{No.of\ Shares}$ | $\frac{Rs. 18,900}{Rs. 1,500}$ $= ₹ 12.6$ | $= \frac{Rs.10,500}{Rs.1,500}$ $= ₹ 7$ |
| Decrease in EPS | $= ₹ 12.6 - ₹ 7 = ₹ 5.6$ $\% \text{ decrease in EPS } 5.6 / 12.6 = 100$ $= 44.44\%$ | |

Question 14

From the given details, PREPARE Income Statement for Alpha Ltd. and Beta Ltd. (MTP 5 Marks April 22)

| Particulars | Alpha Ltd. | Beta Ltd. |
|--------------------|------------|------------|
| Operating Leverage | 1.875 | 1.800 |
| Financial Leverage | 1.600 | 1.250 |
| PV Ratio | 60% | 50% |
| Profit after tax | ₹ 3,00,000 | ₹ 2,40,000 |
| Tax rate | 40% | 40% |

Answer 14

| Particulars | Alpha Ltd. (₹) | Beta Ltd. (₹) | |
|---------------------|----------------|---------------|-------------|
| Sales | 25,00,000 | 18,00,000 | (Bal. fig.) |
| Less: Variable Cost | 10,00,000 | 9,00,000 | |
| Contribution | 15,00,000 | 9,00,000 | |
| Less: Fixed Cost | 7,00,000 | 4,00,000 | (Bal. fig.) |
| EBIT | 8,00,000 | 5,00,000 | |
| Less: Interest | 3,00,000 | 1,00,000 | (Bal. fig.) |
| PBT | 5,00,000 | 4,00,000 | |
| Less: Tax (40%) | 2,00,000 | 1,60,000 | |
| PAT | 3,00,000 | 2,40,000 | |

Working Note:

| Particulars | Alpha Ltd. | Beta Ltd. |
|--------------|------------|------------|
| PAT | ₹ 3,00,000 | ₹ 2,40,000 |
| Tax Rate (t) | 40% | 40% |

| | | |
|---|-------------------------------------|-----------------------------------|
| $\therefore \text{PBT} = \text{PAT} / (1-t)$ | $3,00,000 / 1-0.4 = 5,00,000$ | $2,40,000 / 1-0.4 = 4,00,000$ |
| Finance Leverage | 1.60 | 1.25 |
| $\therefore \text{EBIT} = \text{PBT} \times \text{FL}$ | $5,00,000 \times 1.6 = 8,00,000$ | $4,00,000 \times 1.25 = 5,00,000$ |
| Operating Leverage | 1.875 | 1.800 |
| $\therefore \text{Contribution} = \text{EBIT} \times \text{OL}$ | $8,00,000 \times 1.875 = 15,00,000$ | $5,00,000 \times 1.8 = 9,00,000$ |
| PV ratio | 60% | 50% |
| $\therefore \text{Sales} = \text{Contribution} / \text{PV ratio}$ | $15,00,000 / .60 = 25,00,000$ | $9,00,000 / .50 = 18,00,000$ |

Question 15

Operating risk is associated with cost structure, whereas financial risk is associated with capital structure of a business concern.” Critically EXAMINE this statement. (MTP 3 Marks April 22, Old & New SM)

Answer 15

“Operating risk is associated with cost structure whereas financial risk is associated with capital structure of a business concern”.

Operating risk refers to the risk associated with the firm’s operations. It is represented by the variability of earnings before interest and tax (EBIT). The variability in turn is influenced by revenues and expenses, which are affected by demand of firm’s products, variations in prices and proportion of fixed cost in total cost. If there is no fixed cost, there would be no operating risk. Whereas financial risk refers to the additional risk placed on firm’s shareholders as a result of debt and preference shares used in the capital structure of the concern. Companies that issue more debt instruments would have higher financial risk than companies financed mostly by equity.

Question 16

Following information is provided relating to SVB Ltd.:

Sales price ₹ 21 per unit

Variable cost ₹ 13.50 per unit

Break-even point 30,000 units

You are required to CALCULATE operating leverage at sales volume 37,500 units and 45,000 units. (MTP 5 Marks Sep’22)

Answer 16
Computation of Operating Leverage (OL)

Selling Price = ₹ 21 per unit Variable Cost = ₹ 13.50 per unit

Fixed Cost = BEP \times (Selling price – Variable cost) = $30,000 \times (21 - 13.50) = 30,000 \times 7.5 = 2,25,000$

| Particulars | For 37,500 units (₹) | For 45,000 units (₹) |
|---|----------------------|----------------------|
| Sales (@ ₹ 21 /unit) | 7,87,500 | 9,45,000 |
| Less: Variable Cost (@ 13.50 /unit) | 5,06,250 | 6,07,500 |
| Contribution | 2,81,250 | 3,37,500 |
| Less: Fixed Cost | 2,25,000 | 2,25,000 |
| Earnings before Interest and tax (EBIT) | 56,250 | 1,12,500 |

| | | |
|---|---------------------------|-------------------------------|
| Operating Leverage $\left[\frac{\text{Contribution}}{\text{EBIT}} \right]$ | $\frac{2,81,250}{56,250}$ | $\frac{3,37,500}{(1,12,500)}$ |
| Operating Leverage | 5 times | 3 times |

Question 17

Following are the selected financial information of Alt Car Limited for the year ended 31st March 2022:

| | |
|--|----------|
| Financial Leverage | 3 |
| Interest | ₹ 85,000 |
| Operating Leverage | 2 |
| Variable cost as a percentage of sales | 85% |
| Income tax rate | 25% |

You are required to PREPARE the Income Statement. (MTP 5 Marks March '23) (Same concept different figures MTP 5 Marks Mar'19)

Answer 17

(i) Financial Leverage = $\frac{\text{EBIT}}{\text{EBIT} - \text{Interest}}$

Or, $3 = \frac{\text{EBIT}}{\text{EBIT} - \text{Interest}}$

Or, $3 = \frac{\text{EBIT}}{\text{EBIT} - \text{Interest}}$

Or, EBIT = ₹1,27,500

(ii) Operating Leverage = $\frac{\text{Contribution}}{\text{EBIT}}$

Or, $= \frac{\text{Contribution}}{1,27,500} = 2$

Or, Contribution = ₹ 2,55,000

(iii) Sales = $\frac{\text{Contribution}}{\frac{P}{v} \text{ Ratio}} = \frac{2,55,000}{15\%} = \text{Rs. } 17,00,000$

(iv) Now, Contribution – Fixed cost = EBIT

Or ₹ 2,55,000 – Fixed cost = ₹1,27,500

Or Fixed Cost = ₹1,27,500

Income Statement for the year ended 31st March 2022

| Particulars | ₹ |
|---|-------------|
| Sales | 17,00,000 |
| Less: Variable Cost (85% of Rs.17,00,000) | (14,45,000) |
| Contribution | 2,55,000 |
| Less: Fixed Cost (Contribution - EBIT) | (1,27,500) |
| Earnings Before Interest and Tax (EBIT) | 1,27,500 |
| Less: Interest | (85,000) |
| Earnings Before Tax (EBT) | 42,500 |
| Less: Income Tax @ 25% | (10,625) |

| | |
|---------------------------------|--------|
| Earnings After Tax (EAT or PAT) | 31,875 |
|---------------------------------|--------|

Question 18

Manchow Limited and Noodles Limited are generating same level of Operating Income. The margin of safety for Manchow Ltd is 0.4 and for Noodles Limited it is 1.25 times of Manchow Ltd. The Interest expense of Manchow Limited is ₹ 22,50,000 and it is 40% lower for Noodles Limited. Financial Leverages of Manchow Limited and Noodles Limited are 3 and 2 respectively. Profit Volume Ratio for both companies stand as 40% and 50% respectively. Assuming a tax rate of 30%, PREPARE income statement for both companies (MTP 5 Marks April '23, RTP May 22)

Answer 18

| Particulars | Manchow Ltd (₹) | Noodle Ltd (₹) |
|---------------------|-----------------|----------------|
| Sales | 2,10,93,750 | 1,08,00,000 |
| Less: Variable Cost | 1,26,56,250 | 54,00,000 |
| Contribution | 84,37,500 | 54,00,000 |
| Less: Fixed Cost | 50,62,500 | 27,00,000 |
| EBIT | 33,75,000 | 27,00,000 |
| Less: Interest | 22,50,000 | 13,50,000 |
| EBT | 11,25,000 | 13,50,000 |
| Less: Tax | 3,37,500 | 4,05,000 |
| PAT | 7,87,500 | 9,45,000 |

Workings:
(i) Margin of Safety

For Manchow Ltd= 0.4

For Noodles Ltd= 0.4 x 1.25 = 0.5

(ii) Interest Expense

For Manchow Ltd = ₹ 22,50,000

For Noodles Ltd = ₹ 22,50,000 x 60% = ₹ 13,50,000

(iii) For Manchow Ltd:

Financial Leverage = 3

$$\frac{EBIT}{EBT} = \frac{EBIT}{EBIT - Interest} = 3$$

$$\frac{EBIT}{EBIT - 22,50,000} = 3$$

$$EBIT = 3 EBIT - 67,50,000$$

$$67,50,000 = 2 EBIT$$

$$EBIT = 33,75,000$$

For Noodles Ltd:

Financial Leverage = 2



$$\frac{EBIT}{EBT} = \frac{EBIT}{EBIT - \text{Interest}} = 2$$

$$\frac{EBIT}{EBIT - 22,50,000} = 2$$

$$EBIT = 2 \text{ EBIT} - 27,00,000 \quad EBIT = 27,00,000$$

(iv) Contribution:

For Manchow Ltd

$$\text{Operating Leverage} = 1 / \text{Margin of Safety}$$

$$= 1 / 0.4 = 2.5$$

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

$$2.5 = \text{Contribution} / 33,75,000 \quad \text{Contribution} = 84,37,500$$

For Noodles Ltd

$$\text{Operating Leverage} = 1 / \text{Margin of Safety}$$

$$= 1 / 0.5 = 2$$

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

$$2 = \text{Contribution} / 27,00,000 \quad \text{Contribution} = 54,00,000$$

(v) Sales:

For Manchow Ltd

$$\text{P/V Ratio} = 40\%$$

$$\text{P/V Ratio} = \text{Contribution} / \text{Sales}$$

$$0.4 = 84,37,500 / \text{Sales}$$

$$\text{Sales} = 2,10,93,750$$

For Noodles Ltd

$$\text{P/V Ratio} = 50\%$$

$$\text{P/V Ratio} = \text{Contribution} / \text{Sales}$$

$$0.5 = 54,00,000 / \text{Sales}$$

$$\text{Sales} = 1,08,00,000$$

Question 19

CALCULATE the operating leverage, financial leverage and combined leverage from the following data under Situation I and II and Financial Plan A and B:

| | |
|-----------------------------|---------------------|
| Installed Capacity | 4,000 units |
| Actual Production and Sales | 75% of the Capacity |
| Selling Price | ₹30 per unit |
| Variable Cost | ₹15 per unit |

Fixed Cost:

| | |
|--------------------|----------|
| Under Situation I | ₹ 15,000 |
| Under Situation-II | ₹ 20,000 |

Capital Structure:

| | Financial Plan | |
|--------------------------------|----------------|--------|
| | A (₹) | B (₹) |
| Equity | 10,000 | 15,000 |
| Debt (Rate of Interest at 20%) | 10,000 | 5,000 |
| | 20,000 | 20,000 |

Answer 19
(i) Operating leverages:

| Particulars | Situation-I (₹) | Situation-II (₹) |
|--|-------------------------|-------------------------|
| Sales (S) (3,000 units @ ₹ 30/- per unit) | 90,000 | 90,000 |
| Less: Variable Cost (VC) @ ₹15 per unit | (45,000) | (45,000) |
| Contribution (C) | 45,000 | 45,000 |
| Less: Fixed Cost (FC) | 15,000 | 20,000 |
| EBIT | 30,000 | 25,000 |
| Operating Leverage $\left(\frac{C}{EBIT}\right)$ | $\frac{45,000}{30,000}$ | $\frac{45,000}{25,000}$ |
| | = 1.5 | = 1.8 |

(ii) Financial Leverages:

| | A (₹) | B (₹) |
|--|-------------------------|-------------------------|
| Situation I: | | |
| EBIT | 30,000 | 30,000 |
| Less: Interest on debt | (2,000) | (1,000) |
| EBT | 28,000 | 29,000 |
| Financial Leverage $\left(\frac{EBIT}{EBT}\right)$ | $\frac{30,000}{28,000}$ | $\frac{30,000}{29,000}$ |
| | = 1.07 | = 1.03 |
| Situation-II: | | |
| EBIT | 25,000 | 25,000 |
| Less: Interest on debt | (2,000) | (1,000) |
| EBT | 23,000 | 24,000 |
| Financial Leverage $\left(\frac{EBIT}{EBT}\right)$ | $\frac{25,000}{23,000}$ | $\frac{25,000}{24,000}$ |
| | = 1.09 | = 1.04 |

(iii) Combined Leverages:

| | A (₹) | B (₹) |
|------------------|--------------------------|--------------------------|
| (a) Situation I | $1.5 \times 1.07 = 1.61$ | $1.5 \times 1.03 = 1.55$ |
| (b) Situation II | $1.8 \times 1.09 = 1.96$ | $1.8 \times 1.04 = 1.87$ |

Question 20

A firm has sales of ₹ 75,00,000 variable cost is 56% and fixed cost is ₹ 6,00,000. It has a debt of ₹ 45,00,000 at 9% and equity of ₹ 55,00,000. You are required to INTERPRET:

- The firm's ROI?
- Does it have favorable financial leverage?
- If the firm belongs to an industry whose capital turnover is 3, does it have a high or low capital turnover?
- The operating, financial and combined leverages of the firm?
- If the sales is increased by 10% by what percentage EBIT will increase?

(vi) At what level of sales the EBT of the firm will be equal to zero?

(vii) If EBIT increases by 20%, by what percentage EBT will increase? (RTP Nov '18)

Answer 20

Income Statement

| Particulars | Amount (₹) |
|---|-------------|
| Sales | 75,00,000 |
| Less: Variable cost (56% of 75,00,000) | (42,00,000) |
| Contribution | 33,00,000 |
| Less: Fixed costs | (6,00,000) |
| Earnings before interest and tax (EBIT) | 27,00,000 |
| Less: Interest on debt (@ 9% on ₹ 45 lakhs) | (4,05,000) |
| Earnings before tax (EBT) | 22,95,000 |

$$(i) \quad ROI = \frac{EBIT}{\text{Capital employed}} \times 100 = \frac{EBIT}{\text{Equity} + \text{Debt}} \times 100$$

$$= \frac{27,00,000}{55,00,000 + 45,00,000} \times 100 = 27\%$$

(ROI is calculated on Capital Employed)

(ii) ROI = 27% and Interest on debt is 9%, hence, it has a favourable financial leverage.

$$(iii) \quad \text{Capital Turnover} = \frac{\text{Net Sales}}{\text{Capital}}$$

$$\text{Or} = \frac{\text{Net Sales}}{\text{Capital}} = \frac{\text{Rs. } 75,00,000}{\text{Rs. } 1,00,00,000} = 0.75$$

Which is very low as compared to industry average of 3.

(iv) Calculation of Operating, Financial and Combined leverages

$$(a) \quad \text{Operating Leverage} = \frac{\text{Contribution}}{EBIT} = \frac{\text{Rs. } 33,00,000}{\text{Rs. } 27,00,000} = 1.22 \text{ (approx)}$$

$$(b) \quad \text{Financial Leverage} = \frac{EBIT}{EBT} = \frac{\text{Rs. } 27,00,000}{\text{Rs. } 22,95,000} = 1.18 \text{ (approx)}$$

$$(c) \quad \text{Combined Leverage} = \frac{\text{Contribution}}{EBT} = \frac{\text{Rs. } 33,00,000}{\text{Rs. } 22,95,000} = 1.44 \text{ (approx)}$$

$$\text{Or} = \text{Operating Leverage} \times \text{Financial Leverage} = 1.22 \times 1.18 = 1.44 \text{ (approx)}$$

(i) Operating leverage is 1.22. So if sales is increased by 10%. EBIT will be increased by 1.22×10 i.e. 12.20% (approx)

(ii) Since the combined Leverage is 1.44, sales have to drop by $100/1.44$ i.e. 69.44% to bring EBT to Zero

$$\begin{aligned} \text{Accordingly, New Sales} &= ₹ 75,00,000 \times (1 - 0.6944) \\ &= ₹ 75,00,000 \times 0.3056 \\ &= ₹ 22,92,000 \text{ (approx)} \end{aligned}$$

Hence at ₹22,92,000 sales level EBT of the firm will be equal to Zero.

(iii) Financial leverage is 1.18. So, if EBIT increases by 20% then EBT will increase by 1.18×20
 = 23.6% (approx)

Question 21

The following summarizes the percentage changes in operating income, percentage changes in revenues, and betas for four listed firms.

| Firm | Change in revenue | Change in operating income | Beta |
|--------|-------------------|----------------------------|------|
| A Ltd. | 35% | 22% | 1.00 |
| B Ltd. | 24% | 35% | 1.65 |
| C Ltd. | 29% | 26% | 1.15 |
| D Ltd. | 32% | 30% | 1.20 |

Required:

- CALCULATE** the degree of operating leverage for each of these firms. Comment also.
- Use the operating leverage to **EXPLAIN** why these firms have different beta. (RTP Nov '19)

Answer 21

- Degree of operating leverage = $\frac{\% \text{ Change in Operating income}}{\% \text{ Change in Revenues}}$

$$\text{A Ltd.} = 0.22 / 0.35 = 0.63$$

$$\text{B Ltd.} = 0.35 / 0.24 = 1.46$$

$$\text{C Ltd.} = 0.26 / 0.29 = 0.90$$

$$\text{D Ltd.} = 0.30 / 0.32 = 0.94$$

It is level specific.

- High operating leverage leads to high beta. So when operating leverage is lowest i.e. 0.63, Beta is minimum (1) and when operating leverage is maximum i.e. 1.46, beta is highest i.e. 1.65

Question 22

Following information has been extracted from the accounts of newly incorporated Textyl Pvt. Ltd. for the Financial Year 2020-21:

| | |
|--------------------|-------------|
| Sales | ₹ 15,00,000 |
| P/V ratio | 70% |
| Operating Leverage | 1.4 times |
| Financial Leverage | 1.25 times |

Using the concept of leverage, find out and verify in each case:

- The percentage change in taxable income if sales increase by 15%.
- The percentage change in EBIT if sales decrease by 10%.
- The percentage change in taxable income if EBIT increase by 15%. (RTP May '21)

Answer 22

Workings:

$$\begin{aligned} 1. \text{ Contribution} &= \text{Sales} \times \text{P/V ratio} \\ &= ₹ 15,00,000 \times 70\% = ₹ 10,50,000 \end{aligned}$$

$$2. \text{ Operating Leverage} = \frac{\text{Contribution}}{\text{Earnings before interest and tax (EBIT)}}$$

$$\text{Or, } 1.4 = \frac{\text{Rs. } 10,50,000}{\text{EBIT}}$$

$$\text{EBIT} = \text{Rs. } 7,50,000$$

$$3. \text{ Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}}$$

$$\text{Or, } 1.25 = \frac{\text{Rs. } 7,50,000}{\text{EBT}}$$

$$\text{EBT} = \text{Rs. } 6,00,000$$

$$\begin{aligned} 4. \text{ Fixed Cost} &= \text{Contribution} - \text{EBIT} \\ &= \text{Rs. } 10,50,000 - \text{Rs. } 7,50,000 = \text{Rs. } 3,00,000 \end{aligned}$$

$$\begin{aligned} 5. \text{ Interest} &= \text{EBIT} - \text{EBT} \\ &= \text{Rs. } 7,50,000 - \text{Rs. } 6,00,000 = \text{Rs. } 1,50,000 \end{aligned}$$

6. Income Statement

| Particulars | Amount (₹) |
|--|------------|
| Sales | 15,00,000 |
| Less: Variable cost (30% of ₹ 15,00,000) | 4,50,000 |
| Contribution (70% of ₹ 15,00,000) | 10,50,000 |
| Less: Fixed costs | 3,00,000 |
| Earnings before interest and tax (EBIT) | 7,50,000 |
| Less: Interest | 1,50,000 |
| Earnings before tax (EBT) | 6,00,000 |

$$(i) \text{ Combined Leverage} = \frac{\text{Contribution}}{\text{EBT}} = \frac{\text{Rs. } 10,50,000}{\text{Rs. } 6,00,000} = 1.75 \text{ times}$$

$$\begin{aligned} \text{Or, Combined Leverage} &= \text{Operating Leverage} \times \text{Financial Leverage} \\ &= 1.4 \times 1.25 = \mathbf{1.75 \text{ times}} \end{aligned}$$

So, if sales is increased by 15% then taxable income (EBT) will be increased by $1.75 \times 15\% = \mathbf{26.25\%}$

Verification

| Particulars | Amount (₹) |
|---|------------|
| New Sales after 15% increase (₹ 15,00,000 + 15% of ₹ 15,00,000) | 17,25,000 |
| Less: Variable cost (30% of ₹ 17,25,000) | 5,17,500 |
| Contribution (70% of ₹ 17,25,000) | 12,07,500 |
| Less: Fixed costs | 3,00,000 |
| Earnings before interest and tax (EBIT) | 9,07,500 |
| Less: Interest | 1,50,000 |
| Earnings before tax after change (EBT) | 7,57,500 |

$$\text{Increase in Earnings before tax (EBT)} = \text{Rs. } 7,57,500 - \text{Rs. } 6,00,000 = \text{Rs. } 1,57,500$$

$$\text{So, percentage change in Taxable Income (EBT)} = \frac{\text{Rs. } 1,57,500}{\text{Rs. } 6,00,000} \times 100 = 26.25\%, \text{ hence verified.}$$

(ii) Degree of Operating Leverage (Given) = **1.4 times**

So, if sales is decreased by 10% then EBIT will be decreased by $1.4 \times 10\% = 14\%$

Verification

| Particulars | Amount (₹) |
|---|------------|
| New Sales after 10% decrease (₹ 15,00,000 - 10% of ₹ 15,00,000) | 13,50,000 |
| Less: Variable cost (30% of ₹ 13,50,000) | 4,05,000 |
| Contribution (70% of ₹ 13,50,000) | 9,45,000 |
| Less: Fixed costs | 3,00,000 |
| Earnings before interest and tax after change (EBIT) | 6,45,000 |

Decrease in Earnings before interest and tax (EBIT) = ₹ 7,50,000 - ₹ 6,45,000 = ₹ 1,05,000

So, percentage change in EBIT = $\frac{Rs.1,05,000}{Rs.7,50,000} \times 100 = 14\%$, hence verified.

(iii) Degree of Financial Leverage (Given) = **1.25 times**

So, if EBIT increases by 15% then Taxable Income (EBT) will be increased by $1.25 \times 15\% = 18.75\%$

Verification

| Particulars | Amount (₹) |
|--|------------|
| New EBIT after 15% increase (₹ 7,50,000 + 15% of ₹ 7,50,000) | 8,62,500 |
| Less: Interest | 1,50,000 |
| Earnings before Tax after change (EBT) | 7,12,500 |

Increase in Earnings before tax = ₹ 7,12,500 - ₹ 6,00,000 = ₹ 1,12,500

So, percentage change in Taxable Income (EBT) = $\frac{Rs.1,12,500}{Rs.6,00,000} \times 100 = 18.75\%$, hence verified

Question 23

The following particulars relating to Navya Ltd. for the year ended 31st March 2021 is given:

| | |
|------------------------|-----------------------------------|
| Output | 1,00,000 units at normal capacity |
| Selling price per unit | ₹ 40 |
| Variable cost per unit | ₹ 20 |
| Fixed cost | ₹ 10,00,000 |

The capital structure of the company as on 31st March, 2021 is as follows:

| Particulars | ₹ |
|---|-----------|
| Equity share capital (1,00,000 shares of ₹ 10 each) | 10,00,000 |
| Reserves and surplus | 5,00,000 |
| 7% debentures | 10,00,000 |
| Current liabilities | 5,00,000 |
| Total | 30,00,000 |

Navya Ltd. has decided to undertake an expansion project to use the market potential, that will involve ₹ 10 lakhs. The company expects an increase in output by 50%. Fixed cost will be increased

by ₹ 5,00,000 and variable cost per unit will be decreased by 10%. The additional output can be sold at the existing selling price without any adverse impact on the market.

The following alternative schemes for financing the proposed expansion programme are planned:

- (i) Entirely by equity shares of ₹ 10 each at par.
- (ii) ₹ 5 lakh by issue of equity shares of ₹ 10 each and the balance by issue of 6% debentures of ₹ 100 each at par.
- (iii) Entirely by 6% debentures of ₹ 100 each at par.

FIND out which of the above-mentioned alternatives would you recommend for Navya Ltd. with reference to the risk and return involved, assuming a corporate tax of 40%. (RTP Nov '21, Old & New)

Answer 23

Statement showing Profitability of Alternative Schemes for Financing (₹ in '00,000)

| Particulars | Existing | Alternative Schemes | | |
|--|----------|---------------------|-----------------------|---------|
| | | (i) | (ii) | (iii) |
| Equity Share capital (existing) | 10 | 10 | 10 | 10 |
| New issues | - | 10 | 5 | - |
| | 10 | 20 | 15 | 10 |
| 7% debentures | 10 | 10 | 10 | 10 |
| 6% debentures | - | - | 5 | 10 |
| | 20 | 30 | 30 | 30 |
| Debenture interest (7%) | 0.7 | 0.7 | 0.7 | 0.7 |
| Debenture interest (6%) | - | - | 0.3 | 0.6 |
| | 0.7 | 0.7 | 1.0 | 1.3 |
| | | | | |
| Output (units in lakh) | 1 | 1.5 | 1.5 | 1.5 |
| Contribution per. unit (₹) (Selling price - Variable Cost) | 20 | 22 | 22 | 22 |
| Contribution (₹ lakh) | 20 | 33 | 33 | 33 |
| Less: Fixed cost | 10 | 15 | 15 | 15 |
| EBIT | 10 | 18 | 18 | 18 |
| Less: Interest (as calculated above) | 0.7 | 0.7 | 1.0 | 1.3 |
| EBT | 9.3 | 17.3 | 17 | 16.7 |
| Less: Tax (40%) | 3.72 | 6.92 | 6.8 | 6.68 |
| EAT | 5.58 | 10.38 | 10.20 | 10.02 |
| Operating Leverage (Contribution / EBIT) | 2.00 | 1.83 | 1.83 | 1.83 |
| Financial Leverage (EBIT/EBT) | 1.08 | 1.04 | 1.06 | 1.08 |
| Combined Leverage (Contribution/EBT) | 2.15 | 1.91 | 1.94 | 1.98 |
| EPS (EAT/No. of shares) (₹) | 5.58 | 5.19 | 6.80 | 10.02 |
| Risk | - | Lowest | Lower than option (3) | Highest |
| Return | - | Lowest | Lower than option (3) | Highest |

From the above figures, we can see that the Operating Leverage is same in all alternatives though Financial Leverage differs. Alternative (iii) uses the maximum amount of debt and result into the highest degree of financial leverage, followed by alternative (ii). Accordingly, risk of the company will be maximum in these options. Corresponding to this scheme, however, maximum EPS (i.e., ₹ 10.02 per share) will be also in option (iii).

So, if Navya Ltd. is ready to take a high degree of risk, then alternative (iii) is strongly recommended. In case of opting for less risk, alternative (ii) is the next best option with a reduced EPS of ₹ 6.80 per share. In case of alternative (i), EPS is even lower than the existing option, hence not recommended.

Question 24

Debu Ltd. currently has an equity share capital of ₹ 1,30,00,000 consisting of 13,00,000 Equity shares. The company is going through a major expansion plan requiring to raise funds to the tune of ₹ 78,00,000. To finance the expansion, the management has following plans:

Plan-I : Issue 7,80,000 Equity shares of ₹ 10 each.

Plan-II: Issue 5,20,000 Equity shares of ₹ 10 each and the balance through long-term borrowing at 12% interest p.a.

Plan-III: Issue 3,90,000 Equity shares of ₹ 10 each and 39,000, 9% Debentures of ₹ 100 each.

Plan-IV: Issue 3,90,000 Equity shares of ₹ 10 each and the balance through 6% preference shares.

EBIT of the company is expected to be ₹ 52,00,000 p.a. Considering corporate tax rate @ 40%, you are required to-

- CALCULATE EPS in each of the above plans.**
- ASCERTAIN financial leverage in each plan and comment. (RTP Nov'22)**

Answer 24

| Sources of Capital | Plan I | Plan II | Plan III | Plan IV |
|--------------------------|-------------|-------------|-------------|-------------|
| Present Equity Shares | 13,00,000 | 13,00,000 | 13,00,000 | 13,00,000 |
| New Issue | 7,80,000 | 5,20,000 | 3,90,000 | 3,90,000 |
| Equity share capital (₹) | 2,08,00,000 | 1,82,00,000 | 1,69,00,000 | 1,69,00,000 |
| No. of Equity shares | 20,80,000 | 18,20,000 | 16,90,000 | 16,90,000 |
| 12% Long term loan (₹) | - | 26,00,000 | - | - |
| 9% Debentures (₹) | - | - | 39,00,000 | - |
| 6% Preference Shares (₹) | - | - | - | 39,00,000 |

Computation of EPS and Financial Leverage

| Sources of Capital | Plan I | Plan II | Plan III | Plan IV |
|-------------------------------------|-----------|-----------|-----------|-----------|
| EBIT (₹) | 52,00,000 | 52,00,000 | 52,00,000 | 52,00,000 |
| Less: Interest on 12% Loan (₹) | - | 3,12,000 | - | - |
| Less: Interest on 9% debentures (₹) | - | - | 3,51,000 | - |
| EBT (₹) | 52,00,000 | 48,88,000 | 48,49,000 | 52,00,000 |
| Less: Tax@ 40% | 20,80,000 | 19,55,200 | 19,39,600 | 20,80,000 |
| EAT (₹) | 31,20,000 | 29,32,800 | 29,09,400 | 31,20,000 |
| Less: Preference Dividends (₹) | - | - | - | 2,34,000 |

| | | | | |
|--|-----------|-----------|-----------|-----------|
| (a) Net Earnings available for equity shares (₹) | 31,20,000 | 29,32,800 | 29,09,400 | 28,86,000 |
| (b) No. of equity shares | 20,80,000 | 18,20,000 | 16,90,000 | 16,90,000 |
| (c) EPS (a ÷ b) (₹) | 1.50 | 1.61 | 1.72 | 1.71 |
| Financial leverage = $\frac{EBIT}{EBT}$ | 1.00 | 1.06 | 1.07 | 1.08* |

* Financial Leverage in the case of Preference dividend = $\left[\frac{EBIT}{(EBIT - \text{Interest}) - \left(\frac{D_p}{1-t} \right)} \right]$

$$= \left[\frac{52,00,000}{(52,00,000 - 0) - \left(\frac{2,34,000}{1-40} \right)} \right] = \frac{52,00,000}{48,10,000} = 1.08$$

Question 25

“Financial Leverage is a double-edged sword” DISCUSS (RTP May '18, Old & New SM)

Answer 25

On one hand when cost of 'fixed cost fund' is less than the return on investment financial leverage will help to increase return on equity and EPS. The firm will also benefit from the saving of tax on interest on debts etc. However, when cost of debt will be more than the return it will affect return of equity and EPS unfavorably and as a result firm can be under financial distress. This is why financial leverage is known as “double edged sword”.

Effect on EPS and ROE:

When, ROI > Interest – Favourable – Advantage When, ROI < Interest – Unfavourable – Disadvantage

When, ROI = Interest – Neutral – Neither advantage nor disadvantage.

Question 26

The selected financial data for A, B and C companies for the current year ended 31st March are as follows:

| Particulars | A | B | C |
|-----------------------------------|---------------|---------------|---------------|
| Variable Expenses as a % of sales | 60 | 50 | 40 |
| Interest | ₹ 1,00,000 | ₹ 4,00,000 | ₹ 6,00,000 |
| Degree of Operating Leverage | 4:1 | 3:1 | 2.5:1 |
| Degree of Financial Leverage | 3:1 | 5:1 | 2.5:1 |
| Income Tax Rate | 30% | 30% | 30% |

(a) PREPARE income statement for A, B and C companies

(b) COMMENT on the financial position and structure of these companies (RTP May 23)

Answer 26

Income Statement of companies A, B and C

| Particulars | A | B | C |
|-------------------------|------------|------------|------------|
| Sales | ₹15,00,000 | ₹30,00,000 | ₹41,66,667 |
| Less: Variable Expenses | ₹9,00,000 | ₹15,00,000 | ₹16,66,667 |
| Contribution | ₹6,00,000 | ₹15,00,000 | ₹25,00,000 |

| | | | |
|------------------|-----------|------------|------------|
| Less: Fixed Cost | ₹4,50,000 | ₹10,00,000 | ₹15,00,000 |
| EBIT | ₹1,50,000 | ₹5,00,000 | ₹10,00,000 |
| Less: Interest | ₹1,00,000 | ₹4,00,000 | ₹6,00,000 |
| PBT | ₹50,000 | ₹1,00,000 | ₹4,00,000 |
| Less: Tax @ 30% | ₹15,000 | ₹30,000 | ₹1,20,000 |
| PAT | ₹35,000 | ₹70,000 | ₹2,80,000 |

Working Notes:

(i) Degree of Financial Leverage = $\frac{EBIT}{EBIT - \text{Interest}}$

$$DFL \times (EBIT - \text{Int}) = EBIT$$

$$DFL \times EBIT - \text{Int} \times DFL = EBIT$$

$$DFL \times EBIT - EBIT = \text{Int} \times DFL$$

$$EBIT(DFL - 1) = \text{Int} \times DFL$$

$$EBIT = \frac{\text{int} \times DFL}{DFL - 1}$$

For A,

$$EBIT_A = \frac{Rs.1,00,000 \times 3}{3 - 1}$$

$$EBIT_A = Rs. 150000$$

For B,

$$EBIT_B = \frac{Rs.4,00,000 \times 5}{5 - 1}$$

$$EBIT_B = Rs. 500000$$

For C,

$$EBIT_C = \frac{Rs.6,00,000 \times 2.5}{2.5 - 1}$$

$$EBIT_C = Rs. 10,00,000$$

(ii) $DOL = \frac{\text{Contribution}}{EBIT}$

$$\text{Contribution} = DOL \times EBIT$$

$$\text{Contribution}_A = 4 \times ₹1,50,000$$

$$\text{Contribution}_A = ₹6,00,000$$

$$\text{Contribution}_B = 3 \times ₹5,00,000$$

$$\text{Contribution}_B = ₹15,00,000$$

$$\text{Contribution}_C = 2.5 \times ₹10,00,000$$

$$\text{Contribution}_C = ₹25,00,000$$

(iii) Fixed Cost = Contribution – EBIT

$$\text{Fixed Cost}_A = ₹6,00,000 - ₹1,50,000 = ₹4,50,000$$

$$\text{Fixed Cost}_B = ₹15,00,000 - ₹5,00,000 = ₹10,00,000$$

$$\text{Fixed Cost}_C = ₹25,00,000 - ₹10,00,000 = ₹15,00,000$$

(iv) Contribution = Sales – VC

$$VC = \text{Sales} - \text{Contribution}$$

Sales x VC Ratio = Sales – Contribution

Contribution = Sales – Sales x VC Ratio

Contribution = Sales(1-VCR)

$$\text{Sales} = \frac{\text{Contribution}}{1-VCR}$$

$$\text{Sales}_A = ₹6,00,000 / (1-0.6) = ₹15,00,000$$

$$\text{Sales}_B = ₹15,00,000 / (1-0.5) = ₹30,00,000$$

$$\text{Sales}_C = ₹25,00,000 / (1-0.4) = ₹41,66,667$$

Of all the companies, A has the highest degree of Operating Leverage, B has highest degree of Financial Leverage and C is equally leveraged on both Operating and Financial fronts. If we consider combined leverage companies will have the leverages of 12, 15 and 6.25 (by multiplying both operating and financial leverages). This means A is undertaking a higher degree of operating risk while B is undertaking a higher degree of financial risk.

Question 27

The capital structure of ABC Ltd. for the year ended 31st March 2022 consisted as follows:

| Particulars | Amount in ₹ |
|--|-------------|
| Equity share capital (face value ₹ 100 each) | 20,00,000 |
| 10% debentures (₹ 100 each) | 20,00,000 |

During the year 2021-22, sales decreased to 1,00,000 units as compared to 1,20,000 units in the previous year. However, the selling price stood at ₹ 15 per unit and variable cost at ₹ 10 per unit for both the years. The fixed expenses were at ₹ 2,00,000 p.a. and the income tax rate is 30%.

You are required to CALCULATE the following:

- The degree of financial leverage at 1,20,000 units and 1,00,000 units.
- The degree of operating leverage at 1,20,000 units and 1,00,000 units.
- The percentage change in EPS. (Nov '23)

Answer 27

| Sales in units | 1,20,000 | 1,00,000 |
|----------------|-------------|-------------|
| | (₹) | (₹) |
| Sales Value | 18,00,000 | 15,00,000 |
| Variable Cost | (12,00,000) | (10,00,000) |
| Contribution | 6,00,000 | 5,00,000 |

| | | |
|---|-----------------------------------|-----------------------------------|
| Fixed expenses | (2,00,000) | (2,00,000) |
| EBIT | 4,00,000 | 3,00,000 |
| Debenture Interest | (2,00,000) | (2,00,000) |
| EBT | 2,00,000 | 1,00,000 |
| Tax @ 30% | (60,000) | (30,000) |
| Profit after tax (PAT) | 1,40,000 | 70,000 |
| (i) Financial Leverage = $\frac{EBIT}{EBT}$ | $= \frac{4,00,000}{2,00,000} = 2$ | $= \frac{3,00,000}{1,00,000} = 3$ |



| | | |
|---|--------------------------------------|--------------------------------------|
| (ii) Operating leverage = $\frac{\text{Contribution}}{\text{EBIT}}$ | $= \frac{6,00,000}{4,00,000} = 1.50$ | $= \frac{5,00,000}{3,00,000} = 1.67$ |
| (iii) Earnings per share (EPS) | $\frac{1,40,000}{20,000} = ₹ 7$ | $\frac{70,000}{20,000} = ₹ 3.5$ |
| Decrease in EPS | $= ₹ 7 - ₹ 3.5 = ₹ 3.5$ | |
| % decrease in EPS | $\frac{3.5}{7} \times 100 = 50\%$ | |

Question 28

A company had the following balance sheet as on 31st March, 2021:

| Liabilities | Rs in Crores | Assets | Rs. in Crores |
|--|--------------|----------------|---------------|
| Equity Share Capital (75 lakhs Shares of Rs.10 each) | 7.50 | Building | 12.50 |
| Reserves and Surplus | 1.50 | Machinery | 6.25 |
| 15% Debentures | 15.00 | Current Assets | |
| Current Liabilities | 6.00 | Stock | 3.00 |
| | | Debtors | 3.25 |
| | | Bank Balance | 5.00 |
| | 30.00 | | 30.00 |

The additional information given is as under:

| | |
|---|-------------|
| Fixed cost per annum (excluding interest) | Rs.6 crores |
| Variable operating cost ratio | 60% |
| Total assets turnover ratio | 2.5 |
| Income-tax rate | 40% |

Calculate the following and comment:

- Earnings per share
- Operating Leverage
- Financial Leverage
- Combined Leverage (PYP 10 Marks, July'21, RTP May '19)

Answer 28

| | |
|----------------------------|---------------------------|
| Total Assets | = ₹ 30 crores |
| Total Asset Turnover Ratio | = 2.5 |
| Hence, Total Sales | = 30 × 2.5 = Rs.75 crores |

Computation of Profit after Tax (PAT)

| Particulars | (Rs.in crores) |
|--|----------------|
| Sales | 75.00 |
| Less: Variable Operating Cost @ 60% | 45.00 |
| Contribution | 30.00 |
| Less: Fixed Cost (other than Interest) | 6.00 |
| EBIT/PBIT | 24.00 |

| | |
|---|-------|
| Less: Interest on Debentures (15% X 15) | 2.25 |
| EBT/PBT | 21.75 |
| Less: Tax @ 40% | 8.70 |
| EAT/ PAT | 13.05 |

(i) Earnings per Share

$$EPS = \frac{PAT}{\text{Number of Equity Shares}} = \frac{13.05}{0.75} = \text{Rs.17.40}$$

Number of Equity Shares

It indicates the amount the company earns per share. Investors use this as a guide while valuing the share and making investment decisions. It is also an indicator used in comparing firms within an industry or industry segment.

(ii) Operating Leverage

$$\text{Operating Leverage} = \frac{\text{Contribution}}{EBIT} = \frac{30}{24} = 1.25$$

It indicates the choice of technology and fixed cost in cost structure. It is level specific. When firm operates beyond operating break-even level, then operating leverage is low. It indicates sensitivity of earnings before interest and tax (EBIT) to change in sales at a particular level.

(iii) Financial Leverage

$$\text{Financial Leverage} = \frac{EBIT}{PBT} = \frac{24}{21.75} = 1.103$$

The financial leverage is very comfortable since the debt service obligation is small vis -à- vis EBIT.

(iv) Combined Leverage

$$\text{Combined Leverage} = \frac{\text{Contribution}}{PBT} = \frac{30}{21.75} = 1.379$$

Or,

$$= \text{Operating Leverage} \times \text{Financial Leverage}$$

$$= 1.25 \times 1.103 = 1.379$$

The combined leverage studies the choice of fixed cost in cost structure and choice of debt in capital structure. It studies how sensitive the change in EPS is vis-à-vis change in sales. The leverages operating, financial and combined are used as measurement of risk.

Question 29

The information related to XYZ Company Ltd. for the year ended 31st March, 2020 are as follows:

| | |
|--|--------------|
| Equity Share Capital of Rs.100 each | ₹ 50 Lakhs |
| 12% Bonds of Rs.1000 each | ₹ 30 Lakhs |
| Sales | Rs.84 Lakhs |
| Fixed Cost (Excluding Interest) | Rs.7.5 Lakhs |
| Financial Leverage | 1.39 |
| Profit-Volume Ratio | 25% |
| Market Price per Equity Share | Rs.200 |
| Income Tax Rate Applicable | 30% |
| You are required to compute the following: | |



- (i) Operating Leverage
- (ii) Combined Leverage
- (iii) Earning per share
- (iv) Earning Yield (PYP 10 Marks, Jan'21)

Answer 29

Workings

$$1. \text{ Profit Volume Ratio} = \frac{\text{Contribution}}{\text{Sales}} \times 100$$

$$\text{So. } 25 = \frac{\text{Contribution}}{\text{Rs. } 84,00,000} \times 100$$

$$\text{Contribution} = \frac{\text{Rs. } 84,00,000 \times 25}{100} = \text{Rs. } 21,00,000$$

$$2. \text{ Financial leverage} = \frac{\text{EBIT}}{\text{EBT}}$$

$$\text{Or, } 1.39 = \frac{\text{Rs. } 13,50,000 \text{ (as calculated above)}}{\text{EBT}}$$

$$\text{EBT} = \text{₹ } 9,71,223$$

3. Income Statement

| Particulars | (RS.) |
|--|-------------|
| Sales | 84,00,000 |
| Less: Variable Cost (Sales - Contribution) | (63,00,000) |
| Contribution | 21,00,000 |
| Less: Fixed Cost | (7,50,000) |
| EBIT | 13,50,000 |
| Less: Interest (EBIT - EBT) | (3,78,777) |
| EBT | 9,71,223 |
| Less: Tax @ 30% | (2,91,367) |
| Profit after Tax (PAT) | 6,79,856 |

$$(i) \text{ Operating Leverage} = \frac{\text{Contribution}}{\text{Earnings before interest and tax (EBI)}}$$

$$= \frac{\text{Rs. } 21,00,000}{\text{Rs. } 13,50,000} = 1.556 \text{ (approx.)}$$

$$(ii) \text{ Combined Leverage} = \text{Operating Leverage} \times \text{Financial Leverage}$$

$$= 1.556 \times 1.39 = 2.163 \text{ (approx.)}$$

$$\text{Or, } = \frac{\text{Contribution}}{\text{EBT}} = \frac{\text{Rs. } 21,00,000}{\text{Rs. } 9,71,223} = 2.162 \text{ (approx.)}$$

(iii) Earnings per Share (EPS)

$$\text{EPS} = \frac{\text{PAT}}{\text{No of Shares}} = \frac{\text{Rs. } 6,79,856}{50,000} = \text{Rs. } 13.597$$

(iv) Earning Yield

$$\frac{\text{EPS}}{\text{Market price}} \times 100 = \frac{\text{Rs. } 13.597}{\text{Rs. } 200} = 6.80\% \text{ (approx.)}$$

Note: The question has been solved considering Financial Leverage given in the question as the base for calculating total interest expense including the interest of 12% Bonds of ₹ 30 Lakhs. The question can also be solved in other alternative ways.

Question 30

The following data is available for Stone Ltd.:

(Rs.)

| | |
|-------------------------|----------|
| Sales | 5,00,000 |
| (-) Variable cost @ 40% | 2,00,000 |
| Contribution | 3,00,000 |
| (-) Fixed cost | 2,00,000 |
| EBIT | 1,00,000 |
| (-) Interest | 25,000 |
| Profit before tax | 75,000 |

Using the concept of leverage, find out

- The percentage change in taxable income if EBIT increases by 10%.
 - The percentage change in EBIT if sales increases by 10%.
 - The percentage change in taxable income if sales increases by 10%.
- Also verify the results in each of the above case. (PYP 10 Marks, Nov'20)

Answer 30

$$(i) \text{ Degree of Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{\text{Rs.1,00,000}}{\text{Rs.75,000}} = 1.333 \text{ times}$$

So, If EBIT increases by 10% then Taxable Income (EBT) will be increased by $1.333 \times 10 = 13.33\%$ (approx.)

Verification

| Particulars | Amount (₹) |
|---|------------|
| New EBIT after 10% increase (Rs.1,00,000 + 10%) | 1,10,000 |
| Less: Interest | 25,000 |
| Earnings before Tax after change (EBT) | 85,000 |

Increase in Earnings before Tax = Rs.85,000 - Rs.75,000 = Rs. 10,000

So, percentage change in Taxable Income (EBT) = $\frac{\text{Rs.10,000}}{\text{Rs.75,000}} \times 100 = 13.333\%$, hence verified

$$(ii) \text{ Degree of Operating Leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{\text{Rs.3,00,000}}{\text{Rs.1,00,000}} = 3 \text{ times}$$

So, if sale is increased by 10% then EBIT will be increased by $3 \times 10 = 30\%$

Verification

| Particulars | Amount (₹) |
|--|------------|
| New Sales after 10% increase (Rs.5,00,000 + 10%) | 5,50,000 |
| Less: Variable cost (40% of ₹ 5,50,000) | 2,20,000 |
| Contribution | 3,30,000 |
| Less: Fixed costs | 2,00,000 |
| Earnings before interest and tax after change (EBIT) | 1,30,000 |

Increase in Earnings before interest and tax (EBIT) = Rs.1,30,000 - Rs.1,00,000 = ₹ 30,000

So, percentage change in EBIT = $\frac{\text{Rs.30,000}}{\text{Rs.1,00,000}} \times 100 = 30\%$, hence verified.

(iii) Degree of Combined Leverage = $\frac{\text{Contribution}}{\text{EBT}} = \frac{\text{Rs.3,00,000}}{\text{Rs.75,0000}} = 4$ times

So, if sale is increased by 10% then Taxable Income (EBT) will be increased by $4 \times 10 = 40\%$

Verification

| Particulars | Amount (₹) |
|--|------------|
| New Sales after 10% increase (Rs.5,00,000 + 10%) | 5,50,000 |
| Less: Variable cost (40% of ₹ 5,50,000) | 2,20,000 |
| Contribution | 3,30,000 |
| Less: Fixed costs | 2,00,000 |
| Earnings before interest and tax (EBIT) | 1,30,000 |
| Less: Interest | 25,000 |
| Earnings before tax after change (EBT) | 1,05,000 |

Increase in Earnings before tax (EBT) = Rs.1,05,000 - Rs.75,000 = ₹ 30,000

So, percentage change in Taxable Income (EBT) = $\frac{\text{Rs.30,000}}{\text{Rs.75,0000}} \times 100 = 40\%$, hence verified

Question 31

The Balance Sheet of Gita Shree Ltd. is given below:

| Liabilities | | (Rs.) |
|------------------------------------|-------------|----------|
| Shareholders' fund | | |
| Equity share capital of Rs.10 each | Rs.1,80,000 | |
| Retained earnings | Rs.60,000 | 2,40,000 |
| Non-current liabilities 10% debt | | 2,40,000 |
| Current liabilities | | 1,20,000 |
| | | 6,00,000 |
| Assets | | |
| Fixed Assets | | 4,50,000 |
| Current Assets | | 1,50,000 |
| | | 6,00,000 |

The company's total asset turnover ratio is 4. Its fixed operating cost is Rs.2,00,000 and its variable operating cost ratio is 60%. The income tax rate is 30%.

Calculate:

(i)

- Degree of Operating leverage.
- Degree of Financial leverage.
- Degree of Combined leverage.

(ii) Find out EBIT if EPS is (a) Rs.1 (b) Rs.2 and (c) Rs. 0. (PYP 10 Marks, Nov'19)

Answer 31

Working Notes:

Total Assets = Rs.6,00,000

Total Asset Turnover Ratio i.e. = $\frac{\text{Total Sales}}{\text{Total Assets}} = 4$

Hence, Total Sales = Rs.6,00,000 × 4 = Rs.24,00,000

Computation of Profits after Tax (PAT)

| Particulars | (₹) |
|--|-----------|
| Sales | 24,00,000 |
| Less: Variable operating cost @ 60% | 14,40,000 |
| Contribution | 9,60,000 |
| Less: Fixed operating cost (other than Interest) | 2,00,000 |
| EBIT (Earning before interest and tax) | 7,60,000 |
| Less: Interest on debt (10% – 2,40,000) | 24,000 |
| EBT (Earning before tax) | 7,36,000 |
| Less: Tax 30% | 2,20,800 |
| EAT (Earning after tax) | 5,15,200 |

(i)

a. Degree of Operating Leverage

Degree of Operating leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{\text{Rs.9,60,000}}{\text{Rs.7,60,000}} = 1.263$ (approx.)

b. Degree of Financial Leverage

Degree of Financial Leverage = $\frac{\text{EBIT}}{\text{EBT}} = \frac{\text{Rs.9,60,000}}{\text{Rs.7,60,000}} = 1.033$ (approx.)

c. Degree of Combined Leverage

Degree of Combined Leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{\text{EBIT}}{\text{EBT}} = \frac{\text{Contribution}}{\text{EBT}}$
 $= \frac{\text{Rs.9,60,000}}{\text{Rs.7,60,000}} = 1.304$ (approx.)

Or

Degree of Combined Leverage = Degree of Operating Leverage X Degree of Financial Leverage
 $= 1.263 \times 1.033 = 1.304$ (approx.)

(ii) (a) If EPS is Re. 1

EPS = $\frac{\text{EBIT} - \text{Interest}(1 - \text{tax})}{\text{No of equity shares}}$
 $= \text{Or, } 1 = \frac{(\text{EBIT} - \text{Rs.24,000})(1 - 0.30)}{18000}$

Or, EBIT = Rs. 49,714 (approx.)

(b) If EPS is Rs.2

$2 = (\text{EBIT} - \text{Rs. 24,000})(1 - 0.30) / 18,000$

Or, EBIT = Rs.75,429 (approx.)

(c) If EPS is ₹ 0

$0 = (\text{EBIT} - \text{Rs. 24,000})(1 - 0.30) / 18,000$

Or, EBIT = Rs. 24,000

Alternatively, if EPS is 0 (zero), EBIT will be equal to interest on debt i.e. Rs. 24,000.

Question 32

The capital structure of the Shiva Ltd. consists of equity share capital of Rs.20,00,000 (Share of Rs.100 per value) and Rs.20,00,000 of 10% Debentures, sales increased by 20% from 2,00,000 units to 2,40,000 units, the selling price is Rs.10 per unit; variable costs amount to Rs.6 per unit and fixed expenses amount to Rs.4,00,000. The income tax rate is assumed to be 50%.

(a) You are required to calculate the following:

- (i) The percentage increase in earnings per share;
- (ii) Financial leverage at 2,00,000 units and 2,40,000 units.
- (iii) Operating leverage at 2,00,000 units and 2,40,000 units.

(b) Comment on the behavior of operating and Financial leverages in relation to increase in production from 2,00,000 units to 2,40,000 units. (PYP 10 Marks, May'19)

Answer 32

a)

| Sales in units | 2,00,000 | 2,40,000 |
|---|---|--|
| | (₹) | (₹) |
| Sales Value @ Rs.10 Per Unit | 20,00,000 | 24,00,000 |
| Variable Cost @ Rs.6 per unit | (12,00,000) | (14,40,000) |
| Contribution | 8,00,000 | 9,60,000 |
| Fixed expenses | (4,00,000) | (4,00,000) |
| EBIT | 4,00,000 | 5,60,000 |
| Debenture Interest | (2,00,000) | (2,00,000) |
| EBT | 2,00,000 | 3,60,000 |
| Tax @ 50% | (1,00,000) | (1,80,000) |
| Profit after tax (PAT) | 1,00,000 | 1,80,000 |
| No of Share | 20,000 | 20,000 |
| Earnings per share (EPS) | 5 | 9 |
| (I) The percentage Increase in EPS | $= \frac{4}{5} \times 100 = 80\% \times 100 = 80\%$ | |
| (ii) Financial Leverage = $\frac{EBIT}{EBT}$ | $\frac{Rs.4,00,000}{Rs.2,00,000} = 2$ | $\frac{Rs.5,60,000}{Rs.3,60,000} = 1.56$ |
| (iii) Operating leverage = $\frac{Contribution}{EBT}$ | $\frac{Rs.8,00,000}{Rs.4,00,000} = 2$ | $\frac{Rs.9,60,000}{Rs.5,60,000} = 1.71$ |

- b) When production is increased from 2,00,000 units to 2,40,000 units both financial leverage and operating leverages reduced from 2 to 1.56 and 1.71 respectively. Reduction in financial leverage and operating leverages signifies reduction in business risk and financial risk.

Question 33

Following is the Balance Sheet of Sony Ltd. as on 31st March, 2018:

| Liabilities | Amount in ₹ |
|---|--------------------|
| Shareholder's Fund | |
| Equity Share Capital (Rs.10 each) | 25,00,000 |
| Reserve and Surplus | 5,00,000 |
| Non-Current Liabilities (12 Debentures) | 50,00,000 |
| Current Liabilities | 20,00,000 |
| Total | 1,00,00,000 |
| Assets | Amount in ₹ |
| Non-Current Assets | 60,00,000 |
| Current Assets | 40,00,000 |
| Total | 1,00,00,000 |

Additional Information:

- Variable Cost is 60% of Sales.
- Fixed Cost p.a. excluding interest Rs.20,00,000.
- Total Asset Turnover Ratio is 5 times.
- Income Tax Rate 25% You are required to:
 - Prepare Income Statement
 - Calculate the following and comment:
 - Operating Leverage
 - Financial Leverage
 - Combined Leverage (PYP 10 Marks, Nov'18)

Answer 33

Work-ins:

Total Assets= Rs.1 crore

Total Asset Turnover Ratio i.e. = $\frac{\text{Total Sales}}{\text{Total Assets}} = 5$

Hence, Total Sales = Rs.1 Crore × 5 = ₹ 5 crore

- Income Statement

| | (Rs.in crore) |
|---|---------------|
| Sales | 5 |
| Less: Variable cost @ 60% | 3 |
| Contribution | 2 |
| Less: Fixed cost (other than Interest) | 0.2 |
| EBIT (Earnings before interest and tax) | 1.8 |



| | |
|--|-------|
| Less: Interest on debentures (12% ×50 lakhs) | 0 .06 |
| EBT (Earning before tax) | 1.74 |
| Less: Tax 25% | 0.435 |
| EAT (Earning after tax) | 1.305 |

(2)

a) Operating Leverage

$$\text{Operating leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{2}{1.8} = 1.11$$

It indicates fixed cost in cost structure. It indicates sensitivity of earnings before interest and tax (EBIT) to change in sales at a particular level.

b) Financial Leverage

$$\text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{1.8}{1.74} = 1.03$$

The financial leverage is very comfortable since the debt service obligation is small vis-à-vis EBIT.

c) Combined Leverage

Combined Leverage

$$\frac{\text{Contribution}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{EBT}} = 1.11 \times 1.03 = 1.15$$

Or

$$\frac{\text{Contribution}}{\text{EBT}} = \frac{2}{1.74} = 1.15$$

The combined leverage studies the choice of fixed cost in cost structure and choice of debt in capital structure. It studies how sensitive the change in EPS is vis-à-vis change in sales.

The leverages- operating, financial and combined are measures of risk.

Question 34

The following data have been extracted from the books of LM Ltd: Sales - ₹100 lakhs

Interest Payable per annum - Rs.10 lakhs Operating leverage - 1.2

Combined leverage - 2.16 You are required to calculate:

(i) The financial leverage,

(ii) Fixed cost and

(iii) P/V ratio (PYP 5 Marks, May'18)

Answer 34

i. Calculation of Financial Leverage:

Combined Leverage (CL) = Operating Leverage (OL) × Financial Leverage (FL) 2.16 = 1.2 × FL

FL = 1.8

ii. Calculation of Fixed cost:

$$\text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBT i.e EBIT - Interest}}$$

1.8

$$= \frac{\text{EBIT}}{\text{EBT} - 10,00,000}$$

$$1.8 (\text{EBIT} - 10,00,000) = \text{EBIT}$$

$$1.8 \text{ EBIT} - 18,00,000 = \text{EBIT}$$

$$\text{EBIT} = \frac{18,00,000}{0.8} = \text{Rs.} 22,50,000$$

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

$$= 1.2 = \frac{\text{Contribution}}{\text{Rs.} 22,50,000}$$

$$\text{Contribution} = \text{Rs.} 27,00,000 \quad \text{Fixed Cost} = \text{Contribution} - \text{EBIT}$$

$$= \text{Rs.} 27,00,000 - \text{Rs.} 22,50,000$$

$$\text{Fixed cost} = \text{Rs.} 4,50,000$$

iii. Calculation of P/V ratio:

$$\text{P/V ratio} = \frac{\text{Contribution}(C)}{\text{Sales}(S)} \times 100 = \frac{27,00,000}{100,00,000} \times 100 = 27\%$$

Question 35

Information of A Ltd. is given below:

- Earnings after tax: 5% on sales
- Income tax rate: 50%
- Degree of Operating Leverage: 4 times
- 10% Debenture in capital structure: ₹ 3 lakhs
- Variable costs: ₹ 6 lakhs Required:

(i) From the given data complete following statement:

| | |
|-------------------------|------------|
| Sales | XXXX |
| Less: Variable costs | ₹ 6,00,000 |
| Contribution | XXXX |
| Less: Fixed costs | XXXX |
| EBIT | XXXX |
| Less: Interest expenses | XXXX |
| EBT | XXXX |
| Less: Income tax | XXXX |
| EAT | XXXX |

(ii) Calculate Financial Leverage and Combined Leverage.

(iii) Calculate the percentage change in earning per share, if sales increased by 5%. (PYP 10 Marks Dec '21)

Answer 35

(i) Working Notes

Earning after tax (EAT) is 5% of sales Income tax is 50%

So, EBT is 10% of Sales

Since Interest Expenses is ₹ 30,000



EBIT = 10% of Sales + ₹30,000 (Equation i)

Now Degree of operating leverage = 4

$$\text{So, } \frac{\text{Contribution}}{\text{EBIT}} = 4$$

Or, Contribution = 4 EBIT

Or, Sales – Variable Cost = 4 EBIT

Or, Sales – ₹ 6,00,000 = 4 EBIT (Equation ii)

Replacing the value of EBIT of equation (i) in Equation (ii) We get, Sales – ₹ 6,00,000 = 4 (10% of Sales + ₹ 30,000) Or, Sales – ₹ 6,00,000 = 40% of Sales + ₹ 1,20,000

Or, 60% of Sales = ₹ 7,20,000

$$\text{So, Sales} = \frac{\text{Rs. 7,20,000}}{60\%} = ₹ 12,00,000$$

Contribution = Sales – Variable Cost = ₹ 12,00,000 – ₹ 6,00,000 = ₹ 6,00,000

$$\text{EBIT} = \frac{\text{Rs. 6,00,000}}{4} = ₹ 1,50,000$$

Fixed Cost = Contribution – EBIT = ₹ 6,00,000 – ₹ 1,50,000 = ₹ 4,50,000

EBT = EBIT – Interest = ₹ 1,50,000 – ₹ 30,000 = ₹ 1,20,000

EAT = 50% of ₹ 1,20,000 = ₹ 60,000

Income Statement

| Particulars | (₹) |
|---------------------|-----------|
| Sales | 12,00,000 |
| Less: Variable cost | 6,00,000 |
| Contribution | 6,00,000 |
| Less: Fixed cost | 4,50,000 |
| EBIT | 1,50,000 |
| Less: Interest | 30,000 |
| EBT | 1,20,000 |
| Less: Tax (50%) | 60,000 |
| EAT | 60,000 |

$$(ii) \text{ Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{1,50,000}{1,20,000} = 1.25 \text{ times}$$

Combined Leverage = Operating Leverage X Financial Leverage
= 4 X 1.25 = 5 times

Or,

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{EBT}} = \frac{\text{Contribution}}{\text{EBT}} = \frac{\text{Rs. 6,00,000}}{\text{Rs. 1,20,000}} = 5 \text{ times}$$

(iii) Percentage Change in Earnings per Share

$$\text{Combined Leverage} = \frac{\% \text{ Change in EPS}}{\% \text{ Change in Sales}} = 5 = \frac{\% \text{ Change in EPS}}{5\%}$$



∴ % Change in EPS = 25%

Hence, if sales increased by 5 %, EPS will be increased by 25 %.

Question 36

Details of a company for the year ended 31st March, 2022 are given below:

| | |
|--|------------|
| Sales | ₹ 86 lakhs |
| Profit Volume (P/V) Ratio | 35% |
| Fixed Cost excluding interest expenses | ₹ 10 lakhs |
| 10% Debt | ₹ 55 lakhs |
| Equity Share Capital of ₹ 10 each | ₹ 75 lakhs |
| Income Tax Rate | 40% |

Required:

- Determine company's Return on Capital Employed (Pre-tax) and EPS.
- Does the company have a favourable financial leverage?
- Calculate operating and combined leverages of the company.
- Calculate percentage change in EBIT, if sales increases by 10%.
- At what level of sales, the Earning before Tax (EBT) of the company will be equal to zero? (PYP 10 Marks May'22)

Answer 36

Income Statement

| Particulars | Amount (₹) |
|--|------------|
| Sales | 86,00,000 |
| Less: Variable cost (65% of 86,00,000) | 55,90,000 |
| Contribution (35% of 86,00,000) | 30,10,000 |
| Less: Fixed costs | 10,00,000 |
| Earnings before interest and tax (EBIT) | 20,10,000 |
| Less: Interest on debt (@ 10% on ₹ 55 lakhs) | 5,50,000 |
| Earnings before tax (EBT) | 14,60,000 |
| Tax (40%) | 5,84,000 |
| PAT | 8,76,000 |

$$(i) \text{ ROCE (Pre-tax)} = \frac{\text{EBIT}}{\text{Capital employed}} \times 100 = \frac{\text{EBIT}}{\text{Equity} + \text{Debt}} \times 100$$

$$\frac{₹20,10,000}{₹(75,00,000 + 55,00,000)} \times 100 = 15.46\%$$

EPS (PAT/No. of equity shares) 1.168 or ₹ 1.17

(ii) ROCE is 15.46% and Interest on debt is 10%. Hence, it has a favourable financial leverage.

(iii) Calculation of Operating, Financial and Combined leverages:

$$\text{Operating Leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{₹ 30,10,000}{₹ 20,10,000} = 1.497 \text{ (approx.)}$$

$$\text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{₹ 20,10,000}{₹ 14,60,000} = 1.377 \text{ (approx.)}$$



$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{₹ 30,10,000}{₹ 14,60,000} = 2.062 \text{ (approx.)}$$

$$\text{Or, } = \text{Operating Leverage} \times \text{Financial Leverage} = 1.497 \times 1.377 = 2.06 \text{ (approx.)}$$

- (iv) Operating leverage is 1.497. So, if sales are increased by 10%.
EBIT will be increased by $1.497 \times 10\%$ i.e. 14.97% (approx.)
- (v) Since the combined Leverage is 2.062, sales have to drop by $100/2.062$ i.e. 48.50% to bring EBT to Zero.

$$\begin{aligned} \text{Accordingly, New Sales} &= ₹ 86,00,000 \times (1 - 0.4850) \\ &= ₹ 86,00,000 \times 0.515 \\ &= ₹ 44,29,000 \text{ (approx.)} \end{aligned}$$

Hence, at ₹ 44,29,000 sales level, EBT of the firm will be equal to Zero.

Question 37

The following information is available for SS Ltd.

| | |
|------------------------------|------------|
| Profit volume (PV) ratio | 30% |
| Operating leverage | 2.00 |
| Financial leverage | 1.50 |
| Loan | ₹ 1,25,000 |
| Post-tax interest rate | 5.6% |
| Tax rate | 30% |
| Market Price per share (MPS) | ₹ 140 |
| Price Earnings Ratio (PER) | 10 |
| You are required to: | |

- Prepare the Profit-Loss statement of SS Ltd. and
- Find out the number of equity shares. (PYP 10 Marks Nov '22)

Answer 37

(1) Preparation of Profit – Loss Statement Working Notes:

| | |
|---|------------|
| 1. Post tax interest | 5.60% |
| Tax rate | 30% |
| Pre tax interest rate = $(5.6/70) \times 100$ | 8% |
| Loan amount | ₹ 1,25,000 |
| Interest amount = $1,25,000 \times 8\%$ | ₹ 10,000 |

$$\text{Financial Leverage (FL)} = \left[\frac{\text{EBIT}}{\text{EBT}} \right] = \left[\frac{\text{EBIT}}{\text{EBIT} - \text{Interest}} \right] = \left[\frac{\text{EBIT}}{\text{EBIT} - 10,000} \right]$$

$$1.5 = \left[\frac{\text{EBIT}}{\text{EBIT} - 10,000} \right]$$

$$1.5 \text{ EBIT} - 15,000 = \text{EBIT}$$

$$1.5 \text{ EBIT} - \text{EBIT} = 15,000 \quad 0.5 \text{ EBIT} = 15,000$$

$$\therefore \text{EBIT} = ₹ 30,000$$

$$\text{EBT} = \text{EBIT} - \text{Interest} = 30,000 - 10,000 = ₹ 20,000$$

$$2. \text{ Operating Leverage (OL)} = \frac{\text{Contribution}}{\text{EBIT}}$$



$$2 = \frac{\text{Contribution}}{30,000}$$

$$\text{Contribution} = \text{Rs. } 60,000$$

$$3. \text{Fixed Cost} = \text{Contribution} - \text{Profit}$$

$$= 60,000 - 30,000 = \text{Rs. } 30,000$$

$$4. \text{Sales} = \frac{\text{Contribution}}{\text{PV Ratio}} = \frac{60,000}{30\%} = \text{Rs. } 2,00,000$$

5. If PV ratio is 30%, then the variable cost is 70% on sales.

$$\therefore \text{Variable cost} = 2,00,000 \times 70\% = \text{₹ } 1,40,000$$

Profit – Loss Statement

| Particulars | ₹ |
|---------------------|----------|
| Sales | 2,00,000 |
| Less: Variable cost | 1,40,000 |
| Contribution | 60,000 |
| Less: Fixed cost | 30,000 |
| EBIT | 30,000 |
| Less: Interest | 10,000 |
| EBT | 20,000 |
| Less: Tax @ 30% | 6,000 |
| EAT | 14,000 |

(2) Calculation of no. of Equity shares Market Price per Share (MPS) = ₹140 Price Earnings Ratio (PER) = 10 WKT,

$$\text{EPS} = \frac{\text{MPS}}{\text{PER}} = \frac{140}{10} = \text{Rs. } 14$$

Total earnings (EAT) = ₹ 14,000

$$\therefore \text{No. of Equity Shares} = 14,000 / 14 = 1000$$

Question 38

Following information is given for X Ltd.:

| | |
|------------------------------------|----------|
| Total contribution (₹) | 4,25,000 |
| Operating leverage | 3.125 |
| 15% Preference shares (₹ 100 each) | 1,000 |
| Number of equity shares | 2,500 |
| Tax rate | 50% |

Calculate EPS of X Ltd., if 40% decrease in sales will result EPS to zero. (PYP 5 Marks May '23)

Answer 38

$$i) \text{ Operating Leverage (OL)} = \frac{\text{Contribution}}{\text{EBIT}} \text{ or, } 3.125 = \frac{4,25,000}{\text{EBIT}} \text{ or EBIT} = \text{₹ } 1,36,000$$



ii) Degree of Combined Leverage (CL) = $\frac{\% \text{ Change in EPS}}{\% \text{ Change in Sales}} = \frac{100}{40} = 2.5$

iii) Combined Leverage = OL × FL = 3.125 × FL

So, Financial Leverage = 2.5 / 3.125 = 0.8

iv) Financial Leverage = $\frac{EBIT}{EBT} = \frac{1,36,000}{EBT} = 0.8$

So, EBT = $\frac{1,36,000}{0.80} = ₹ 1,70,000$

Calculation of EPS of X Ltd

| Particulars | (₹) |
|--------------------------------------|----------|
| EBT | 1,70,000 |
| Less: Tax (50%) | 85,000 |
| EAT | 85,000 |
| Preference Dividend | 15,000 |
| Net Earnings for Equity Shareholders | 70,000 |
| Number of equity shares | 2,500 |
| EPS | 28 |



Chapter 7 Investment Decisions

Question 1

Hindlever Company is considering a new product line to supplement its range of products. It is anticipated that the new product line will involve cash investments of ₹ 7,00,000 at time 0 and ₹ 10,00,000 in year 1. After-tax cash inflows of ₹ 2,50,000 are expected in year 2, ₹ 3,00,000 in year 3, ₹ 3,50,000 in year 4 and ₹ 4,00,000 each year thereafter through year 10. Although the product line might be viable even after year 10, the company prefers to be conservative and end all calculations at that time.

- If the required rate of return is 15 per cent, COMPUTE net present value of the project. Is it acceptable?
- ANALYSE what would be the case if the required rate of return were 10 percent?
- CALCULATE its internal rate of return.
- COMPUTE the project's payback period. (Old & New SM) (Same concept different figures MTP 7 Marks, Oct'19) (Old & New SM)

Answer 1

a) Computation of NPV at 15% discount rate

| Year | Cash flow | Discount Factor (15%) | Present value |
|-------------------|-------------|-----------------------|---------------|
| | (₹) | | (₹) |
| 0 | (7,00,000) | 1.000 | (7,00,000) |
| 1 | (10,00,000) | 0.870 | (8,70,000) |
| 2 | 2,50,000 | 0.756 | 1,89,000 |
| 3 | 3,00,000 | 0.658 | 1,97,400 |
| 4 | 3,50,000 | 0.572 | 2,00,200 |
| 5 ₹ 10 | 4,00,000 | 2.163 | 8,65,200 |
| Net Present Value | | | (1,18,200) |

As the net present value is negative, the project is unacceptable.

b) Computation of NPV if discount rate would be 10% discount rate

| Year | Cash flow | Discount Factor (10%) | Present value |
|-------------------|-------------|-----------------------|---------------|
| | (₹) | | (₹) |
| 0 | (7,00,000) | 1.000 | (7,00,000) |
| 1 | (10,00,000) | 0.909 | (9,09,000) |
| 2 | 2,50,000 | 0.826 | 2,06,500 |
| 3 | 3,00,000 | 0.751 | 2,25,300 |
| 4 | 3,50,000 | 0.683 | 2,39,050 |
| 5 ₹ 10 | 4,00,000 | 2.974 | 11,89,600 |
| Net Present Value | | | 2,51,450 |

Since NPV = ₹ 2,51,450 is positive, hence the project would be acceptable.

c) Calculation of IRR:

$$\text{IRR} = \text{LR} + \frac{\text{NPV}_{\text{at LR}}}{\text{NPV}_{\text{at LR}} - \text{NPV}_{\text{at HR}}} (\text{HR} - \text{LR})$$

$$10\% + \frac{\text{Rs. } 2,51,450}{\text{Rs. } 2,51,450 - (-1,18,200)} (15\% - 10\%)$$

$$= 10\% + 3.4012 \text{ or } 13.40\%$$



d) **Computation of Pay-back period of the project:**

Payback Period = 6 years:

$$- ₹ 7,00,000 + ₹ 10,00,000 + ₹ 2,50,000 + ₹ 3,00,000 + ₹ 3,50,000 + ₹ 4,00,000 = 0$$

Question 2

STATE Modified Internal Rate of Return method. (MTP 2 Marks, March'18)

Answer 2

Modified Internal Rate of Return (MIRR): There are several limitations attached with the concept of the conventional Internal Rate of Return. The MIRR addresses some of these deficiencies. For example, it eliminates multiple IRR rates; it addresses the reinvestment rate issue and produces results, which are consistent with the Net Present Value method.

Under this method, all cash flows, apart from the initial investment, are brought to the terminal value using an appropriate discount rate (usually the cost of capital). This results in a single stream of cash inflow in the terminal year. The MIRR is obtained by assuming a single outflow in the zeroth year and the terminal cash inflow as mentioned above. The discount rate which equates the present value of the terminal cash in flow to the zeroth year outflow is called the MIRR.

Question 3

You are a financial analyst of B Limited. The director of finance has asked you to analyse two capital investments proposals, Projects X and Y. Each project has a cost of ₹10,000 and the cost of capital for each project is 12 per cent. The project's expected net cash flows are as follows:

| Year | Expected net cash flows | |
|------|-------------------------|---------------|
| | Project X (₹) | Project Y (₹) |
| 0 | (10,000) | (10,000) |
| 1 | 6,500 | 3,500 |
| 2 | 3,000 | 3,500 |
| 3 | 3,000 | 3,500 |
| 4 | 1,000 | 3,500 |

- CALCULATE each project's payback period, net present value (NPV) and internal rate of return (IRR).
- DETERMINE, which project or projects should be accepted if they are independent? (MTP 10 Marks, March'18)

Answer 3

i) Payback Period Method

The cumulative cash flows for each project are as follows:

| Year | Cumulative Cash Flows | |
|------|-----------------------|---------------|
| | Project X (₹) | Project Y (₹) |
| 0 | (10,000) | (10,000) |
| 1 | (3,500) | (6,500) |
| 2 | (500) | (3,000) |
| 3 | 2,500 | 500 |
| 4 | 3,500 | 4,000 |

$$\text{Payback}_x = 2 + \frac{\text{Rs.500}}{\text{RS.3000}} = 2.17 \text{ years}$$

$$\text{Payback}_y = \frac{\text{Rs.3000}}{\text{RS.3500}} \times 2.86 \text{ years.}$$

Net Present Value (NPV)



$$NPV_x = -Rs.1000 + \frac{Rs.6500}{(1.12)^1} + \frac{Rs.3000}{(1.12)^2} + \frac{Rs.3000}{(1.12)^3} + \frac{Rs.1000}{(1.12)^4}$$

= Rs.630.72

Internal Rate of Return (IRR)

To solve for each project's IRR, find the discount rates that equate each NPV to zero: IRR_x = 18.0%.

IRR_y = 15.0%.

(ii) The following table summarizes the project rankings by each method:

| | Project that ranks higher |
|---------|---------------------------|
| Payback | X |
| NPV | X |
| IRR | X |

Analysis: All methods rank Project X over Project Y. In addition, both projects are acceptable under the NPV and IRR criteria. Thus, both projects should be accepted if they are independent.

Question 4

A company has to make a choice between two projects namely A and B. The initial capital outlay of two Projects are Rs.1,35,00,000 and Rs.2,40,00,000 respectively for A and B. There will be no scrap value at the end of the life of both the projects. The opportunity cost of capital of the company is 16%. The annual incomes are as under:

| Year | Project A | Project B | Discounting factor @ 16% |
|------|-------------|-------------|--------------------------|
| 1 | -- | 60,00,000 | 0.862 |
| 2 | 30,00,000 | 84,00,000 | 0.743 |
| 3 | 1,32,00,000 | 96,00,000 | 0.641 |
| 4 | 84,00,000 | 1,02,00,000 | 0.552 |
| 5 | 84,00,000 | 90,00,000 | 0.476 |

You are required to CALCULATE for each project:

- Discounted payback period
- Profitability index
- Net present value (MTP 10 Marks, Aug'18, RTP May '18)

Answer 4

(1) Computation of Net Present Values of Projects (Amount in Rest. '000)

| Year | Cash flows | | Discount factor @ 16 % | Discounted Cash flow | |
|-------------------|-----------------|-----------------|------------------------|----------------------|-----------------|
| | Project A (Rs.) | Project B (Rs.) | | Project A (Rs.) | Project B (Rs.) |
| | (1) | (2) | (3) | (3) × (1) | (3) × (2) |
| 0 | (13,500) | (24,000) | 1.000 | (13,500) | (24,000) |
| 1 | -- | 6,000 | 0.862 | -- | 5,172 |
| 2 | 3,000 | 8,400 | 0.743 | 2,229 | 6,241.2 |
| 3 | 13,200 | 9,600 | 0.641 | 8,461.2 | 6,153.6 |
| 4 | 8,400 | 10,200 | 0.552 | 4,636.8 | 5,630.4 |
| 5 | 8,400 | 9,000 | 0.476 | 3,998.4 | 4,284 |
| Net present value | | | | 5,825.4 | 3,481.2 |

(2) Computation of Cumulative Present Values of Projects Cash inflows (Amount in Rs. '000)

| | Project A | Project B |
|--|-----------|-----------|
|--|-----------|-----------|

| Year | PV of cash inflows (Rs.) | Cumulative PV (Rs.) | PV of cash inflows (Rs.) | Cumulative PV (Rs.) |
|------|--------------------------|---------------------|--------------------------|---------------------|
| 1 | -- | -- | 5,172 | 51,72 |
| 2 | 2,229 | 22,29 | 6,241.2 | 11,413.2 |
| 3 | 8,461.2 | 10,690.2 | 6,153.6 | 17,566.8 |
| 4 | 4,636.8 | 15,327 | 5,630.4 | 23,197.2 |
| 5 | 3,998.4 | 19,325.4 | 4,284 | 27,481.2 |

(i) **Discounted payback period:** (Refer to Working note 2)

Cost of Project A = Rs.1,35,00,000 Cost of Project B = Rs.2,40,00,000

Cumulative PV of cash inflows of Project A after 4 years = Rs.1,53,27,000 Cumulative PV of cash inflows of Project B after 5 years = Rs.2,74,81,200

A comparison of projects cost with their cumulative PV clearly shows that the project A's cost will be recovered in less than 4 years and that of project B in less than 5 years. The exact duration of discounted payback period can be computed as follows:

| | Project A | Project B |
|--|---|--|
| Excess PV of cash inflows over the project cost (Rs.) | 18,27,000 (Rs.1,53,27,000 - Rs.1,35,00,000) | 34,81,200 (Rs. 2,74,81,200 - Rs.2,40,00,000) |
| Computation of period required to recover excess amount of cumulative PV over project cost (Refer to Working note 2) | 0.39 year (Rs. 18,27,000 ÷ Rs.46,36,800) | 0.81 years (Rs.34,81,200 ÷ Rs. 42,84,000) |
| Discounted payback period | 3.61 year (4 - 0.39) years | 4.19 years (5 - 0.81) years |

Profitability Index=

$$\frac{\text{Sum of discounted cash in flows}}{\text{Initial cash outly}}$$

Profitability Index (for Project A) = $\frac{\text{Rs.1,9,32,5400}}{\text{Rs.1,35,00,000}} = 1.43$

Profitability Index (for Project B) = $\frac{\text{Rs.2,74,81,200}}{\text{Rs.2,40,00,000}} = 1.15$

(i) **Net present value** (for Project A) = Rs.58,25,400 (Refer to Working note 1)

Net present value (for Project B) = Rs.34,81,200

Question 5

X Limited is considering to purchase of new plant worth Rs. 80,00,000. The expected net cash flows after taxes and before depreciation are as follows:

| Year | Net Cash Flows (Rs.) |
|------|----------------------|
| 1 | 14,00,000 |
| 2 | 14,00,000 |
| 3 | 14,00,000 |
| 4 | 14,00,000 |
| 5 | 14,00,000 |
| 6 | 16,00,000 |



| | |
|----|-----------|
| 7 | 20,00,000 |
| 8 | 30,00,000 |
| 9 | 20,00,000 |
| 10 | 8,00,000 |

The rate of cost of capital is 10%.

You are required to CALCULATE

- (i) Pay-back period
- (ii) Net present value at 10 discount factor
- (iii) Profitability index at 10 discount factor
- (iv) Internal rate of return with the help of 10% and 15% discount

factor The following present value table is given for you:

| Year | Present value of Rs. 1 at 10% discount rate | Present value of Rs. 1 at 15% discount rate |
|------|---|---|
| 1 | .909 | .870 |
| 2 | .826 | .756 |
| 3 | .751 | .658 |
| 4 | .683 | .572 |
| 5 | .621 | .497 |
| 6 | .564 | .432 |
| 7 | .513 | .376 |
| 8 | .467 | .327 |
| 9 | .424 | .284 |
| 10 | .386 | .247 |

(MTP 10 Marks, Oct'18, Old & New SM)

Answer 5

- (i) Calculation of Pay-back Period

Cash Outlay of the Project = Rs. 80,00,000

Total Cash Inflow for the first five years = Rs. 70,00,000

Balance of cash outlay left to be paid back in the 6th year Rs. 10,00,000

Cash inflow for 6th year = 16,00,000

So the payback period is between 5th and 6th years, i.e., 5 Years + Rs.10,00,000 / Rs.6,00,000

= 5.625 years or 5 years 7.5 months

- (ii) Calculation of Net Present Value (NPV) @10% discount rate:

| Year | Net Cash Inflow (Rs.) | Present Value at Discount Rate of 10% | Present Value (Rs.) |
|------|--------------------------|--|------------------------|
| | (a) | (b) | (c) = (a) × (b) |
| 1 | 14,00,000 | 0.909 | 12,72,600 |
| 2 | 14,00,000 | 0.826 | 11,56,400 |
| 3 | 14,00,000 | 0.751 | 10,51,400 |
| 4 | 14,00,000 | 0.683 | 9,56,200 |
| 5 | 14,00,000 | 0.621 | 8,69,400 |
| 6 | 16,00,000 | 0.564 | 9,02,400 |
| 7 | 20,00,000 | 0.513 | 10,26,000 |
| 8 | 30,00,000 | 0.467 | 14,01,000 |
| 9 | 20,00,000 | 0.424 | 8,48,000 |

| | | | |
|----|----------|-------|-----------|
| 10 | 8,00,000 | 0.386 | 3,08,800 |
| | | | 97,92,200 |

Net Present Value (NPV) = Cash Outflow – Present Value of Cash Inflows
 = Rs. 80,00,000 – Rs. 97,92,200 = 17,92,200

(iii) Calculation of Profitability Index @ 10% discount rate:

Profitability Index

$$\frac{\text{Present Value of Cash inflows}}{\text{Cost of the investment}}$$

$$= \frac{\text{Rs.}97,92,200}{\text{Rs.}80,00,000} = 1.224$$

(iv) Calculation of Internal Rate of Return:

Net present value @ 10% interest rate factor has already been calculated in (ii) above, we will calculate Net present value @ 15% rate factor.

| Year | Net Cash Inflow (Rs.) | Present Value at Discount Rate of 15% | Present Value (Rs.) |
|------|-----------------------|---------------------------------------|---------------------|
| | (a) | (b) | (c) = (a) × (b) |
| 1 | 14,00,000 | 0.870 | 12,18,000 |
| 2 | 14,00,000 | 0.756 | 10,58,400 |
| 3 | 14,00,000 | 0.658 | 9,21,200 |
| 4 | 14,00,000 | 0.572 | 8,00,800 |
| 5 | 14,00,000 | 0.497 | 6,95,800 |
| 6 | 16,00,000 | 0.432 | 6,91,200 |
| 7 | 20,00,000 | 0.376 | 7,52,000 |
| 8 | 30,00,000 | 0.327 | 9,81,000 |
| 9 | 20,00,000 | 0.284 | 5,68,000 |
| 10 | 8,00,000 | 0.247 | 1,97,600 |
| | | | 78,84,000 |

Net Present Value at 15% = Rs. 78,84,000 – Rs. 80,00,000 = Rs. -1,16,000

As the net present value @ 15% discount rate is negative, hence internal rate of return falls in between 10% and 15%. The correct internal rate of return can be calculated as follows:

$$\begin{aligned} \text{IRR} &= L + \frac{\text{NPV}_L}{\text{NPV}_L - \text{NPV}_H} (H - L) \\ 10\% + \frac{\text{Rs.}17,92,200}{\text{Rs.}17,92,200 - (-\text{Rs.}1,16,000)} (15\% - 10\%) \\ &= 10\% + \frac{\text{Rs.}17,92,200}{\text{Rs.}19,08,200} \times 5\% = 14.7\% \end{aligned}$$

Question 6

X Ltd. is considering to select a machine out of two mutually exclusive machines. The company's cost of capital is 15 per cent and corporate tax rate is 30 per cent. Other information relating to both machines is as follows:

Machine – I
Cost of Machine

Machine – II
Rs. 30,00,000

Rs. 40,00,000

| | | |
|--------------------------------------|----------------------|----------------------|
| Expected Life | 10 years. | 10 years. |
| Annual Income | | |
| (Before Tax and Depreciation) | Rs. 12,50,000 | Rs. 17,50,000 |

Depreciation is to be charged on straight line basis:

You are required to CALCULATE:

- (i) Discounted Pay Back Period
- (ii) Net Present Value
- (iii) Profitability Index

The present value factors of Re.1 @ 15% are as follows: [MTP 10 Marks, Mach'19]

| | | | | | |
|------------------------|--------------|--------------|--------------|--------------|---------------|
| Year | 01 | 02 | 03 | 04 | 05 |
| PV factor @ 15% | 0.870 | 0.756 | 0.658 | 0.572 | 0.497. |

Answer 6

Working Notes:

Depreciation on Machine-I = $\frac{30,00,000}{10} = \text{Rs. } 3,00,000$

Depreciation on Machine-II = $\frac{40,00,000}{10} = \text{Rs. } 4,00,000$

| Particulars | Machine-I (Rs.) | Machine – II (Rs.) |
|---|------------------------|---------------------------|
| Annual Income (before Tax and Depreciation) | 12,50,000 | 17,50,000 |
| Less: Depreciation | 3,00,000 | 4,00,000 |
| Annual Income (before Tax) | 9,50,000 | 13,50,000 |
| Less: Tax @ 30% | (2,85,000) | (4,05,000) |
| Annual Income (after Tax) | 6,65,000 | 9,45,000 |
| Add: Depreciation | 3,00,000 | 4,00,000 |
| Annual Cash Inflows | 9,65,000 | 13,45,000 |
| | Machine – I | Machine - II |

| Year | PV of Re 1 @ 15% | Cash flow | PV | Cumulative PV | Cash flow | PV | Cumulative PV |
|-------------|-------------------------|------------------|-----------|----------------------|------------------|-----------|----------------------|
| 1 | 0.870 | 9,65,000 | 8,39,550 | 8,39,550 | 13,45,000 | 11,70,150 | 11,70,150 |
| 2 | 0.756 | 9,65,000 | 7,29,540 | 15,69,090 | 13,45,000 | 10,16,820 | 21,86,970 |
| 3 | 0.658 | 9,65,000 | 6,34,970 | 22,04,060 | 13,45,000 | 8,85,010 | 30,71,980 |
| 4 | 0.572 | 9,65,000 | 5,51,980 | 27,56,040 | 13,45,000 | 7,69,340 | 38,41,320 |
| 5 | 0.497 | 9,65,000 | 4,79,605 | 32,35,645 | 13,45,000 | 6,68,465 | 45,09,785 |

- (i) Discounted Payback Period

Machine – I

$$\text{Discounted Payback Period} = 4 + \frac{(3,00,000 - 27,56,040)}{4,79,605}$$

$$= 4 + \frac{2,43,960}{4,79,605} = 4 + 0.5087 = 4.5087 \text{ years or 4 years 6.10 months}$$

Machine – II

$$\text{Discounted Payback Period} = 4 + \frac{(40,00,000 - 38,41,320)}{6,68,465}$$

$$4 + \frac{1,58,680}{6,68,465}$$

$$= 4 + 0.2374 = 4.2374 \text{ years or 4 years 2.85 months}$$

- (ii) Net Present Value (NPV)

Machine – I

$$\text{NPV} = 32,35,645 - 30,00,000 = \text{Rs. } 2,35,645$$

Machine – II

$$NPV = 45,09,785 - 40,00,000 = \text{Rs. } 5,09,785$$

(iii) Profitability Index

Machine – I

$$\text{Profitability Index} = \frac{32,35,645}{30,00,000} = 1.08$$

Machine – II

$$\frac{45,09,785}{40,00,000} = 1.13$$

Conclusion:

| Method | Machine - I | Machine - II | Rank |
|---------------------------|---------------|--------------|------|
| Discounted Payback Period | 4.51 years | 4.24 years | II |
| Net Present Value | Rs. .2,35,645 | Rs. 5,09,785 | II |
| Profitability Index | 1.08 | 1.13 | II |

Question 7

Prem Ltd has a maximum of Rs. 8,00,000 available to invest in new projects. Three possibilities have emerged and the business finance manager has calculated Net Present Value (NPVs) for each of the projects as follows:

| Investment | Initial cash outlay Rs. | NPV Rs. |
|------------|----------------------------|------------|
| Alfa (α) | 5,40,000 | 1,00,000 |
| Beta(β) | 6,00,000 | 1,50,000 |
| Gama (γ) | 2,60,000 | 58,000 |

DETERMINE which investment/combination of investments should the company invest in, if we assume that the projects can be divided? (MTP 6 Marks, April'19)

Answer 7

Since funds available are restricted, the normal Net Present Value (NPV) rule of accepting investments decisions with the highest NPVs cannot be adopted straight way. Further, as the projects are divisible, a Profitability Index (PI) can be utilized to provide the most beneficial combination of investment for Rio Ltd.

| Project | PV Per Rs. | Rank as per PI |
|----------|-------------------------------------|----------------|
| Alfa (α) | Rs. 6,40,000 / Rs. 5,40,000 = 1.185 | III |
| Beta (β) | Rs. 7,50,000 / Rs. 6,00,000 = 1.250 | I |
| Gama (γ) | Rs. 3,18,000 / Rs. 2,60,000 = 1.223 | II |

Therefore, Rio Ltd should invest Rs. 6,00,000 into project β (Rank I) earnings Rs. 1,50,000 and Rs.2,00,000 into project γ (Rank II) earning Rs. 44,615 Rs. 2,00,000 / Rs. 2,60,000 × Rs. 58,000

So, total NPV will be Rs.1,94,615

Rs. 1,50,000 + Rs. 44,615 from Rs. 8,00,000 of investment.

Question 8

EXPLAIN the concept of discounted payback period. (MTP 2 Marks, Oct'19)

Answer 8

Concept of Discounted Payback Period

Pay back period is time taken to recover the original investment from project cash flows. It is also termed as break even period. The focus of the analysis is on liquidity aspect and it suffers from the limitation of ignoring time value of money and profitability. Discounted payback period considers present value of cash flows, discounted at company's cost of capital to estimate breakeven period i.e. it is that period in which future discounted cash flows equal the initial outflow. The shorter the period, better it is. It also ignores post discounted payback period cash flows.

Question 9

A company proposes to install a machine involving a Capital Cost of Rs.72,00,000. The life of the machine is 5 years and its salvage value at the end of the life is nil. The machine will produce the net operating income after depreciation of Rs.13,60,000 per annum. The Company's tax rate is 35%(MTP 5 Marks 'May'20 & Oct '23 Old & New SM)

The Net Present Value factors for 5 years are as under:

| | | | | | | | |
|-------------|---|------|------|------|------|------|------|
| Discounting | : | 14 | 15 | 16 | 17 | 18 | 19 |
| Rate | | | | | | | |
| Cumulative | : | 3.43 | 3.35 | 3.27 | 3.20 | 3.13 | 3.06 |
| factor | | | | | | | |

You are required to COMPUTE the internal rate of return (IRR) of the proposal.

Answer 9

| Computation of cash inflow per annum | Rs. |
|--|-----------|
| Net operating income per annum | 13,60,000 |
| Less: Tax @ 35% | 4,76,000 |
| Profit after tax | 8,84,000 |
| Add: Depreciation (Rs.72,00,000 / 5 years) | 14,40,000 |
| Cash inflow | 23,24,000 |

The IRR of the investment can be found as follows: NPV = -Rs. 72,00,000 + Rs. 23,24,000 (PVA_{F5, r}) = 0

$$\text{or PVA } F5 \text{ r (Cumulative factor)} = \frac{\text{Rs.72,00,000}}{\text{Rs.23,24,000}} = 3.09$$

Computation of Internal Rate of Return (IRR)

| | | |
|-------------------------|-----------|-----------------------|
| Discounting rate | 15% | 19% |
| Cumulative factor | 3.35 | 3.06 |
| Total NPV (Rs.) | 77,85,400 | 71,11,440 |
| (Rs.23,24,000 × 3.35) | | (Rs.23,24,000 × 3.06) |
| Internal outlay (Rs.) | 72,00,000 | 72,00,000 |
| Surplus (Deficit) (Rs.) | 5,85,400 | (88,560) |

$$\begin{aligned} \text{IRR} &= \text{LR} + \frac{\text{NPV at LR}}{\text{NPV at LR} - \text{NPV at HR}} \times (\text{HR} - \text{LR}) \\ &= 15\% + \frac{5,85,400}{5,85,400 - (88,560)} \times (19\% - 15\%) \\ &= 15\% + 3.47 = 18.47\% \end{aligned}$$

Question 10

ABC Ltd. is considering a project "X" with an initial outlay of Rs.16,00,000 and the possible three cash inflow attached with the project is as follows:)

(Amount in ₹ '000)

| Particular | Year 1 | Year 2 | Year 3 |
|------------|--------|--------|--------|
| Scenario 1 | 550 | 500 | 800 |
| Scenario 2 | 650 | 550 | 900 |
| Scenario 3 | 750 | 600 | 1000 |

Assuming the cost of capital as 9%.

- DETERMINE NPV in each scenario.
- If ABC Ltd. is certain about the 1st and 2ND year's results in scenario 2 but uncertain about the third year's cash flow, DETERMINE NPV expecting scenario 1 in the third year.

| Year | 1 | 2 | 3 |
|---------|------|-------|-------|
| DF @ 9% | 0.91 | 0.842 | 0.772 |
| | 7 | | |



[MTP 5 Marks, Oct'20]

Answer 10

(I) The possible outcomes under different scenario will be as follows:

(Amount in ₹ '000)

| Year | PVF @ 9% | Scenario 1 | | Scenario 2 | | Scenario 3 | |
|------|----------|------------|---------|------------|--------|------------|--------|
| | | Cash Flow | PV | Cash Flow | PV | Cash Flow | PV |
| 0 | 1.000 | (1600) | (1600) | (1600) | (1600) | (1600) | (1600) |
| 1 | 0.917 | 550.00 | 504.35 | 650.00 | 596.05 | 750.00 | 687.75 |
| 2 | 0.842 | 500.00 | 421.00 | 550.00 | 463.10 | 600.00 | 505.20 |
| 3 | 0.772 | 800.00 | 617.60 | 900.00 | 694.80 | 1000.00 | 772.00 |
| NPV | | | (57.05) | | 153.95 | | 364.95 |

(ii) The company is bit confident about the estimates in the first two years, but not sure about the third year's cash inflow, the NPV in such case expecting scenario 1 in the third year will be as follows:

$$\begin{aligned}
 &= -16,00,000 + (6,50,000 \times 0.917 + 5,50,000 \times 0.842 + 8,00,000 \times 0.772) \\
 &= -16,00,000 + (5,96,050 + 4,63,100 + 6,17,600) \\
 &= ₹ 76,750
 \end{aligned}$$

Question 11

GG Pathology Lab Ltd. is using 2D sonography machine which has reached the end of its useful life. The lab is intending to upgrade along with the technology by investing in 3D sonography machine as per the choices preferred by the patients. Following new 3D sonography machine of two different brands with same features is available in the market:

| Brand | Cost of machine (Rs.) | Life of machine (Rs.) | Maintenance Cost (Rs.) | | | SLM Depreciation rate (%) |
|-------|-----------------------|-----------------------|------------------------|-----------|------------|---------------------------|
| | | | Year 1-5 | Year 6-10 | Year 11-15 | |
| X | 15,00,000 | 15 | 50,000 | 70,000 | 98,000 | 6 |
| Y | 10,00,000 | 10 | 70,000 | 1,15,000 | - | 6 |

Residual Value of machines shall be dropped by 10% and 40% of Purchase price for Brand X and Y respectively in the first year and thereafter shall be depreciated at the rate mentioned above on the original cost.

Alternatively, the machine of Brand Y can also be taken on rent to be returned back to the owner after use on the following terms and conditions:

- Annual Rent shall be paid in the beginning of each year and for first year it shall be Rs. 2,24,000. Annual Rent for the subsequent 4 years shall be Rs. 2,25,000.
- Annual Rent for the final 5 years shall be Rs. 2,70,000.
- The Rent/Agreement can be terminated by GG Labs by making a payment of Rs. 2,20,000 as penalty. This penalty would be reduced by Rs. 22,000 each year of the period of rental agreement. You are required to:

(i) ADVISE which brand of 3D sonography machine should be acquired assuming that the use of machine shall be continued for a period of 20 years.

(ii) STATE which of the option is most economical if machine is likely to be used for a period of 5 years? The cost of capital of GG Labs is 12%.

The present value factor of Rs. 1 @ 12% for different years is given as under:

| Year | PVF | Year | PVF |
|------|-------|------|-------|
| 1 | 0.893 | 9 | 0.361 |



| | | | |
|---|-------|----|-------|
| 2 | 0.797 | 10 | 0.322 |
| 3 | 0.712 | 11 | 0.287 |
| 4 | 0.636 | 12 | 0.257 |
| 5 | 0.567 | 13 | 0.229 |
| 6 | 0.507 | 14 | 0.205 |
| 7 | 0.452 | 15 | 0.183 |
| 8 | 0.404 | 16 | 0.163 |

(MTP 10 Marks, March'21, RTP May '19)

Answer 11

Since the life span of each machine is different and time span exceeds the useful lives of each mode, we shall use Equivalent Annual Cost method to decide which brand should be chosen.

- (i) If machine is used for 20 years
 (a) Residual value of machine of brand X
 $= [\text{Rs. } 15,00,000 - (1 - 0.10)] - (\text{Rs. } 15,00,000 \times 0.06 \times 14) = \text{Rs. } 90,000$
 (b) Residual value of machine of brand Y
 $= [\text{Rs. } 10,00,000 - (1 - 0.40)] - (\text{Rs. } 10,00,000 \times 0.06 \times 9) = \text{Rs. } 60,000$

Present Value (PV) of cost if machine of brand X is purchased

| Period | Cash Outflow (Rs.) | PVF @ 12% | PV (Rs.) |
|--------|--------------------|-----------|-----------|
| 0 | 15,00,000 | 1.000 | 15,00,000 |
| 1-5 | 50,000 | 3.605 | 1,80,250 |
| 6-10 | 70,000 | 2.046 | 1,43,220 |
| 11-15 | 98,000 | 1.161 | 1,13,778 |
| 15 | (90,000) | 0.183 | (16,470) |
| | | | 19,20,778 |

PVAF for 1-15 years = 6.812

Equivalent Annual Cost = $\frac{\text{Rs. } 19,20,778}{6.812} = \text{Rs. } 2,81,969.76$

Present Value (PV) of cost if machine of brand Y is purchased

| Period | Cash Outflow (Rs.) | PVF @ 12% | PV (Rs.) |
|--------|--------------------|-----------|-----------|
| 0 | 10,00,000 | 1.000 | 10,00,000 |
| 1-5 | 70,000 | 3.605 | 2,52,350 |
| 6-10 | 1,15,000 | 2.046 | 2,35,290 |
| 10 | (60,000) | 0.322 | (19,320) |
| | | | 14,68,320 |

PVAF for 1-10 years = 5.651

Equivalent Annual Cost =

$\frac{\text{Rs. } 14,68,320}{5.651} = \text{Rs. } 2,59,833.66$

Present Value (PV) of cost if machine of brand Y is taken on rent

| Period | Cash Outflow (Rs.) | PVF @ 12% | PV (Rs.) |
|--------|--------------------|-----------|-----------|
| 0 | 2,24,000 | 1.000 | 2,24,000 |
| 1-4 | 2,25,000 | 3.038 | 6,83,550 |
| 5-9 | 2,70,000 | 2.291 | 6,18,570 |
| | | | 15,26,120 |

PVAF for 1-10 years = 5.651

Equivalent Annual Cost =

$\frac{\text{Rs. } 15,26,120}{5.651}$



= Rs. 2,70,061.94

Decision: Since Equivalent Annual Cash Outflow is least in case of purchase of Machine of brand Y the same should be purchased.

(ii) If machine is used for 5 years

(a) Scrap value of machine of brand X

= [Rs. 15,00,000 – (1 - 0.10)] - (Rs. 15,00,000 × 0.06 × 4) = Rs. 9,90,000

(b) Scrap value of machine of brand Y

= [Rs. 10,00,000 – (1 - 0.40)] - (Rs. 10,00,000 × 0.06 × 4) = Rs. 3,60,000

Present Value (PV) of cost if machine of brand X is purchased

| Period | Cash Outflow (Rs.) | PVF @ 12% | PV (Rs.) |
|--------|--------------------|-----------|------------|
| 0 | 15,00,000 | 1.000 | 15,00,000 |
| 1-5 | 50,000 | 3.605 | 1,80,250 |
| 5 | (9,90,000) | 0.567 | (5,61,330) |
| | | | 11,18,920 |

Present Value (PV) of cost if machine of brand Y is purchased

| Period | Cash Outflow (Rs.) | PVF @ 12% | PV (Rs.) |
|--------|--------------------|-----------|------------|
| 0 | 10,00,000 | 1.000 | 10,00,000 |
| 1-5 | 70,000 | 3.605 | 2,52,350 |
| 5 | (3,60,000) | 0.567 | (2,04,120) |
| | | | 10,48,230 |

Present Value (PV) of cost if machine of brand Y is taken on rent

| Period | Cash Outflow (Rs.) | PVF @ 12% | PV (Rs.) |
|--------|--------------------|-----------|----------|
| 0 | 2,24,000 | 1.000 | 2,24,000 |
| 1-4 | 2,25,000 | 3.038 | 6,83,550 |
| 5 | 1,10,000* | 0.567 | 62,370 |
| | | | 9,69,920 |

* [Rs. 2,20,000 - (Rs. 22,000 × 5) = Rs. 1,10,000]

Decision: Since Cash Outflow is least in case of rent of Machine of brand Y the same should be taken on rent.

Question 12

City Clap Ltd. is in the business of providing housekeeping services. There is a proposal before the company to purchase a mechanized cleaning system for a sum of Rs. 40 lakhs. The present system of the company is to use manual Labour for the cleaning job. You are provided with the following information:

Proposed Mechanized System:

Cost of the machine

Rs. 40 lakhs

Life of the machine

7 years

Depreciation (on straight line basis)

15%

Operating cost of mechanized system

Rs. 20 lakhs per annum Present system

(Manual):

Manual Labour

350 persons

Cost of manual Labour

Rs. 15,000 per person per annum

The company has an after-tax cost of fund at 10% per annum.

The applicable tax rate is 50%.

PV factor for 7 years at 10% are as follows:

| Years | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|-------|---|---|---|---|---|---|---|
|-------|---|---|---|---|---|---|---|



| P.V. factor | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 | 0.564 | 0.513 |
|-------------|-------|-------|-------|-------|-------|-------|-------|
|-------------|-------|-------|-------|-------|-------|-------|-------|

You are required to DETERMINE whether it is advisable to purchase the mechanized cleaning system. Give your recommendations with workings. (MTP 10 Marks, April'21)

Answer 12

Calculation of NPV

| | (Rs.) | (Rs.) |
|--|-----------|-----------|
| Cost of Manual System (Rs. 15,000 x 350) | | 52,50,000 |
| Less: Cost of Mechanized System: | | |
| Operating Cost | 20,00,000 | |
| Depreciation (Rs. 40,00,000 x 0.15) | 6,00,000 | 26,00,000 |
| Saving per annum | | 26,50,000 |
| Less: Tax (50%) | | 13,25,000 |
| Saving after tax | | 13,25,000 |
| Add: Depreciation | | 6,00,000 |
| Cash flow per annum | | 19,25,000 |
| Cumulative PV Factor for 7 years @ 10% | | 4.867 |
| Present value of cash flow for 7 years | | 93,68,975 |
| Less: Cost of the Machine | | 40,00,000 |
| NPV | | 53,68,975 |

The mechanized cleaning system should be purchased since NPV is positive by Rs. 53,68,975.

Question 13

Superb Ltd. constructs customized parts for satellites to be launched by USA and Canada. The parts are constructed in eight locations (including the central headquarter) around the world. The Finance Director, Ms. Kuthrapali, chooses to implement video conferencing to speed up the budget process and save travel costs. She finds that, in earlier years, the company sent two officers from each location to the central headquarter to discuss the budget twice a year. The average travel cost per person, including air fare, hotels and meals, is ₹ 27,000 per trip. The cost of using video conferencing is Rs.8,25,000 to set up a system at each location plus Rs.300 per hour average cost of telephone time to transmit signals. A total 48 hours of transmission time will be needed to complete the budget each year. The company depreciates this type of equipment over five years by using straight line method. An alternative approach is to travel to local rented video conferencing facilities, which can be rented for Rs. 1,500 per hour plus Rs.400 per hour average cost for telephone charges. You are Senior Officer of Finance Department. You have been asked by Ms. Kuthrapali to EVALUATE the proposal and SUGGEST if it would be worthwhile for the company to implement video conferencing. [MTP 10 Marks, Nov'21]

Answer 13

Option I: Cost of travel, in case Video Conferencing facility is not provided

Total Trip = No. of Locations × No. of Persons × No. of Trips per Person = 7×2×2 = 28 Trips

Total Travel Cost (including air fare, hotel accommodation and meals) (28 trips × Rs. 27,000 per trip) = Rs.7,56,000

Option II: Video Conferencing Facility is provided by Installation of Own Equipment at Different Locations

Cost of Equipment at each location (Rs.8,25,000 × 8 locations) = Rs.66,00,000 Economic life of

Machines (5 years). Annual depreciation (66,00,000/5) = Rs.13,20,000



Annual transmission cost (48 hrs. transmission × 8 locations × Rs.300 per hour) = Rs.1,15,200 Annual cost of operation (13,20,000 + 1,15,200) = Rs.14,35,200

Option III: Engaging Video Conferencing Facility on Rental Basis Rental cost (48 hrs. × 8 locations × Rs. 1,500 per hr.) = Rs.5,76,000 Telephone cost (48 hrs.× 8 locations × Rs.400 per hr.) = Rs.1,53,600 Total rental cost of equipment (5,76,000 + 1,53,600) = Rs.7,29,600

Analysis: The annual cash outflow is minimum, if video conferencing facility is engaged on rental basis. Therefore, Option III is suggested.

Question 14

A manufacturing company is presently paying a garbage disposer company ₹ 0.50 per kilogram to dispose-off the waste resulting from its manufacturing operations. At normal operating capacity, the waste is about 2,00,000 kilograms per year.

After spending ₹ 1,20,000 on research, the company discovered that the waste could be sold for ₹ 5 per kilogram if it was processed further. Additional processing would, however, require an investment of

₹ 12,00,000 in new equipment, which would have an estimated life of 10 years with no salvage value. Depreciation would be calculated by straight line method.

No change in the present selling and administrative expenses is expected except for the costs incurred in advertising ₹ 40,000 per year, if the new product is sold. Additional processing costs would include variable cost of ₹ 2.50 per kilogram of waste put into process along with fixed cost of ₹ 60,000 per year (excluding Depreciation).

There will be no losses in processing, and it is assumed that the total waste processed in a given year will be sold in the same year. Estimates indicate that 2,00,000 kilograms of the product could be sold each year.

The management when confronted with the choice of disposing off the waste or processing it further and selling it, seeks your ADVICE. Which alternative would you RECOMMEND? Assume that the firm's cost of capital is 15% and it pays on an average 50% Tax on its income. Consider Present value of Annuity of ₹ 1 per year @ 15% p.a. for 10 years as 5.019. [MTP 10 Marks March 22, Old & New SM]

Answer 14

Evaluation of Alternatives: Savings in disposing off the waste

| Particulars | (₹) |
|-----------------------------|---------------|
| Outflow (2,00,000 × ₹ 0.50) | 1,00,000 |
| Less: tax savings @ 50% | 50,000 |
| Net Outflow per year | 50,000 |

Calculation of Annual Cash inflows in Processing of waste Material

| Particulars | Amount (₹) | Amount (₹) |
|--|------------|------------|
| Sale value of waste (₹ 5 × 2,00,000 kilograms) | | 10,00,000 |
| Less: Variable processing cost (₹ 2.50 × 2,00,000 kilograms) | 5,00,000 | |
| Less: Fixed processing cost | 60,000 | |
| Less: Advertisement cost | 40,000 | |
| Less: Depreciation | 1,20,000 | (7,20,000) |



| | |
|---------------------------|------------|
| Earnings before tax (EBT) | 2,80,000 |
| Less: Tax @ 50% | (1,40,000) |
| Earnings after tax (EAT) | 1,40,000 |
| Add: Depreciation | 1,20,000 |
| Annual Cash inflows | 2,60,000 |

Total Annual Benefits = Annual Cash inflows + Net savings (adjusting tax) in disposal cost
 $= ₹ 2,60,000 + ₹ 50,000 = ₹ 3,10,000$

Calculation of Net Present Value

| Year | Particulars | Amount (₹) |
|---------|---|-------------|
| 0 | Investment in new equipment | (12,00,000) |
| 1 to 10 | Total Annual benefits × PVAF(10 years, 15%) ₹ 3,10,000 × 5.019 | 15,55,890 |
| | Net Present Value | 3,55,890 |

Recommendation: Processing of waste is a better option as it gives a positive Net Present Value.

Note- Research cost of ₹ 1,20,000 is not relevant for decision making as it is sunk cost.

Question 15

The Modern Chemicals Ltd. requires ₹ 25,00,000 for a new plant. This plant is expected to yield earnings before interest and taxes of ₹ 5,00,000. While deciding about the financial plan, the company considers the objective of maximising earnings per share. It has three alternatives to finance the project- by raising debt of ₹ 2,50,000 or ₹ 10,00,000 or ₹ 15,00,000 and the balance, in each case, by issuing equity shares. The company's share is currently selling at ₹ 150, but is expected to decline to ₹ 125 in case the funds are borrowed in excess of ₹ 10,00,000. The funds can be borrowed at the rate of 10% upto ₹ 2,50,000, at 15% over ₹ 2,50,000 and upto ₹ 10,00,000 and at 20% over ₹ 10,00,000. The tax rate applicable to the company is 50%. ANALYSE, which form of financing should the company choose?

(MTP 7 Marks April 22)

Answer 15

Calculation of Earnings per share for three alternatives to finance the project

| Particulars | Alternatives | | |
|---------------------------------------|--|--|--|
| | I To raise debt of ₹ 2,50,000 and equity of ₹ 22,50,000 (₹) | II To raise debt of ₹ 10,00,000 and equity of ₹ 15,00,000 (₹) | III To raise debt of ₹ 15,00,000 and equity of ₹ 10,00,000 (₹) |
| Earnings before interest and tax | 5,00,000 | 5,00,000 | 5,00,000 |
| Less: Interest on debt at the rate of | 25,000 (10% on ₹ 2,50,000) | 1,37,500 (10% on ₹ 2,50,000) (15% on ₹ 7,50,000) | 2,37,500 (10% on ₹ 2,50,000) (15% on ₹ 7,50,000) (20% on ₹ 10,00,000) |



| | | | |
|---|----------|----------|-------------|
| | | | ₹ 5,00,000) |
| Earnings before tax | 4,75,000 | 3,62,500 | 2,62,500 |
| Less: Tax (@ 50%) | 2,37,500 | 1,81,250 | 1,31,250 |
| Earnings after tax: (A) | 2,37,500 | 1,81,250 | 1,31,250 |
| Number of shares : (B) (Refer to working note) | 15,000 | 10,000 | 8,000 |
| Earnings per share: (A)/(B) | 15.833 | 18.125 | 16.406 |

So, the earning per share (EPS) is higher in alternative II i.e. if the company finance the project by raising debt of ₹ 10,00,000 and issue equity shares of ₹ 15,00,000. Therefore, the company should choose this alternative to finance the project.

Working Note:

| | Alternatives | | |
|---------------------------------|--------------|-------------|-------------|
| | I | II | III |
| Equity financing : (A) | ₹ 22,50,000 | ₹ 15,00,000 | ₹ 10,00,000 |
| Market price per share : (B) | ₹ 150 | ₹ 150 | ₹ 125 |
| Number of equity share: (A)/(B) | 15,000 | 10,000 | 8,000 |

Question 16

Manoranjan Ltd is a News broadcasting channel having its broadcasting Centre in Mumbai. There are total 200 employees in the organisation including top management. As a part of employee benefit expenses, the company serves tea or coffee to its employees, which is outsourced from a third -party. The company offers tea or coffee three times a day to each of its employees. 120 employees prefer tea all three times, 40 employees prefer coffee all three times and remaining prefer tea only once in a day. The third-party charges ₹ 10 for each cup of tea and ₹ 15 for each cup of coffee. The company works for 200 days in a year. Looking at the substantial amount of expenditure on tea and coffee, the finance department has proposed to the management an installation of a master tea and coffee vending machine which will cost ₹ 10,00,000 with a useful life of five years. Upon purchasing the machine, the company will have to enter into an annual maintenance contract with the vendor, which will require a payment of ₹ 75,000 every year. The machine would require electricity consumption of 500 units p.m. and current incremental cost of electricity for the company is ₹ 12 per unit. Apart from these running costs, the company will have to incur the following consumables expenditure also:

- (1) Packets of Coffee beans at a cost of ₹ 90 per packet.
- (2) Packet of tea powder at a cost of ₹ 70 per packet.
- (3) Sugar at a cost of ₹ 50 per Kg.
- (4) Milk at a cost of ₹ 50 per litre.
- (5) Paper cup at a cost of 20 paise per cup.

Each packet of coffee beans would produce 200 cups of coffee and same goes for tea powder packet. Each cup of tea or coffee would consist of 10g of sugar on an average and 100 ml of milk.

The company anticipate that due to ready availability of tea and coffee through vending machines its employees would end up consuming more tea and coffee. It estimates that the consumption will increase by on an average 20% for all class of employees. Also, the paper cups consumption will be 10% more than the actual cups served due to leakages in them.

The company is in the 25% tax bracket and has a current cost of capital at 12% per annum. Straight



line method of depreciation is allowed for the purpose of taxation. You as a financial consultant is required to ADVISE on the feasibility of acquiring the vending machine.

PV factors @ 12%:

| Year | 1 | 2 | 3 | 4 | 5 |
|------|--------|--------|--------|--------|--------|
| PVF | 0.8929 | 0.7972 | 0.7118 | 0.6355 | 0.5674 |

(MTP 10 Marks April 22)

Answer 16

A. Computation of CFAT (Year 1 to 5)

| Particulars | Amount (₹) |
|---|------------|
| (a) Savings in existing Tea & Coffee charges $(120 \times 10 \times 3) + (40 \times 15 \times 3) + (40 \times 10 \times 1) \times 200$ days | 11,60,000 |
| (b) AMC of machine | (75,000) |
| (c) Electricity charges $500 \times 12 \times 12$ | (72,000) |
| (d) Coffee Beans (W.N.) 144×90 | (12,960) |
| (e) Tea Powder (W.N.) 480×70 | (33,600) |
| (f) Sugar (W.N.) 1248×50 | (62,400) |
| (g) Milk (W.N.) 12480×50 | (6,24,000) |
| (h) Paper Cup (W.N.) $1,37,280 \times 0.2$ | (27,456) |
| (i) Depreciation $10,00,000/5$ | (2,00,000) |
| Profit before Tax | 52,584 |
| (-) Tax @ 25% | (13,146) |
| Profit after Tax | 39,438 |
| Depreciation | 2,00,000 |
| CFAT | 2,39,438 |

B. Computation of NPV

| Year | Particulars | CF | PVF @ 12% | PV |
|------|-------------------|------------|-----------|-------------|
| 0 | Cost of machine | (10,00,00) | 1 | (10,00,000) |
| 1-5 | CFAT | 2,39,438 | 3.6048 | 8,63,126 |
| | Net Present Value | | | (1,36,874) |

Since NPV of the machine is negative, it should not be purchased.

Working Note:

Computation of Qty of consumable

No. of Tea Cups = $[(120 \times 3 \times 200 \text{ days}) + (40 \times 1 \times 200 \text{ days}) \times 1.2 = 96,000$

No. of Coffee cups = $40 \times 3 \times 200 \text{ days} \times 1.2 = 28,800$

No. of coffee beans packet = $\frac{28,800}{200} = 144$

No. of Tea Powder packet = $\frac{96,000}{200} = 480$

Qty of sugar = $\frac{(96,000 + 28,800) \times 10g}{1,000g} = 1248 \text{ kgs}$



$$\text{Qty of Milk} = \frac{(96,000+28,800) \times 100 \text{ ml}}{1,000 \text{ ml}} = 12,480 \text{ liters}$$

$$\text{No. of paper cups} = (96,000+28,000) \times 1.1 = 1,37,280$$

Question 17

EXPLAIN the term 'Payback reciprocal'. (MTP 2 Marks April 22, RTP Nov '19)

Answer 17

Financial ratios provide clues but not conclusions. These are tools only in the hands of experts because there is no standard ready-made interpretation of financial ratios

As the name indicates it is the reciprocal of payback period. A major drawback of the payback period method of capital budgeting is that it does not indicate any cut off period for the purpose of investment decision. It is, however, argued that the reciprocal of the payback would be a close approximation of the Internal Rate of Return (later discussed in detail) if the life of the project is at least twice the payback period and the project generates equal amount of the annual cash inflows. In practice, the payback reciprocal is a helpful tool for quickly estimating the rate of return of a project provided its life is at least twice the payback period.

The payback reciprocal can be calculated as follows:

$$\text{Payback Reciprocal} = \frac{\text{Average annual cash in flow}}{\text{initial investment}}$$

Question 18

Embros Ltd. is planning to invest in a new product with a project life of 8 years. Initial equipment cost will be ₹ 35 crores. Additional equipment costing ₹ 2.50 crores will be purchased at the end of the third year from the cash inflow of this year. At the end of 8th year, the original equipment will have no resale value, but additional equipment can be sold at 10% of its original cost. A working capital of ₹ 4 crores will be needed, and it will be released at the end of 8th year. The project will be financed with sufficient amount of equity capital.

The sales volumes over eight years have been estimated as follows:

| Year | 1 | 2 | 3 | 4 - 5 | 6 - 8 |
|-------|-----------|-----------|-----------|-----------|-----------|
| Units | 14,40,000 | 21,60,000 | 52,00,000 | 54,00,000 | 36,00,000 |

Sales price of ₹ 120 per unit is expected and variable expenses will amount to 60% of sales revenue. Fixed cash operating costs will amount ₹ 3.60 crores per year. The loss of any year will be set off from the profits of subsequent year. The company follows straight line method of depreciation and is subject to 30% tax rate. Considering 12% after-tax cost of capital for this project, you are required to CALCULATE the net present value (NPV) of the project and advise the management to take appropriate decision. PV factors @ 12% are:

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|------|------|------|------|------|------|------|------|------|
| | .893 | .797 | .712 | .636 | .567 | .507 | .452 | .404 |

(MTP 10 Marks Sep'22) (Same concept different figures Old & New SM)

Answer 18

Calculation of year-wise Cash Inflow

₹ in crores)

| Year | Sales | VC (60% of Sales Value) | FC | Dep. | Profit | Tax (@30%) | PAT | Dep. | Cash inflow |
|------|-------|----------------------------|-----|--------|---------|---------------|----------|-------|-------------|
| 1 | 17.28 | 10.368 | 3.6 | 4.375 | (1.063) | - | (1.0630) | 4.375 | 3.312 |
| 2 | 25.92 | 15.552 | 3.6 | 4.375 | 2.393 | 0.3990* | 1.9940 | 4.375 | 6.369 |
| 3 | 62.4 | 37.44 | 3.6 | 4.375 | 16.985 | 5.0955 | 11.8895 | 4.375 | 16.2645 |
| 4-5 | 64.8 | 38.88 | 3.6 | 4.825# | 17.495 | 5.2485 | 12.2465 | 4.825 | 17.0715 |
| 6-8 | 43.2 | 25.92 | 3.6 | 4.825 | 8.855 | 2.6565 | 6.1985 | 4.825 | 11.0235 |

$$*(30\% \text{ of } 2.393 - 30\% \text{ of } 1.063) = 0.7179 - 0.3189 = 0.3990$$

$$\#4.375 + (2.50 - .25)/5 = 4.825$$

Calculation of Cash Outflow at the beginning

| Particulars | ₹ |
|-----------------------|--------------|
| Cost of New Equipment | 35,00,00,000 |
| Add: Working Capital | 4,00,00,000 |
| Outflow | 39,00,00,000 |

Calculation of NPV

| Year | Cash inflows | PV factor | NPV |
|------|---|-----------|--------------|
| | (₹) | | (₹) |
| 1 | 3,31,20,000 | .893 | 2,95,76,160 |
| 2 | 6,36,90,000 | .797 | 5,07,60,930 |
| 3 | 16,26,45,000 - 2,50,00,000 = 13,76,45,000 | .712 | 9,80,03,240 |
| 4 | 17,07,15,000 | .636 | 10,85,74,740 |
| 5 | 17,07,15,000 | .567 | 9,67,95,405 |
| 6 | 11,02,35,000 | .507 | 5,58,89,145 |
| 7 | 11,02,35,000 | .452 | 4,98,26,220 |
| 8 | 11,02,35,000 + 4,00,00,000 + 25,00,000 = 15,27,35,000 | .404 | 6,17,04,940 |
| | Present Value of Inflow | | 55,11,30,780 |
| | Less: Out flow | | 39,00,00,000 |
| | Net Present Value | | 16,11,30,780 |

Advise: Since the project has a positive NPV, it may be accepted.

Question 19

DISTINGUISH between Net Present Value and Internal Rate of Return. (MTP 4 Marks Oct'22)

Answer 19

NPV versus IRR: NPV and IRR methods differ in the sense that the results regarding the choice of an asset under certain circumstances are mutually contradictory under two methods. In case of mutually exclusive investment projects, in certain situations, they may give contradictory results such that if the NPV method finds one proposal acceptable, IRR favours another. The different rankings given by the NPV and IRR methods could be due to size disparity problem, time disparity problem and unequal expected lives.

The net present value is expressed in financial values whereas internal rate of return (IRR) is expressed in percentage terms.

In the net present value cash flows are assumed to be re-invested at cost of capital rate. In IRR reinvestment is assumed to be made at IRR rates.

Question 20

What do you UNDERSTAND by desirability factor/profitability index? (MTP 2 Marks Oct'22)

Answer 20
Desirability Factor/Profitability Index

In certain cases, we have to compare a number of proposals each involving different amount of cash inflows. One of the methods of comparing such proposals is to work out what is known as the 'Desirability factor' or 'Profitability index'. In general terms, a project is acceptable if its profitability index value is greater than

Mathematically, the desirability factor is calculated as below:

Sum of Discounted Cashinflows
 Initial Cash outlay or Total Discounted Cash outflow (as the case may be)

Question 21

WRITE a short note on “Cut-off Rate”. (MTP 2 Marks Oct’22)

Answer 21

Cut-off Rate: It is the minimum rate which the management wishes to have from any project. Usually this is based upon the cost of capital. The management gains only if a project gives return of more than the cut - off rate. Therefore, the cut - off rate can be used as the discount rate or the opportunity cost rate.

Question 22

WQ Limited is considering relaxing its present credit policy and is in the process of evaluating two proposed polices. Currently, the firm has annual credit sales of Rs. 180 lakh and Debtors turnover ratio of 4 times a year. The current level of loss due to bad debts is Rs. 6 lakhs. The firm is required to give a return of 25% on the investment in new accounts receivables. The company’s variable costs are 60% of the selling price. Given the following information, DETERMINE which is a better Policy?

(Amount in lakhs)

| | Present Policy | Proposed Policy | |
|---------------------------|----------------|-----------------|-----------|
| | | Option I | Option II |
| Annual credit sales (Rs.) | 180 | 220 | 280 |
| Debtors turnover ratio | 4 | 3.2 | 2.4 |
| Bad debt losses (Rs.) | 6 | 18 | 38 |

(MTP 10 Marks, April’21)

Answer 22

Statement showing evaluation of Credit Policies

Amount in lakhs)

| | Particulars | Present (Rs.) | Proposed Policy (Rs.) | |
|---|--|---------------|-----------------------|-----------|
| | | | Option I | Option II |
| A | Expected Profit: | | | |
| | (a) Credit Sales | 180 | 220 | 280 |
| | (b) Total Cost other than Bad Debts: | | | |
| | Variable Costs (60%) | 108 | 132 | 168 |
| | (c) Bad Debts | 6 | 18 | 38 |
| | (d) Expected Profit [(a)-(b)-(c)] | 66 | 70 | 74 |
| B | Opportunity Cost of Investment in Debtors (Refer workings) | 6.75 | 10.31 | 17.5 |
| C | Net Benefits [A - B] | 59.25 | 59.69 | 56.5 |

Recommendation: The Proposed Policy I should be adopted since the net benefits under this policy is higher than those under other policies.

Workings:

Calculation of Opportunity Cost of Investment in Debtors

Opportunity Cost= Total Cost=

$$= \frac{\text{Collection period} \times \text{Rate of Return}}{12 \times 100}$$

Collection period (in months) = 12/Debtors turnover ratio

$$\text{Present Policy} = \text{Rs.} 180 \times \frac{12/4}{12} \times \frac{25}{100} = \text{Rs. } 6.75 \text{ lakhs}$$

$$\text{Proposed Policy I} = \text{Rs.} 168 \times \frac{12/2.4}{12} \times \frac{25}{100} = \text{Rs. } 17.5 \text{ lakhs}$$

$$\text{Proposed Policy II} = \text{Rs.} 132 \times \frac{12/3.2}{12} \times \frac{25}{100} = \text{Rs. } 10.31 \text{ lakhs}$$

Question 23

Yellow bells Ltd. wants to replace its old machine with new automatic machine. The old machine had been fully depreciated for tax purpose but has a book value of ₹3,50,000 on 31st March 2022. The machine cannot fetch more than ₹45,000 if sold in the market at present. It will have no realizable value after 10 years. The company has been offered ₹1,60,000 for the old machine as a trade in on the new machine which has a price (before allowance for trade in) of ₹6,50,000. The expected life of new machine is 10 years with salvage value of ₹63,000.

Further, the company follows straight line depreciation method but for tax purpose, written down value method depreciation @ 9% is allowed taking that this is the only machine in the block of assets.

Given below are the expected sales and costs from both old and new machine:

| | Old machine (₹) | New machine (₹) |
|-------------------------|-----------------|-----------------|
| Sales | 11,74,500 | 11,74,500 |
| Material cost | 2,61,000 | 1,83,063 |
| Labour cost | 1,95,750 | 1,59,500 |
| Variable overhead | 81,563 | 68,875 |
| Fixed overhead | 1,30,500 | 1,41,375 |
| Depreciation | 34,800 | 60,175 |
| Profit Before Tax (PBT) | 4,70,888 | 5,61,513 |
| Tax @ 25% | 1,17,722 | 1,40,378 |
| Profit After Tax (PAT) | 3,53,166 | 4,21,134 |

From the above information, ANALYSE whether the old machine should be replaced or not if required rate of return is 10%? Ignore capital gain tax.

PV factors @ 10%:

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| PVF | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 | 0.564 | 0.513 | 0.467 | 0.424 | 0.386 |

(MTP 10 Marks March '23)

Answer 23

(i) Calculation of Base for depreciation or Cost of New Machine

| Particulars | (₹) |
|---------------------------------|-----------------|
| Purchase price of new machine | 6,50,000 |
| Less: Sale price of old machine | 1,60,000 |
| | 4,90,000 |

(ii) Calculation of Profit before tax as per books

| Particulars | Old machine (₹) | New machine (₹) | Difference (₹) |
|------------------|--------------------|--------------------|-------------------|
| PBT as per books | 4,70,888 | 5,61,513 | 90,625 |

| | | | |
|--|----------|----------|----------|
| Add: Depreciation as per books | 34,800 | 60,175 | 25,375 |
| Profit before tax and depreciation (PBT) | 5,05,688 | 6,21,688 | 1,16,000 |

Calculation of Incremental NPV

| Year | PVF | PBTD | Dep. @ 9% | PBT | Tax @ 25% | Cash Inflows | PV of Cash Inflows |
|--|-------|-------------|-----------|-----------|------------------|-----------------------|--------------------|
| | @ 10% | (₹) | (₹) | (₹) | (₹) | (₹) | (₹) |
| | 1 | 2 | 3 | 4(2-3) | (5) = (4) x 0.25 | (6) = (4) – (5) + (3) | (7) = (6) x (1) |
| 1 | 0.909 | 1,16,000.00 | 44,100.00 | 71,900.00 | 17,975.00 | 98,025.00 | 89,104.73 |
| 2 | 0.826 | 1,16,000.00 | 40,131.00 | 75,869.00 | 18,967.25 | 97,032.75 | 80,149.05 |
| 3 | 0.751 | 1,16,000.00 | 36,519.21 | 79,480.79 | 19,870.20 | 96,129.80 | 72,193.48 |
| 4 | 0.683 | 1,16,000.00 | 33,232.48 | 82,767.52 | 20,691.88 | 95,308.12 | 65,095.45 |
| 5 | 0.621 | 1,16,000.00 | 30,241.56 | 85,758.44 | 21,439.61 | 94,560.39 | 58,722.00 |
| 6 | 0.564 | 1,16,000.00 | 27,519.82 | 88,480.18 | 22,120.05 | 93,879.95 | 52,948.29 |
| 7 | 0.513 | 1,16,000.00 | 25,043.03 | 90,956.97 | 22,739.24 | 93,260.76 | 47,842.77 |
| 8 | 0.467 | 1,16,000.00 | 22,789.16 | 93,210.84 | 23,302.71 | 92,697.29 | 43,289.63 |
| 9 | 0.424 | 1,16,000.00 | 20,738.14 | 95,261.86 | 23,815.47 | 92,184.53 | 39,086.24 |
| 10 | 0.386 | 1,16,000.00 | 18,871.70 | 97,128.30 | 24,282.07 | 91,717.93 | 35,403.12 |
| | | | | | | | 5,83,834.77 |
| Add: PV of Salvage value of new machine (₹ 63,000 × 0.386) | | | | | | | 24,318.00 |
| Total PV of incremental cash inflows | | | | | | | 6,08,152.77 |
| Less: Cost of new machine [as calculated in point(i)] | | | | | | | 4,90,000.00 |
| Incremental Net Present Value | | | | | | | 1,18,152.77 |

Analysis: Since the Incremental NPV is positive, the old machine should be replaced.

Question 24

Rambow Ltd. is contemplating purchasing machinery that would cost ₹ 10,00,000 plus GST @ 18% at the beginning of year 1. Cash inflows after tax from operations have been estimated at ₹ 2,56,000 per annum for 5 years. The company has two options for the smooth functioning of the machinery - one is service, and another is replacement of parts. The company has the option to service a part of the machinery at the end of each of the years 2 and 4 at ₹ 1,00,000 plus GST @ 18% for each year. In such a case, the scrap value at the end of year 5 will be ₹ 76,000. However, if the company decides not to service the part, then it will have to be replaced at the end of year 3 at ₹ 3,00,000 plus GST @ 18% and in this case, the machinery will work for the 6th year also and get operational cash inflow of ₹ 1,86,000 for the 6th year. It will have to be scrapped at the end of year 6 at ₹ 1,36,000.

Assume cost of capital at 12% and GST paid on all inputs including capital goods are eligible for input tax credit in the same month as and when incurred.

- DECIDE whether the machinery should be purchased under option 1 or under option 2 or it shouldn't be purchased at all.
- If the supplier gives a discount of ₹ 90,000 for purchase, WHAT would be your decision? Note: The PV factors at 12% are:

| Year | 0 | 1 | 2 | 3 | 4 | 5 | 6 |
|-----------|---|--------|--------|--------|--------|--------|--------|
| PV Factor | 1 | 0.8928 | 0.7972 | 0.7118 | 0.6355 | 0.5674 | 0.5066 |

(MTP 5 Marks April '23)

Answer 24

Option I: Purchase Machinery and Service Part at the end of Year 2 and 4.

Net Present value of cash flow @ 12% per annum discount rate.

$$\text{NPV (in ₹)} = -10,00,000 + 2,56,000 \times (0.8928 + 0.7972 + 0.7118 + 0.6355 + 0.5674) - (1,00,000 \times 0.7972 + 1,00,000 \times 0.6355) + (76,000 \times 0.5674)$$

$$= -10,00,000 + (2,56,000 \times 3.6047) - 1,43,270 + 43,122.4$$

$$= -10,00,000 + 9,22,803.2 - 1,43,270 + 43,122.4$$

$$\text{NPV} = -1,77,344.4$$

Since Net Present Value is negative; therefore, this option is not to be considered.

If Supplier gives a discount of ₹ 90,000, then:

$$\text{NPV (in ₹)} = +90,000 - 1,77,344.4 = -87,344.4$$

In this case, Net Present Value is still negative; therefore, this option may not be advisable

Option II: Purchase Machinery and Replace Part at the end of Year 2.

$$\text{NPV (in ₹)} = -10,00,000 + 2,56,000 \times (0.8928 + 0.7972 + 0.7118 + 0.6355 + 0.5674) - (3,00,000 \times 0.7118) + (1,86,000 \times 0.5066 + 1,36,000 \times 0.5066)$$

$$= -10,00,000 + (2,56,000 \times 3.6047) - 2,13,540 + 1,63,125.2$$

$$= -10,00,000 + 9,22,803.2 - 2,13,540 + 1,63,125.2$$

$$\text{NPV} = -1,27,611.6$$

Net Present Value is negative, the machinery should not be purchased.

If the Supplier gives a discount of ₹ 90,000, then:

$$\text{NPV (in ₹)} = 90,000 - 1,27,611.6 = -37,611.6$$

In this case, Net Present Value is still negative; therefore, this option may not be advisable.

Decision: The Machinery should not be purchased as it will earn a negative NPV in both options of repair and replacement.

Question 25

Genzy Ltd. is planning to introduce a new product with a project life of 10 years. The initial equipment cost will be ₹ 2.5 crores. At the end of 10 years, the equipment will have a resale value of 50 lakhs. A working capital of ₹ 30,00,000 will be needed and it will be released at the end of the tenth year. The project will be financed with the following capital sources.

| Particulars | Amount (₹) | Issue Price (Market price) |
|---|-------------|----------------------------|
| Equity Share Capital of Face value ₹ 10 each | 1,50,00,000 | ₹30 |
| Debentures of face value ₹ 100 each with a maturity of 10 years | 90,00,000 | ₹90 |
| Preference shares of ₹ 100 each with a maturity of 10 years | 60,00,000 | ₹96 |

The existing yield on T-bills is averaging 8% p.a. The systematic risk measure for the proposed project is 1.6.

NSE NIFTY is expected to yield 14% p.a. on average for the foreseeable future. Debenture holders have been promised a coupon of 12% and preference shareholders have been committed a dividend of 15%.

The sales volumes over 10 years have been estimated as follows:

| Year | 1 | 2 | 3-5 | 6-8 | 9-10 |
|----------------|--------|--------|----------|----------|----------|
| Units per year | 70,000 | 98,000 | 2,10,000 | 2,50,000 | 1,20,000 |

A sales price of ₹ 300 per unit is expected and variable expenses will amount to 60% of sales revenue. Fixed cash operating costs will amount to ₹ 40,00,000 per year. The loss of any year will be set off from the profits of subsequent years.

The company is subject to a 30 per cent tax rate. The company follows straight line method of depreciation which is to be assumed to be admissible for tax purpose also.

CALCULATE the net present value of the project for the company and advise the management to take appropriate decision.

The PV factors are to be taken as rounded figures upto 2 decimals. Use market value weights to **COMPUTE** overall cost of capital. (MTP 10 Marks April '23)

Answer 25

Cost of Equity

$$K_e = R_f + \text{Beta} * (R_m - R_f) \quad K_e =$$

$$8\% + 1.6 * (14\% - 8\%)$$

$$K_e = 8\% + (1.6 * 6\%)$$

$$K_e = 17.6\%$$

1. Cost of Redeemable Debentures (Post-Tax)

$$K_d = \frac{\frac{\text{Int}(1-t) + \frac{RV-NP}{n}}{2}}{\frac{RV-NP}{2}}$$

$$K_d = \frac{12,00,000 * (1-30\%) + (1,00,00,000 - 90,00,000) / 10}{(1,00,00,000 + 90,00,000) / 2}$$

$$K_d = \frac{8,40,000 + 1,00,000}{95,00,000}$$

$$K_d = 9.89\%$$

2. Cost of Redeemable Preference Shares

$$K_p = \frac{\frac{PD + \frac{RV-NP}{n}}{2}}{\frac{RV-NP}{2}}$$

$$K_p = \frac{(62,50,000 * 15\%) + (62,50,000 - 60,00,000) / 10}{(62,50,000 + 60,00,000) / 2}$$

$$K_p = \frac{9,37,500 + 25,000}{61,25,000}$$

$$K_p = 15.71\%$$

3. Weighted Average Cost of Capital (WACC) – Book Value Method

| Source of Capital | Market Value | Weights | After Tax Cost of Capital | WACC |
|----------------------|--------------|---------|---------------------------|-------|
| Equity Share Capital | 1,50,00,000 | 0.5 | 17.6% | 0.088 |

| | | | | |
|--------------------------|-------------|-------|--------|-------|
| Debentures | 90,00,000 | 0.3 | 9.89% | 0.030 |
| Preference Share Capital | 60,00,000 | 0.2 | 15.71% | 0.031 |
| | 3,00,00,000 | 1.000 | | 0.149 |

WACC = 14.9%

4. Computation of CFAT

| | (year 1 to year 4) | | | | | |
|---------|---|-------------|-------------|-------------|-------------|-------------|
| Sr. No. | Particulars / Year | 1 | 2 | 3-5 | 6-8 | 9-10 |
| A | Sale Price p.u. | 300 | 300 | 300 | 300 | 300 |
| | Sale units | 70,000 | 98,000 | 2,10,000 | 2,50,000 | 1,20,000 |
| C | Sales (A x B) | 2,10,00,000 | 2,94,00,000 | 6,30,00,000 | 7,50,00,000 | 3,60,00,000 |
| D | Variable Cost p.u. | 180 | 180 | 180 | 180 | 180 |
| E | Variable Cost (B x D) | 1,26,00,000 | 1,76,40,000 | 3,78,00,000 | 4,50,00,000 | 2,16,00,000 |
| F | Contribution (C - E) | 84,00,000 | 1,17,60,000 | 2,52,00,000 | 3,00,00,000 | 1,44,00,000 |
| G | Less: Fixed Cost | 40,00,000 | 40,00,000 | 40,00,000 | 40,00,000 | 40,00,000 |
| H | PBDT (F-G) | 44,00,000 | 77,60,000 | 2,12,00,000 | 2,60,00,000 | 1,04,00,000 |
| I | Less: Depreciation (2,50,00,000-50,00,000) / 10 | 20,00,000 | 20,00,000 | 20,00,000 | 20,00,000 | 20,00,000 |
| J | PBT | 24,00,000 | 57,60,000 | 1,92,00,000 | 2,40,00,000 | 84,00,000 |
| K | Less: Taxes @ 30% | 7,20,000 | 17,28,000 | 57,60,000 | 72,00,000 | 25,20,000 |
| L | PAT | 16,80,000 | 40,32,000 | 1,34,40,000 | 1,68,00,000 | 58,80,000 |
| M | Add: Depreciation | 20,00,000 | 20,00,000 | 20,00,000 | 20,00,000 | 20,00,000 |
| N | CFAT | 36,80,000 | 60,32,000 | 1,54,40,000 | 1,88,00,000 | 78,80,000 |

5. Computation of NPV

| Sr. No. | Particulars / Year | 1 | 2 | 3-5 | 6-8 | 9-10 |
|---------|-------------------------|-----------|-----------|-------------------------|-------------------------|--------------------|
| I | CFAT | 36,80,000 | 60,32,000 | 1,54,40,000 | 1,88,00,000 | 78,80,000 |
| II | PVAF @ 14.9% | 0.87 | 0.76 | (0.66+0.57+0.50) = 1.73 | (0.43+0.38+0.33) = 1.14 | (0.29+0.25) = 0.54 |
| III | PV of CFATs (I x II) | 32,01,600 | 45,84,320 | 2,67,11,200 | 2,14,32,000 | 42,55,200 |
| IV | Salvage + Release of WC | | | | | 80,00,000 |
| V | PVF @ 14.9% | | | | | 0.25 |
| VI | PV of Salvage (IV x V) | | | | | 20,00,000 |

PV of Inflows = 32,01,600 + 45,84,320 + 2,67,11,200 + 2,14,32,000 + 42,55,200 + 20,00,000

PV of Inflows = 6,21,84,320

PV of Outflows = Investment + Introduction of Working Capital

PV of Outflows = 2,50,00,000 + 30,00,000

PV of Outflows = 2,80,00,000

NPV = PV of Inflows – PV of Outflows NPV = 6,21,84,320 - 2,80,00,000

NPV = 3,41,84,320

The management should consider taking up the project as the Net Present Value of the Project is Positive.

Question 26

Shiv Limited is thinking of replacing its existing machine by a new machine which would cost ₹ 60 lakhs. The company's current production is 80,000 units, and is expected to increase to 1,00,000 units, if the new machine is bought. The selling price of the product would remain unchanged at ₹ 200 per unit. The following is the cost of producing one unit of product using both the existing and new machine:

| Unit cost (₹) | | | |
|-------------------------------|------------------------------------|---------------------------------|------------|
| | Existing Machine (80,000 units) | New Machine (1,00,000 units) | Difference |
| Materials | 75.0 | 63.75 | (11.25) |
| Wages & Salaries | 51.25 | 37.50 | (13.75) |
| Supervision | 20.0 | 25.0 | 5.0 |
| Repairs and Maintenance | 11.25 | 7.50 | (3.75) |
| Power and Fuel | 15.50 | 14.25 | (1.25) |
| Depreciation | 0.25 | 5.0 | 4.75 |
| Allocated Corporate Overheads | 10.0 | 12.50 | 2.50 |
| | 183.25 | 165.50 | (17.75) |

The existing machine has an accounting book value of ₹ 1,00,000, and it has been fully depreciated for tax purpose. It is estimated that machine will be useful for 5 years. The supplier of the new machine has offered to accept the old machine for ₹ 2,50,000. However, the market price of old machine today is ₹ 1,50,000 and it is expected to be ₹ 35,000 after 5 years. The new machine has a life of 5 years and a salvage value of ₹ 2,50,000 at the end of its economic life. Assume corporate Income tax rate at 40%, and depreciation is charged on straight line basis for Income-tax purposes. Further assume that book profit is treated as ordinary income for tax purpose. The opportunity cost of capital of the Company is 15%.

Required:

- ESTIMATE net present value of the replacement decision.
- CALCULATE the internal rate of return of the replacement decision.
- Should Company go ahead with the replacement decision? ANALYSE.

| Year (t) | 1 | 2 | 3 | 4 | 5 |
|------------------------|--------|--------|--------|--------|--------|
| PVIF _{0.15,t} | 0.8696 | 0.7561 | 0.6575 | 0.5718 | 0.4972 |
| PVIF _{0.20,t} | 0.8333 | 0.6944 | 0.5787 | 0.4823 | 0.4019 |
| PVIF _{0.25,t} | 0.80 | 0.64 | 0.512 | 0.4096 | 0.3277 |
| PVIF _{0.30,t} | 0.7692 | 0.5917 | 0.4552 | 0.3501 | 0.2693 |
| PVIF _{0.35,t} | 0.7407 | 0.5487 | 0.4064 | 0.3011 | 0.2230 |

(RTP Nov '18)

Answer 26

- Net Cash Outlay of New Machine

Purchase Price ₹ 60,00,000

Less: Exchange value of old machine

[2,50,000 – 0.4(2,50,000 – 0)] 1,50,000

₹ 58,50,000



Market Value of Old Machine: The old machine could be sold for ₹ 1,50,000 in the market. Since the exchange value is more than the market value, this option is not attractive. This opportunity will be lost whether the old machine is retained or replaced. Thus, on incremental basis, it has no impact.

Depreciation base: Old machine has been fully depreciated for tax purpose. Thus, the depreciation base of the new machine will be its original cost i.e. ₹ 60,00,000.

Net Cash Flows: Unit cost includes depreciation and allocated overheads. Allocated overheads are allocated from corporate office therefore they are irrelevant. The depreciation tax shield may be computed separately. Excluding depreciation and allocated overheads, unit costs can be calculated. The company will obtain additional revenue from additional 20,000 units sold.

Thus, after-tax saving, excluding depreciation, tax shield, would be

$$= \{100,000(200 - 148) - 80,000(200 - 173)\} \times (1 - 0.40)$$

$$= \{52,00,000 - 21,60,000\} \times 0.60$$

$$= ₹ 18,24,000$$

After adjusting depreciation tax shield and salvage value, net cash flows and net present value are estimated.

Calculation of Cash flows and Project Profitability

| | | ₹ ('000) | | | | | |
|----|---|-----------|----------|----------|---------|---------|---------|
| | | 0 | 1 | 2 | 3 | 4 | 5 |
| 1 | After-tax savings | - | 1824 | 1824 | 1824 | 1824 | 1824 |
| 2 | Depreciation (₹ 60,00,000 – 2,50,000)/5 | - | 1150 | 1150 | 1150 | 1150 | 1150 |
| 3 | Tax shield on depreciation (Depreciation × Tax rate) | - | 460 | 460 | 460 | 460 | 460 |
| 4 | Net cash flows from operations (1 + 3)* | - | 2284 | 2284 | 2284 | 2284 | 2284 |
| 5 | Initial cost | (5850) | | | | | |
| 6 | Net Salvage Value (2,50,000 – 35,000) | - | - | - | - | - | 215 |
| 7 | Net Cash Flows (4+5+6) | (5850) | 2284 | 2284 | 2284 | 2284 | 2499 |
| 8 | PVF at 15% | 1.00 | 0.8696 | 0.7561 | 0.6575 | 0.5718 | 0.4972 |
| 9 | PV | (5850) | 1986.166 | 1726.932 | 1501.73 | 1305.99 | 1242.50 |
| 10 | NPV | ₹ 1913.32 | | | | | |

* Alternately Net Cash flows from operation can be calculated as follows:

Profit before depreciation and tax = ₹ 1,00,000 (200 -148) - 80,000 (200 -173)

= ₹ 52,00,000 – 21,60,000

= ₹ 30,40,000

So profit after depreciation and tax is ₹ (30,40,000 -11,50,000) × (1 - .40)

= ₹ 11,34,000

So profit before depreciation and after tax is :

₹ 11,34,000 + ₹ 11,50,000 (Depreciation added back) = ₹ 22,84,000

(ii)

| ₹ ('000) | | | | | | |
|----------|--------|------|------|------|------|------|
| | 0 | 1 | 2 | 3 | 4 | 5 |
| NCF | (5850) | 2284 | 2284 | 2284 | 2284 | 2499 |

| | | | | | | |
|----------------|---------|----------|---------|----------|---------|---------|
| PVF at 20% | 1.00 | 0.8333 | 0.6944 | 0.5787 | 0.4823 | 0.4019 |
| PV | (5850) | 1903.257 | 1586.01 | 1321.751 | 1101.57 | 1004.35 |
| PV of benefits | 6916.94 | | | | | |
| PVF at 30% | 1.00 | 0.7692 | 0.5917 | 0.4550 | 0.3501 | 0.2693 |
| PV | (5850) | 1756.85 | 1351.44 | 1039.22 | 799.63 | 672.98 |
| PV of benefits | 5620.12 | | | | | |

$$IRR = 20\% + 10\% \times \frac{1066.94}{1296.82} = 28.23\%$$

(iii) Advise: The Company should go ahead with replacement project, since it is positive NPV decision.

Question 27

MTR Limited is considering buying a new machine which would have a useful economic life of five years, at a cost of ₹25,00,000 and a scrap value of ₹3,00,000, with 80 per cent of the cost being payable at the start of the project and 20 per cent at the end of the first year. The machine would produce 75,000 units per annum of a new product with an estimated selling price of ₹300 per unit. Direct costs would be ₹285 per unit and annual fixed costs, including depreciation calculated on a straight- line basis, would be ₹8,40,000 per annum.

In the first year and the second year, special sales promotion expenditure, not included in the above costs, would be incurred, amounting to ₹1,00,000 and ₹1,50,000 respectively.

EVALUATE the project using the NPV method of investment appraisal, assuming the company's cost of capital to be 15 percent. (RTP Nov '19 & Nov '23) (Same concept different figures Old & New SM)

Answer 27

Calculation of Net Cash flows

$$\text{Contribution} = (300 - 285) \times 75,000 = ₹11,25,000$$

$$\text{Fixed costs} = 8,40,000 - [(25,00,000 - 3,00,000)/5] = ₹4,00,000$$

| Year | Capital (₹) | Contribution (₹) | Fixed costs (₹) | Adverts (₹) | Net cash flow (₹) |
|------|-------------|------------------|-----------------|-------------|-------------------|
| 0 | (20,00,000) | | | | (20,00,000) |
| 1 | (5,00,000) | 11,25,000 | (4,00,000) | (1,00,000) | 1,25,000 |
| 2 | | 11,25,000 | (4,00,000) | (1,50,000) | 5,75,000 |
| 3 | | 11,25,000 | (4,00,000) | | 7,25,000 |
| 4 | | 11,25,000 | (4,00,000) | | 7,25,000 |
| 5 | 3,00,000 | 11,25,000 | (4,00,000) | | 10,25,000 |

Calculation of Net Present Value

| Year | Net cash flow (₹) | 12% discount factor | Present value (₹) |
|------|-------------------|---------------------|-------------------|
| 0 | (20,00,000) | 1.000 | (20,00,000) |
| 1 | 1,25,000 | 0.892 | 1,11,500 |
| 2 | 5,75,000 | 0.797 | 4,58,275 |
| 3 | 7,25,000 | 0.711 | 5,15,475 |
| 4 | 7,25,000 | 0.635 | 4,60,375 |
| 5 | 10,25,000 | 0.567 | 5,81,175 |
| | | | 1,26,800 |

The net present value of the project is ₹1,26,800.

Question 28

A company is considering the proposal of taking up a new project which requires an investment of ₹800 lakhs on machinery and other assets. The project is expected to yield the following earnings (before depreciation and taxes) over the next five years:

| Year | Earnings (₹ in lakhs) |
|------|-----------------------|
| 1 | 320 |
| 2 | 320 |
| 3 | 360 |
| 4 | 360 |
| 5 | 300 |

The cost of raising the additional capital is 12% and assets have to be depreciated at 20% on written down value basis. The scrap value at the end of the five year period may be taken as zero. Income-tax applicable to the company is 40%.

You are required to CALCULATE the net present value of the project and advise the management to take appropriate decision. Also CALCULATE the Internal Rate of Return of the Project.

Note: Present values of Re. 1 at different rates of interest are as follows:

(RTP May '20)

| Year | 10% | 12% | 14% | 16% | 20% |
|------|------|------|------|------|------|
| 1 | 0.91 | 0.89 | 0.88 | 0.86 | 0.83 |
| 2 | 0.83 | 0.80 | 0.77 | 0.74 | 0.69 |
| 3 | 0.75 | 0.71 | 0.67 | 0.64 | 0.58 |
| 4 | 0.68 | 0.64 | 0.59 | 0.55 | 0.48 |
| 5 | 0.62 | 0.57 | 0.52 | 0.48 | 0.40 |

Answer 28
(i) Calculation of Net Cash Flow

| (₹ in lakhs) | | | | | |
|--------------|----------------------------|-------------------------------------|--------|--------|---------------|
| Year | Profit before dep. and tax | Depreciation (20% on WDV) | PBT | PAT | Net cash flow |
| (1) | (2) | (3) | (4) | (5) | (3) + (5) |
| 1 | 320 | $800 \times 20\% = 160$ | 160 | 96 | 256 |
| 2 | 320 | $(800 - 160) \times 20\% = 128$ | 192 | 115.20 | 243.20 |
| 3 | 360 | $(640 - 128) \times 20\% = 102.4$ | 257.6 | 154.56 | 256.96 |
| 4 | 360 | $(512 - 102.4) \times 20\% = 81.92$ | 278.08 | 166.85 | 248.77 |
| 5 | 300 | $(409.6 - 81.92) = 327.68^*$ | -27.68 | -16.61 | 311.07 |

*this is treated as a short term capital loss.

(ii) Calculation of Net Present Value (NPV)

| (₹ in lakhs) | | | | | | | |
|--------------|---------------|------|--------|------|--------|------|--------|
| Year | Net Cash Flow | 12% | | 16% | | 20% | |
| | | D.F | P.V | D.F | P.V | D.F | P.V |
| 1 | 256 | 0.89 | 227.84 | 0.86 | 220.16 | 0.83 | 212.48 |
| 2 | 243.20 | 0.80 | 194.56 | 0.74 | 179.97 | 0.69 | 167.81 |
| 3 | 256.96 | 0.71 | 182.44 | 0.64 | 164.45 | 0.58 | 149.03 |
| 4 | 248.77 | 0.64 | 159.21 | 0.55 | 136.82 | 0.48 | 119.41 |



| | | | | | | | |
|---|--------------------------|------|--------|------|--------|------|--------|
| 5 | 311.07 | 0.57 | 177.31 | 0.48 | 149.31 | 0.40 | 124.43 |
| | Less: Initial Investment | | 941.36 | | 850.71 | | 773.16 |
| | | | 800.00 | | 800.00 | | 800.00 |
| | | NPV | 141.36 | | 50.71 | | -26.84 |

(iii) **Advise:** Since Net Present Value of the project at 12% = 141.36 lakhs, therefore the project should be implemented.

(iv) Calculation of Internal Rate of Return (IRR)

$$\begin{aligned} \text{IRR} &= 16\% + \frac{50.71 \times 4}{50.71 - (-26.84)} \\ &= 16\% + \frac{2.03}{77.55} = 16\% + 2.62\% = 18.62\% \end{aligned}$$

Question 29

A large profit making company is considering the installation of a machine to process the waste produced by one of its existing manufacturing process to be converted into a marketable product. At present, the waste is removed by a contractor for disposal on payment by the company of ₹ 150 lakh per annum for the next four years. The contract can be terminated upon installation of the aforesaid machine on payment of a compensation of ₹ 90 lakh before the processing operation starts. This compensation is not allowed as deduction for tax purposes.

The machine required for carrying out the processing will cost ₹ 600 lakh to be financed by a loan repayable in 4 equal instalments commencing from end of the year 1. The interest rate is 14% per annum. At the end of the 4th year, the machine can be sold for ₹ 60 lakh and the cost of dismantling and removal will be ₹ 45 lakh.

Sales and direct costs of the product emerging from waste processing for 4 years are estimated as under:
(₹ In lakh)

| Year | 1 | 2 | 3 | 4 |
|--|-----|-----|-------|-------|
| Sales | 966 | 966 | 1,254 | 1,254 |
| Material consumption | 90 | 120 | 255 | 255 |
| Wages | 225 | 225 | 255 | 300 |
| Other expenses | 120 | 135 | 162 | 210 |
| Factory overheads | 165 | 180 | 330 | 435 |
| Depreciation (as per income tax rules) | 150 | 114 | 84 | 63 |

Initial stock of materials required before commencement of the processing operations is ₹ 60 lakh at the start of year 1. The stock levels of materials to be maintained at the end of year 1, 2 and 3 will be ₹ 165 lakh and the stocks at the end of year 4 will be nil. The storage of materials will utilise space which would otherwise have been rented out for ₹ 30 lakh per annum. Labour costs include wages of 40 workers, whose transfer to this process will reduce idle time payments of ₹ 45 lakh in the year - 1 and ₹ 30 lakh in the year - 2. Factory overheads include apportionment of general factory overheads except to the extent of insurance charges of ₹ 90 lakh per annum payable on this venture. The company's tax rate is 30%.

Present value factors for four years are as under:

| Year | 1 | 2 | 3 | 4 |
|-----------------|-------|-------|-------|-------|
| PV factors @14% | 0.877 | 0.769 | 0.674 | 0.592 |

ADVISE the management on the desirability of installing the machine for processing the waste. All calculations should form part of the answer. (RTP Nov '20, Old & New SM)

Answer 29

Statement of Operating Profit from processing of waste

(₹ in lakh)

| Year | 1 | 2 | 3 | 4 |
|--|-------|-------|-------|-------|
| Sales : (A) | 966 | 966 | 1,254 | 1,254 |
| Material consumption | 90 | 120 | 255 | 255 |
| Wages | 180 | 195 | 255 | 300 |
| Other expenses | 120 | 135 | 162 | 210 |
| Factory overheads (insurance only) | 90 | 90 | 90 | 90 |
| Loss of rent on storage space (opportunity cost) | 30 | 30 | 30 | 30 |
| Interest @14% | 84 | 63 | 42 | 21 |
| Depreciation (as per income tax rules) | 150 | 114 | 84 | 63 |
| Total cost: (B) | 744 | 747 | 918 | 969 |
| Profit (C)=(A)-(B) | 222 | 219 | 336 | 285 |
| Tax (30%) | 66.6 | 65.7 | 100.8 | 85.5 |
| Profit after Tax (PAT) | 155.4 | 153.3 | 235.2 | 199.5 |

Statement of Incremental Cash Flows

(₹ in lakh)

| Year | 0 | 1 | 2 | 3 | 4 |
|---|--------|--------|--------|---------|--------|
| Material stock | (60) | (105) | - | - | 165 |
| Compensation for contract | (90) | - | - | - | - |
| Contract payment saved | - | 150 | 150 | 150 | 150 |
| Tax on contract payment | - | (45) | (45) | (45) | (45) |
| Incremental profit | - | 222 | 219 | 336 | 285 |
| Depreciation added back | - | 150 | 114 | 84 | 63 |
| Tax on profits | - | (66.6) | (65.7) | (100.8) | (85.5) |
| Loan repayment | - | (150) | (150) | (150) | (150) |
| Profit on sale of machinery (net) Total | - | - | - | - | 15 |
| incremental cash flows Present value factor | (150) | 155.4 | 222.3 | 274.2 | 397.5 |
| | 1.00 | 0.877 | 0.769 | 0.674 | 0.592 |
| Present value of cash flows | (150) | 136.28 | 170.95 | 184.81 | 235.32 |
| Net present value | 577.36 | | | | |

Advice: Since the net present value of cash flows is ₹ 577.36 lakh which is positive the management should install the machine for processing the waste.

Notes:

- Material stock increases are taken in cash flows.
- Idle time wages have also been considered.
- Apportioned factory overheads are not relevant only insurance charges of this project are relevant.
- Interest calculated at 14% based on 4 equal instalments of loan repayment.
- Sale of machinery- Net income after deducting removal expenses taken. Tax on Capital gains ignored.
- Saving in contract payment and income tax thereon considered in the cash flows.

Question 30

The General Manager of Merry Ltd. is considering the replacement of five -year-old equipment. The company has to incur excessive maintenance cost of the equipment. The equipment has zero written down value. It can be modernized at a cost of ₹ 1,40,000 enhancing its economic life to 5 years. The



equipment could be sold for ₹ 30,000 after 5 years. The modernization would help in material handling and in reducing labour, maintenance & repairs costs. The company has another alternative to buy a new machine at a cost of ₹ 3,50,000 with an economic life of 5 years and salvage value of ₹ 60,000. The new machine is expected to be more efficient in reducing costs of material handling, labour, maintenance & repairs, etc.

The annual cost are as follows:

| | Existing Equipment (₹) | Modernization (₹) | New Machine (₹) |
|------------------|------------------------|-------------------|-----------------|
| Wages & Salaries | 45,000 | 35,500 | 15,000 |
| Supervision | 20,000 | 10,000 | 7,000 |
| Maintenance | 25,000 | 5,000 | 2,500 |
| Power | 30,000 | 20,000 | 15,000 |
| | 1,20,000 | 70,500 | 39,500 |

Assuming tax rate of 50% and required rate of return of 10%, should the company modernize the equipment or buy a new machine?

PV factor at 10% are as follows: (RTP May '21)

| Year | 1 | 2 | 3 | 4 | 5 |
|-----------|-------|-------|-------|-------|-------|
| PV factor | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 |

Answer 30

Workings:

Calculation of Depreciation:

On Modernized Equipment = $\frac{Rs.1,40,000 - Rs.30,000}{5 \text{ years}}$ = Rs. 22,000 p.a.

On New machine = $\frac{Rs.3,50,000 - Rs.60,000}{5 \text{ years}}$ = Rs. 58,000 p.a.

(i) Calculation of Incremental annual cash inflows/ savings:

| Particulars | Existing Equipment (₹) | Modernization | | New Machine | |
|---------------------------|---------------------------|---------------|----------------|---------------|----------------|
| | | Amount (₹) | Savings (₹) | Amount (₹) | Savings (₹) |
| | (1) | (2) | (3)=(1)-(2) | (4) | (5)=(1)-(4) |
| Wages & Salaries | 45,000 | 35,500 | 9,500 | 15,000 | 30,000 |
| Supervision | 20,000 | 10,000 | 10,000 | 7,000 | 13,000 |
| Maintenance | 25,000 | 5,000 | 20,000 | 2,500 | 22,500 |
| Power | 30,000 | 20,000 | 10,000 | 15,000 | 15,000 |
| Total | 1,20,000 | 70,500 | 49,500 | 39,500 | 80,500 |
| Less: Depreciation | | | 22,000 | | 58,000 |
| (Refer Workings) | | | | | |
| Total Savings | | | 27,500 | | 22,500 |
| Less: Tax @ 50% | | | 13,750 | | 11,250 |
| After Tax Savings | | | 13,750 | | 11,250 |
| Add: Depreciation | | | 22,000 | | 58,000 |
| Incremental Annual | | | 35,750 | | 69,250 |



| | | | | |
|--------------|--|--|--|--|
| Cash Inflows | | | | |
|--------------|--|--|--|--|

(ii) Calculation of Net Present Value (NPV)

| Particulars | Year | Modernization (₹) | New Machine (₹) |
|---------------------------|------|---------------------------------|---------------------------------|
| Initial Cash outflow (A) | 0 | 1,40,000.00 | 3,50,000.00 |
| Incremental Cash Inflows | 1-5 | 1,35,492.50 | 2,62,457.50 |
| | | (₹ 35,750 x 3.790) | (₹ 69,250 x 3.790) |
| Salvage value | 5 | 18,630.00 (₹ 30,000 x 0.621) | 37,260.00 (₹ 60,000 x 0.621) |
| PV of Cash inflows (B) | | 1,54,122.50 | 2,99,717.50 |
| Net Present Value (B - A) | | 14,122.50 | (50,282.50) |

Advise: The company should modernize its existing equipment and not buy a new machine because NPV is positive in modernization of equipment.

Question 31

HMR Ltd. is considering replacing a manually operated old machine with a fully automatic new machine. The old machine had been fully depreciated for tax purpose but has a book value of ₹ 2,40,000 on 31st March 2021. The machine has begun causing problems with breakdowns and it cannot fetch more than ₹ 30,000 if sold in the market at present. It will have no realizable value after 10 years. The company has been offered ₹ 1,00,000 for the old machine as a trade in on the new machine which has a price (before allowance for trade in) of ₹ 4,50,000. The expected life of new machine is 10 years with salvage value of ₹ 35,000.

Further, the company follows straight line depreciation method but for tax purpose, written down value method depreciation @ 7.5% is allowed taking that this is the only machine in the block of assets. Given below are the expected sales and costs from both old and new machine:

| | Old machine (₹) | New machine (₹) |
|-------------------|-----------------|-----------------|
| Sales | 8,10,000 | 8,10,000 |
| Material cost | 1,80,000 | 1,26,250 |
| Labour cost | 1,35,000 | 1,10,000 |
| Variable overhead | 56,250 | 47,500 |
| Fixed overhead | 90,000 | 97,500 |
| Depreciation | 24,000 | 41,500 |
| PBT | 3,24,750 | 3,87,250 |
| Tax @ 30% | 97,425 | 1,16,175 |
| PAT | 2,27,325 | 2,71,075 |

From the above information, ANALYSE whether the old machine should be replaced or not if required rate of return is 10%? Ignore capital gain tax.

PV factors @ 10%:(RTP Nov '21, Old & New SM)

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| PVF | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 | 0.564 | 0.513 | 0.467 | 0.424 | 0.386 |

Answer 31

Workings:

1. Calculation of Base for depreciation or Cost of New Machine

| Particulars | (₹) |
|-------------|-----|
|-------------|-----|

| | |
|---------------------------------|----------|
| Purchase price of new machine | 4,50,000 |
| Less: Sale price of old machine | 1,00,000 |
| | 3,50,000 |

2. Calculation of Profit before tax as per books

| Particulars | Old machine (₹) | New machine (₹) | Difference (₹) |
|---|--------------------|--------------------|-------------------|
| PBT as per books | 3,24,750 | 3,87,250 | 62,500 |
| Add: Depreciation as per books | 24,000 | 41,500 | 17,500 |
| Profit before tax and depreciation (PBTB) | 3,48,750 | 4,28,750 | 80,000 |

Calculation of Incremental NPV

| Year | PVF @ 10% | PBTB (₹) | Dep. @ 7.5% (₹) | PBT (₹) | Tax @ 30% (₹) | Cash Inflows (₹) | PV of Cash Inflows (₹) |
|------|--------------|-------------|-----------------------|------------|------------------|--------------------------|--|
| | (1) | (2) | (3) | (4) | (5) = (4) x 0.30 | (6) = (4) – (5) + (3) | (7) = (6) x (1) |
| 1 | 0.909 | 80,000.00 | 26,250.00 | 53,750.00 | 16,125.00 | 63,875.00 | 58,062.38 |
| 2 | 0.826 | 80,000.00 | 24,281.25 | 55,718.75 | 16,715.63 | 63,284.38 | 52,272.89 |
| 3 | 0.751 | 80,000.00 | 22,460.16 | 57,539.84 | 17,261.95 | 62,738.05 | 47,116.27 |
| 4 | 0.683 | 80,000.00 | 20,775.64 | 59,224.36 | 17,767.31 | 62,232.69 | 42,504.93 |
| 5 | 0.621 | 80,000.00 | 19,217.47 | 60,782.53 | 18,234.76 | 61,765.24 | 38,356.21 |
| 6 | 0.564 | 80,000.00 | 17,776.16 | 62,223.84 | 18,667.15 | 61,332.85 | 34,591.73 |
| 7 | 0.513 | 80,000.00 | 16,442.95 | 63,557.05 | 19,067.12 | 60,932.88 | 31,258.57 |
| 8 | 0.467 | 80,000.00 | 15,209.73 | 64,790.27 | 19,437.08 | 60,562.92 | 28,282.88 |
| 9 | 0.424 | 80,000.00 | 14,069.00 | 65,931.00 | 19,779.30 | 60,220.70 | 25,533.58 |
| 10 | 0.386 | 80,000.00 | 13,013.82 | 66,986.18 | 20,095.85 | 59,904.15 | 23,123.00 |
| | | | | | | | 3,81,102.44 |
| | | | | | | | Add: PV of Salvage value of new machine (₹ 35,000 X 0.386) |
| | | | | | | | 13,510.00 |
| | | | | | | | Total PV of incremental cash inflows |
| | | | | | | | 3,94,612.44 |
| | | | | | | | Less: Cost of new machine |
| | | | | | | | 3,50,000.00 |
| | | | | | | | Incremental Net Present Value |
| | | | | | | | 44,612.44 |

Analysis: Since the Incremental NPV is positive, the old machine should be replaced.

Question 32

ABC & Co. is considering whether to replace an existing machine or to spend money on revamping it. ABC & Co. currently pays no taxes. The replacement machine costs ₹ 18,00,000 now and requires maintenance of ₹ 2,00,000 at the end of every year for eight years. At the end of eight years, it would have a salvage value of ₹ 4,00,000 and would be sold. The existing machine requires increasing amounts of maintenance each year and its salvage value fall each year as follows:

| Year | Maintenance (₹) | Salvage (₹) |
|---------|-----------------|-------------|
| Present | 0 | 8,00,000 |
| 1 | 2,00,000 | 5,00,000 |
| 2 | 4,00,000 | 3,00,000 |

| | | |
|---|----------|----------|
| 3 | 6,00,000 | 2,00,000 |
| 4 | 8,00,000 | 0 |

The opportunity cost of capital for ABC & Co. is 15%. REQUIRED:

When should the company replace the machine? The following present value table is given for you:

| Year | Present value of ₹ 1 at 15% discount rate |
|------|---|
| 1 | 0.8696 |
| 2 | 0.7561 |
| 3 | 0.6575 |
| 4 | 0.5718 |
| 5 | 0.4972 |
| 6 | 0.4323 |
| 7 | 0.3759 |
| 8 | 0.3269 |

(RTP May 22, Old & New SM)

Answer 32

ABC & Co. Equivalent Annual Cost (EAC) of new machine

| | (₹) |
|---|-----------|
| (i) Cost of new machine now | 18,00,000 |
| Add: PV of annual repairs @ ₹ 2,00,000 per annum for 8 years (₹ 2,00,000 X 4.4873) | 8,97,460 |
| | 26,97,460 |
| Less: PV of salvage value at the end of 8 years (₹ 4,00,000 X 0.3269) | 1,30,760 |
| | 25,66,700 |
| Equivalent annual cost (EAC) (₹ 25,66,700/4.4873) | 5,71,992 |

PV of cost of replacing the old machine in each of 4 years with new machine

| Scenario | Year | Cash Flow (₹) | PV @ 15% | PV (₹) |
|------------------------|------|------------------|----------|------------|
| Replace Immediately | 0 | (5,71,992) | 1.00 | (5,71,992) |
| | 0 | 8,00,000 | 1.00 | 8,00,000 |
| | | | | 2,28,008 |
| Replace in one year | 1 | (5,71,992) | 0.8696 | (4,97,404) |
| | 1 | (2,00,000) | 0.8696 | (1,73,920) |
| | 1 | 5,00,000 | 0.8696 | 4,34,800 |
| | | | | (2,36,524) |
| Replace in two years | 1 | (2,00,000) | 0.8696 | (1,73,920) |
| | 2 | (5,71,992) | 0.7561 | (4,32,483) |
| | 2 | (4,00,000) | 0.7561 | (3,02,440) |
| | 2 | 3,00,000 | 0.7561 | 2,26,830 |
| | | | | (6,82,013) |
| Replace in three years | 1 | (2,00,000) | 0.8696 | (1,73,920) |

| | | | | |
|-----------------------|---|------------|--------|-------------|
| | 2 | (4,00,000) | 0.7561 | (3,02,440) |
| | 3 | (5,71,992) | 0.6575 | (3,76,085) |
| | 3 | (6,00,000) | 0.6575 | (3,94,500) |
| | 3 | 2,00,000 | 0.6575 | 1,31,500 |
| | | | | (11,15,445) |
| Replace in four years | 1 | (2,00,000) | 0.8696 | (1,73,920) |
| | 2 | (4,00,000) | 0.7561 | (3,02,440) |
| | 3 | (6,00,000) | 0.6575 | (3,94,500) |
| | 4 | (5,71,992) | 0.5718 | (3,27,065) |
| | 4 | (8,00,000) | 0.5718 | (4,57,440) |
| | | | | (16,55,365) |

Advice: The company should replace the old machine immediately because the PV of cost of replacing the old machine with new machine is least.

Question 33

K. K. M. Hospital is considering purchasing an MRI machine. Presently, the hospital is outsourcing the work received relating to MRI machine and is earning commission of ₹ 6,60,000 per annum (net of tax). The following details are given regarding the machine:

| | (₹) |
|---|-----------|
| Cost of MRI machine | 90,00,000 |
| Operating cost per annum (excluding Depreciation) | 14,00,000 |
| Expected revenue per annum | 45,00,000 |
| Salvage value of the machine (after 5 years) | 10,00,000 |
| Expected life of the machine | 5 years |

Assuming tax rate @ 40%, whether it would be profitable for the hospital to purchase the machine?

Give your RECOMMENDATION under:

- (i) Net Present Value Method, and
- (ii) Profitability Index Method.

PV factors at 10% are given below:

| Year | 1 | 2 | 3 | 4 | 5 |
|-----------|-------|-------|-------|-------|-------|
| PV factor | 0.909 | 0.826 | 0.751 | 0.683 | 0.620 |

(RTP Nov'22, Old & New SM)

Answer 34

A. Determination of Cash inflows

| Elements | (₹) |
|--|-----------|
| Sales Revenue | 45,00,000 |
| Less: Operating Cost | 14,00,000 |
| | 31,00,000 |
| Less: Depreciation $(90,00,000 - 10,00,000)/5$ | 16,00,000 |
| Net Income | 15,00,000 |
| Tax @ 40% | 6,00,000 |
| Earnings after Tax (EAT) | 9,00,000 |
| Add: Depreciation | 16,00,000 |



| | |
|-------------------------------------|-----------|
| Cash inflow after tax per annum | 25,00,000 |
| Less: Loss of Commission Income | 6,60,000 |
| Net Cash inflow after tax per annum | 18,40,000 |
| In 5th Year: | |
| New Cash inflow after tax | 18,40,000 |
| Add: Salvage Value of Machine | 10,00,000 |
| Net Cash inflow in year 5 | 28,40,000 |

Calculation of Net Present Value (NPV)

| Yea | CFAT | PV Factor @10% | Present Value of Cash inflows |
|---------------------|-----------|----------------|-------------------------------|
| 1 to 4 | 18,40,000 | 3.169 | 58,30,960 |
| 5 | 28,40,000 | 0.620 | 17,60,800 |
| | | | 75,91,760 |
| Less: Cash Outflows | | | 90,00,000 |
| NPV | | | (14,08,240) |

$$\text{Profitability Index} = \frac{\text{Sum of discounted cash inflows}}{\text{Present value of cash outflows}} = \frac{75,91,760}{90,00,000} = 0.844$$

Advise: Since the net present value is negative and profitability index is also less than 1, therefore, the hospital should not purchase the MRI machine

Question 35

Dharma Ltd, an existing profit-making company, is planning to introduce a new product with a projected life of 8 years. Initial equipment cost will be ₹ 240 lakhs and additional equipment costing ₹ 26 lakhs will be needed at the beginning of third year. At the end of 8 years, the original equipment will have resale value equivalent to the cost of removal, but the additional equipment would be sold for ₹ 2 lakhs. Working Capital of ₹ 25 lakhs will be needed at the beginning of the operations. The 100% capacity of the plant is of 4,00,000 units per annum, but the production and sales volume expected are as under:

| Year | Capacity (%) |
|------|--------------|
| 1 | 20 |
| 2 | 30 |
| 3-5 | 75 |
| 6-8 | 50 |

A sale price of ₹ 100 per unit with a profit volume ratio (contribution/sales) of 60% is likely to be obtained. Fixed operating cash cost are likely to be ₹ 16 lakhs per annum. In addition to this the advertisement expenditure will have to be incurred as under:

| Year | 1 | 2 | 3-5 | 6-8 |
|---------------------------------|----|----|-----|-----|
| Expenditure (₹ Lakhs each year) | 30 | 15 | 10 | 4 |

The company is subjected to 50% tax rate and consider 12% to be an appropriate cost of capital. Straight line method of depreciation is followed by the company. ADVISE the management on the desirability of the project. (RTP May 23)

Answer 35

Calculation of Cash Flow After tax

| | Year | 1 | 2 | 3 to 5 | 6 to 8 |
|---|----------|---|-------|--------|--------|
| A | Capacity | | 20% | 30% | 75% |
| B | Units | | 80000 | 120000 | 200000 |



| | | | | | | | |
|---|--------------------------------------|---------------|-----|--------------|----|---------------|---------------|
| C | Contribution p.u. | | ₹60 | ₹60 | | ₹60 | ₹60 |
| D | Contribution | ₹48,00,000 | | ₹72,00,000 | | ₹1,80,00,000 | ₹1,20,00,000 |
| E | Fixed Cash Cost | ₹16,00,000 | | ₹16,00,000 | | ₹16,00,000 | ₹16,00,000 |
| | Depreciation | | | | | | |
| F | Original Equipment (₹240Lakhs/8) | ₹30,00,000 | | ₹30,00,000 | | ₹30,00,000 | ₹30,00,000 |
| G | Additional Equipment (₹24Lakhs/6) | | -- | | -- | ₹4,00,000 | ₹4,00,000 |
| H | Advertisement Expenditure | ₹30,00,000 | | ₹15,00,000 | | ₹10,00,000 | ₹4,00,000 |
| I | Profit Before Tax (D- E-F-G-H) | ₹ (28,00,000) | | ₹11,00,000 | | ₹1,20,00,000 | ₹66,00,000 |
| J | Tax savings/ (expenditure) | ₹14,00,000 | | ₹ (5,50,000) | | ₹ (60,00,000) | ₹ (33,00,000) |
| K | Profit After Tax | ₹ (14,00,000) | | ₹5,50,000 | | ₹60,00,000 | ₹33,00,000 |
| L | Add: Depreciation (F+G) | ₹30,00,000 | | ₹30,00,000 | | ₹34,00,000 | ₹34,00,000 |
| M | Cash Flow After Tax | ₹16,00,000 | | ₹35,50,000 | | ₹94,00,000 | ₹67,00,000 |

Calculation of NPV

| Year | Particulars | Cash Flows | PV factor | PV |
|------|----------------------------|-----------------|-----------|-----------------|
| 0 | Initial Investment | ₹ (2,40,00,000) | 1.000 | ₹ (2,40,00,000) |
| 0 | Working Capital Introduced | ₹ (25,00,000) | 1.000 | ₹ (25,00,000) |
| 1 | CFAT | ₹16,00,000 | 0.893 | ₹ 14,28,800 |
| 2 | CFAT | ₹ 35,50,000 | 0.797 | ₹ 28,29,350 |
| 2 | Additional Equipment | ₹ (26,00,000) | 0.797 | ₹ (20,72,200) |
| 3 | CFAT | ₹ 94,00,000 | 0.712 | ₹ 66,92,800 |
| 4 | CFAT | ₹ 94,00,000 | 0.636 | ₹ 59,78,400 |
| 5 | CFAT | ₹ 94,00,000 | 0.567 | ₹ 53,29,800 |
| 6 | CFAT | ₹ 67,00,000 | 0.507 | ₹ 33,96,900 |
| 7 | CFAT | ₹ 67,00,000 | 0.452 | ₹ 30,28,400 |
| 8 | CFAT | ₹ 67,00,000 | 0.404 | ₹ 27,06,800 |
| 8 | WC Released | ₹ 25,00,000 | 0.404 | ₹ 10,10,000 |
| 8 | Salvage Value | ₹ 2,00,000 | 0.404 | ₹ 80,800 |
| | Net Present Value | | | ₹39,09,850 |

Since the NPV is positive, the proposed project should be implemented.

Question 36

An existing company has a machine which has been in operation for two years, its estimated remaining useful life is 4 years with no residual value in the end. Its current market value is Rs.3 lakhs. The management is considering a proposal to purchase an improved model of a machine gives increase output. The details are as under:

| Particulars | Existing Machine | New Machine |
|-------------|------------------|-------------|
|-------------|------------------|-------------|

| | | |
|---|-------------|--------------|
| Purchase Price | Rs.6,00,000 | Rs.10,00,000 |
| Estimated Life | 6 years | 4 years |
| Residual Value | 0 | 0 |
| Annual Operating days | 300 | 300 |
| Operating hours per day | 6 | 6 |
| Selling price per unit | Rs.10 | Rs.10 |
| Material cost per unit | Rs.2 | Rs.2 |
| Output per hour in units | 20 | 40 |
| Labour cost per hour | Rs.20 | Rs.30 |
| Fixed overhead per annum excluding depreciation | Rs.1,00,000 | Rs.60,000 |
| Working Capital | Rs.1,00,000 | Rs.2,00,000 |
| Income-tax rate | 30% | 30% |

Assuming that - cost of capital is 10% and the company uses written down value of depreciation @ 20% and it has several machines in 20% block.

Advice the management on the Replacement of Machine as per the NPV method. The discounting factors table given below:

| Discounting Factors | Year 1 | Year 2 | Year 3 | Year 4 |
|---------------------|--------|--------|--------|--------|
| 10% | 0.909 | 0.826 | 0.751 | 0.683 |

(PYP 10 Marks, July'21)

Answer 36

i. Calculation of Net Initial Cash Outflows:

| Particulars | Rs. |
|---|-----------|
| Purchase Price of new machine | 10,00,000 |
| Add: Net Working Capital | 1,00,000 |
| Less: Sale proceeds of existing machine | 3,00,000 |
| Net initial cash outflows | 8,00,000 |

ii. Calculation of annual Profit Before Tax and depreciation

| Particulars | Existing machine | New Machine | Differential |
|---------------------------------------|------------------|--------------|-----------------|
| (1) | (2) | (3) | (4) = (3) – (2) |
| Annual output | 36,000 units | 72,000 units | 36,000 units |
| | Rs. | Rs. | Rs. |
| (A) Sales revenue @ Rs.10 per unit | 3,60,000 | 7,20,000 | 3,60,000 |
| (B) Cost of Operation | | | |
| Material @ Rs.2 per unit | 72,000 | 1,44,000 | 72,000 |
| Labour | | | |
| Old = 1,800 × Rs.20 | 36,000 | | |
| New = 1,800 × Rs.30 | | 54,000 | 18,000 |
| Fixed overhead excluding depreciation | 1,00,000 | 60,000 | (40,000) |
| Total Cost (B) | 2,08,000 | 2,58,000 | 50,000 |

| | | | |
|---|----------|----------|----------|
| Profit Before Tax and depreciation (PBSD) (A – B) | 1,52,000 | 4,62,000 | 3,10,000 |
|---|----------|----------|----------|

iii. Calculation of Net Present value on replacement of machine

| Yea | PBSD | Depreciate on @ 20% WDV | PBT | Tax @ 30% | PAT | Net cash flow | PVF @ 10% | PV |
|--|----------|-------------------------|-----------|-----------|-----------|---------------|-----------|--------------|
| (1) | (2) | (3) | (4 = 2-3) | (5) | (6 = 4-5) | (7 = 6 + 3) | (8) | (9 = 7 x 8) |
| 1 | 3,10,000 | 1,40,000 | 1,70,000 | 51,000 | 1,19,000 | 2,59,000 | 0.909 | 2,35,431.000 |
| 2 | 3,10,000 | 1,12,000 | 1,98,000 | 59,400 | 1,38,600 | 2,50,600 | 0.826 | 2,06,995.600 |
| 3 | 3,10,000 | 89,600 | 2,20,400 | 66,120 | 1,54,280 | 2,43,880 | 0.751 | 1,83,153.880 |
| 4 | 3,10,000 | 71,680 | 2,38,320 | 71,496 | 1,66,824 | 2,38,504 | 0.683 | 1,62,898.232 |
| | | | | | | | | 7,88,478.712 |
| Add: Release of net working capital at year end 4 (1,00,000 x 0.683) | | | | | | | | 68,300.000 |
| Less: Initial Cash Outflow | | | | | | | | 8,00,000.000 |
| NPV | | | | | | | | 56,778.712 |

Advice: Since the incremental NPV is positive, existing machine should be replaced.

Working Notes:

1. Calculation of Annual Output

Annual output = (Annual operating days' x Operating hours per day) x output per hour Existing machine
 = (300 x 6) x 20 = 1,800 x 20 = 36,000 units

New machine = (300 x 6) x 40 = 1,800 x 40 = 72,000 units

2. Base for incremental depreciation

| Particulars | ₹ |
|---|-----------|
| WDV of Existing Machine | |
| Purchase price of existing machine | 6,00,000 |
| Less: Depreciation for year 1 | 1,20,000 |
| Depreciation for Year 2 | 96,000 |
| WDV of Existing Machine (I) | 3,84,000 |
| Depreciation base of New Machine | |
| Purchase price of new machine | 10,00,000 |
| Add: WDV of existing machine | 3,84,000 |
| Less: Sales value of existing machine | 3,00,000 |
| Depreciation base of New Machine (ii) | 10,84,000 |
| Base for incremental depreciation [(ii) – (I)] | 7,00,000 |

(Note: The above solution has been done based on incremental approach) Alternatively, solution can be done based on Total Approach as below:

(i) Calculation of depreciation:

| Existing Machine | | | | | | |
|--------------------------|----------|----------|----------|----------|----------|-------------|
| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 |
| Opening balance | 6,00,000 | 4,80,000 | 3,84,000 | 3,07,200 | 2,45,760 | 1,96,608.00 |
| Less: Depreciation @ 20% | 1,20,000 | 96,000 | 76,800 | 61,440 | 49,152 | 39,321.60 |
| WDV | 4,80,000 | 3,84,000 | 3,07,200 | 2,45,760 | 1,96,608 | 1,57,286.40 |

| New Machine | | | | |
|--------------------------|------------|----------|----------|-------------|
| | Year 1 | Year 2 | Year 3 | Year 4 |
| Opening balance | 10,84,000* | 8,67,200 | 6,93,760 | 5,55,008.00 |
| Less: Depreciation @ 20% | 2,16,800 | 1,73,440 | 1,38,752 | 1,11,001.60 |
| WDV | 8,67,200 | 6,93,760 | 5,55,008 | 4,44,006.40 |

*As the company has several machines in 20% block, the value of Existing Machine from the block calculated as below shall be added to the new machine of Rs.10,00,000:

WDV of existing machine at the beginning of the year Rs.3,84,000 Less:

Sale Value of Machine Rs.3,00,000

WDV of existing machine in the block Rs.84,000

Therefore, opening balance for depreciation of block = Rs.10,00,000 + Rs.84,000 = Rs.10,84,000

(ii) Calculation of annual cash inflows from operation:

| Particulars | EXISTING MACHINE | | | |
|---|------------------|--------------|--------------|--------------|
| | Year 3 | Year 4 | Year 5 | Year 6 |
| Annual output (300 operating days x 6 operating hours x 20 output per hour) | 36,000 units | 36,000 units | 36,000 units | 36,000 units |
| | ₹ | ₹ | ₹ | ₹ |
| (A) Sales revenue @ Rs.10 per unit | 3,60,000.00 | 3,60,000.00 | 3,60,000.00 | 3,60,000.00 |
| (B) Less: Cost of Operation | | | | |
| Material @ Rs.2 per unit | 72,000.00 | 72,000.00 | 72,000.00 | 72,000.00 |
| Labour @ Rs.20 per hour for (300 x 6) hours | 36,000.00 | 36,000.00 | 36,000.00 | 36,000.00 |
| Fixed overhead | 1,00,000.00 | 1,00,000.00 | 1,00,000.00 | 1,00,000.00 |
| Depreciation | 76,800.00 | 61,440.00 | 49,152.00 | 39,321.60 |
| Total Cost (B) | 2,84,800.00 | 2,69,440.00 | 2,57,152.00 | 2,47,321.60 |
| Profit Before Tax (A – B) | 75,200.00 | 90,560.00 | 1,02,848.00 | 1,12,678.40 |
| Less: Tax @ 30% | 22,560.00 | 27,168.00 | 30,854.40 | 33,803.52 |
| Profit After Tax | 52,640.00 | 63,392.00 | 71,993.60 | 78,874.88 |
| Add: Depreciation | 76,800.00 | 61,440.00 | 49,152.00 | 39,321.60 |
| Add: Release of Working | | | | |

| | | | | |
|---------------------|-------------|-------------|-------------|-------------|
| Capital | | | | 1,00,000.00 |
| Annual Cash Inflows | 1,29,440.00 | 1,24,832.00 | 1,21,145.60 | 2,18,196.48 |

| Particulars | NEW MACHINE | | | |
|---|--------------------|--------------------|--------------------|--------------------|
| | Year 1 | Year 2 | Year 3 | Year 4 |
| Annual output (300 operating days x 6 operating hours x 40 output per hour) | 72,000 units | 72,000 units | 72,000 units | 72,000 units |
| | ₹ | ₹ | ₹ | ₹ |
| (A) Sales revenue @ Rs.10 per unit | 7,20,000.00 | 7,20,000.00 | 7,20,000.00 | 7,20,000.00 |
| (B) Less: Cost of Operation | | | | |
| Material @ Rs.2 per unit | 1,44,000.00 | 1,44,000.00 | 1,44,000.00 | 1,44,000.00 |
| Labour @ Rs.30 per hour for (300 x 6) hours | 54,000.00 | 54,000.00 | 54,000.00 | 54,000.00 |
| Fixed overhead | 60,000.00 | 60,000.00 | 60,000.00 | 60,000.00 |
| Depreciation | 2,16,800.00 | 1,73,440.00 | 1,38,752.00 | 1,11,001.60 |
| Total Cost (B) | 4,74,800.00 | 4,31,440.00 | 3,96,752.00 | 3,69,001.60 |
| Profit Before Tax (A – B) | 2,45,200.00 | 2,88,560.00 | 3,23,248.00 | 3,50,998.40 |
| Less: Tax @ 30% | 73,560.00 | 86,568.00 | 96,974.40 | 1,05,299.52 |
| Profit After Tax | 1,71,640.00 | 2,01,992.00 | 2,26,273.60 | 2,45,698.88 |
| Add: Depreciation | 2,16,800.00 | 1,73,440.00 | 1,38,752.00 | 1,11,001.60 |
| Add: Release of Working Capital | | | | 2,00,000.00 |
| Annual Cash Inflows | 3,88,440.00 | 3,75,432.00 | 3,65,025.60 | 5,56,700.48 |

(i) Calculation of Incremental Annual Cash Flow:

| Particulars | Year 1 (₹) | Year 2 (₹) | Year 3 (₹) | Year 4 (₹) |
|--------------------------------------|-------------|-------------|-------------|------------|
| Existing Machine (A) | 1,29,440.00 | 1,24,832.00 | 1,21,145.60 | 18,196.48 |
| New Machine (B) | 3,88,440.00 | 3,75,432.00 | 3,65,025.60 | 56,700.48 |
| Incremental Annual Cash Flow (B – A) | 2,59,000.00 | 2,50,600.00 | 2,43,880.00 | 38,504.00 |

(ii) Calculation of Net Present Value on replacement of machine:

| Year | Incremental Annual Cash Flow (₹) (A) | Discounting factor @ 10% (B) | Present Value of Incremental Annual Cash Flow (₹) (A x B) |
|--|--------------------------------------|------------------------------|---|
| 1 | 2,59,000.00 | 0.909 | 2,35,431.000 |
| 2 | 2,50,600.00 | 0.826 | 2,06,995.600 |
| 3 | 2,43,880.00 | 0.751 | 1,83,153.880 |
| 4 | 3,38,504.00 | 0.683 | 2,31,198.232 |
| Total Incremental Inflows | | | 8,56,778.712 |
| Less: Net Initial Cash Outflows (Working note) | | | 8,00,000.000 |



| | |
|-----------------|------------|
| Incremental NPV | 56,778.712 |
|-----------------|------------|

Advice: Since the incremental NPV is positive, existing machine should be replaced.

Working Note:

Calculation of Net Initial Cash Outflows:

| Particulars | ₹ |
|---|-----------|
| Cost of new machine | 10,00,000 |
| Less: Sale proceeds of existing machine | 3,00,000 |
| Add: incremental working capital required (Rs.2,00,000 – Rs.1,00,000) | 1,00,000 |
| Net initial cash outflows | 8,00,000 |

Question 37

Explain the limitations of Average Rate of Return. (PYP 2 Marks, July'21)

Answer 37

Limitations of Average Rate of Return

- The accounting rate of return technique, like the payback period technique, ignores the **time value of money** and considers the value of all cash flows to be equal.
- The technique uses accounting numbers that are dependent on the organization's **choice of accounting procedures**, and different accounting procedures, e.g., depreciation methods, can lead to substantially different amounts for an investment's net income and book values.
- The method **uses net income rather than cash flows**; while net income is a useful measure of profitability, the net cash flow is a better measure of an investment's performance.
- Furthermore, inclusion of only the book value of the invested asset **ignores** the fact that a project can require **commitments of working capital** and other outlays that are not included in the book value of the project.

Question 38

A company wants to buy a machine, and two different models namely A and B are available. Following further particulars are available:

| Particulars | Machine-A | Machine-B |
|-------------------------|-----------|-----------|
| Original Cost (₹) | 8,00,000 | 6,00,000 |
| Estimated Life in years | 4 | 4 |
| Salvage Value (₹) | 0 | 0 |

The company provides depreciation under Straight Line Method. Income tax rate applicable is 30%. The present value of Rs.1 at 12% discounting factor and net profit before depreciation and tax are as under:

| Year | Net Profit Before Depreciation and tax | | PV Factor |
|------|--|----------------|-----------|
| | Machine-A ₹ | Machine-B ₹ | |
| 1. | 2,30,000 | 1,75,000 | 0.893 |
| 2. | 2,40,000 | 2,60,000 | 0.797 |
| 3. | 2,20,000 | 3,20,000 | 0.712 |
| 4. | 5,60,000 | 1,50,000 | 0.636 |

Calculate:



1. NPV (Net Present Value)
2. Discounted pay-back period
3. PI (Profitability Index)

Suggest: Purchase of which machine is more beneficial under Discounted pay-back period method, NPV method and PI method. (PYP 10 Marks, Jan'21)

Answer 38

Workings:

(i) Calculation of Annual Depreciation

$$\text{Depreciation on Machine - A} = \frac{\text{Rs.8,00,000}}{4} = 2,00,000$$

$$\text{Depreciation on Machine - B} = \frac{\text{Rs.8,00,000}}{4} = \text{Rs.1,50,000}$$

(ii) Calculation of Annual Cash Inflows

| Particulars | Machine-A (₹) | | | |
|--|-----------------|-----------------|-----------------|-----------------|
| | 1 | 2 | 3 | 4 |
| Net Profit before Depreciation and Tax | 2,30,000 | 2,40,000 | 2,20,000 | 5,60,000 |
| Less: Depreciation | 2,00,000 | 2,00,000 | 2,00,000 | 2,00,000 |
| Profit before Tax | 30,000 | 40,000 | 20,000 | 3,60,000 |
| Less: Tax @ 30% | 9,000 | 12,000 | 6,000 | 1,08,000 |
| Profit after Tax | 21,000 | 28,000 | 14,000 | 2,52,000 |
| Add: Depreciation | 2,00,000 | 2,00,000 | 2,00,000 | 2,00,000 |
| Annual Cash Inflows | 2,21,000 | 2,28,000 | 2,14,000 | 4,52,000 |

| Particulars | Machine-B (₹) | | | |
|--|-----------------|-----------------|-----------------|-----------------|
| | 1 | 2 | 3 | 4 |
| Net Profit before Depreciation and Tax | 1,75,000 | 2,60,000 | 3,20,000 | 1,50,000 |
| Less: Depreciation | 1,50,000 | 1,50,000 | 1,50,000 | 1,50,000 |
| Profit before Tax | 25,000 | 1,10,000 | 1,70,000 | 0 |
| Less: Tax @ 30% | 7,500 | 33,000 | 51,000 | 0 |
| Profit after Tax | 17,500 | 77,000 | 1,19,000 | 0 |
| Add: Depreciation | 1,50,000 | 1,50,000 | 1,50,000 | 1,50,000 |
| Annual Cash Inflows | 1,67,500 | 2,27,000 | 2,69,000 | 1,50,000 |

(i) Calculation of PV of Cash Flows

| Year | Machine - A | | | | Machine - B | | |
|------|------------------|---------------|--------|-------------------|---------------|--------|-------------------|
| | PV of Re 1 @ 12% | Cash flow (₹) | PV (₹) | Cumulative PV (₹) | Cash flow (₹) | PV (₹) | Cumulative PV (₹) |

| | | | | | | | |
|---|-------|----------|----------|----------|----------|----------|----------|
| 1 | 0.893 | 2,21,000 | 1,97,353 | 1,97,353 | 1,67,500 | 1,49,578 | 1,49,578 |
| 2 | 0.797 | 2,28,000 | 1,81,716 | 3,79,069 | 2,27,000 | 1,80,919 | 3,30,497 |
| 3 | 0.712 | 2,14,000 | 1,52,368 | 5,31,437 | 2,69,000 | 1,91,528 | 5,22,025 |
| 4 | 0.636 | 4,52,000 | 2,87,472 | 8,18,909 | 1,50,000 | 95,400 | 6,17,425 |

1. NPV (Net Present Value) Machine – A

$$\text{NPV} = \text{Rs.}8,18,909 - \text{Rs.}8,00,000 = \text{Rs. } 18,909$$

Machine – B

$$\text{NPV} = \text{Rs.}6,17,425 - \text{Rs.}6,00,000 = \text{Rs. } 17,425$$

2. Discounted Payback Period Machine – A

$$\text{Discounted Payback Period} = 3 + \frac{\text{Rs.}8,00,000 - ₹ 5,31,437}{\text{Rs.}2,87,472}$$

$$= 3 + 0.934$$

$$= 3.934 \text{ years or 3 years 11.21 months}$$

Machine – B

$$\text{Discounted Payback Period} = 3 + \frac{\text{Rs.}6,00,000 - ₹ 5,22,025}{\text{Rs.}95,400}$$

$$= 3 + 0.817$$

$$= 3.817 \text{ years or 3 years 9.80 months}$$

3. PI (Profitability Index)

Machine – A

$$\text{Profitability Index} = \frac{\text{Rs.}8,18,909}{\text{Rs.}8,00,000} = 1.024$$

Machine – B

$$\text{Profitability Index} = \frac{\text{Rs.}6,17,425}{\text{Rs.}6,00,000} = 1.029$$

Suggestion:

| Method | Machine - A | Machine - B | Suggested Machine |
|---------------------------|-------------|-------------|-------------------|
| Net Present Value | Rs.18,909 | Rs.17,425 | Machine A |
| Discounted Payback Period | 3.934 years | 3.817 years | Machine B |
| Profitability Index | 1.024 | 1.029 | Machine B |

Question 39

Define Internal Rate of Return (IRR) (PYP 2 Marks, Jan'21)

Answer 39

Internal rate of return: Internal rate of return for an investment proposal is the discount rate that equates the present value of the expected cash inflows with the initial cash outflow.

Question 40

CK Ltd. is planning to buy a new machine. Details of which are as follows:

| | |
|--|--------------------|
| Cost of the Machine at the commencement | Rs.2,50,000 |
| Economic Life of the Machine | 8 year |

Residual Value Nil
Annual Production Capacity of the Machine 1,00,000 units
Estimated Selling Price per unit Rs.6
Estimated Variable Cost per unit Rs.3
Estimated Annual Fixed Cost Rs.1,00,000 (Excluding depreciation)
Advertisement Expenses in 1st year in addition of annual fixed cost Rs. 20,000
Maintenance Expenses in 5th year in addition of annual fixed cost Rs. 30,000
Cost of Capital 12%
Ignore Tax.
Analyze the above mentioned proposal using the Net Present Value Method and advice.
P.V. factor @ 12% is as under:

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|-----------|-------|-------|-------|-------|-------|-------|-------|-------|
| PV Factor | 0.893 | 0.797 | 0.712 | 0.636 | 0.567 | 0.507 | 0.452 | 0.404 |

(PYP 5 Marks, Nov'20)

Answer 40

Calculation of Net Cash flows

Owners equity = $50\% \times \text{Rs.}10,00,000 = 0.203$ or 20.3%

Contribution = $(\text{Rs.}6 - \text{Rs.}3) \times 1,00,000 \text{ units} = \text{Rs.}3,00,000$

Fixed costs (excluding depreciation) = Rs.1,00,000

| Year | Capital (₹) | Contribution (₹) | Fixed costs (₹) | Advertisement/Maintenance expenses (₹) | Net cash flow (₹) |
|------|-------------|------------------|-----------------|--|-------------------|
| 0 | (2,50,000) | | | | (2,50,000) |
| 1 | | 3,00,000 | (1,00,000) | (20,000) | 1,80,000 |
| 2 | | 3,00,000 | (1,00,000) | | 2,00,000 |
| 3 | | 3,00,000 | (1,00,000) | | 2,00,000 |
| 4 | | 3,00,000 | (1,00,000) | | 2,00,000 |
| 5 | | 3,00,000 | (1,00,000) | (30,000) | 1,70,000 |
| 6 | | 3,00,000 | (1,00,000) | | 2,00,000 |
| 7 | | 3,00,000 | (1,00,000) | | 2,00,000 |
| 8 | | 3,00,000 | (1,00,000) | | 2,00,000 |

Calculation of Net Present Value

| Year | Net cash flow (₹) | 12% discount factor | Present value (₹) |
|------|-------------------|---------------------|-------------------|
| 0 | (2,50,000) | 1.000 | (2,50,000) |
| 1 | 1,80,000 | 0.893 | 1,60,740 |
| 2 | 2,00,000 | 0.797 | 1,59,400 |
| 3 | 2,00,000 | 0.712 | 1,42,400 |
| 4 | 2,00,000 | 0.636 | 1,27,200 |
| 5 | 1,70,000 | 0.567 | 96,390 |
| 6 | 2,00,000 | 0.507 | 1,01,400 |
| 7 | 2,00,000 | 0.452 | 90,400 |

| | | | |
|---|----------|-------|----------|
| 8 | 2,00,000 | 0.404 | 80,800 |
| | | | 7,08,730 |

Advise: CK Ltd. should buy the new machine, as the net present value of the proposal is positive i.e. ₹ 7,08,730.

Question 41

AT Limited is considering three projects A, B and C. The cash flows associated with the projects are given below:

Cash flows associated with the Three Projects (₹)

| Project | C0 | C1 | C2 | C3 | C4 |
|---------|----------|-------|-------|-------|--------|
| A | (10,000) | 2,000 | 2,000 | 6,000 | 0 |
| B | (2,000) | 0 | 2,000 | 4,000 | 6,000 |
| C | (10,000) | 2,000 | 2,000 | 6,000 | 10,000 |

You are required to:

- Calculate the payback period of each of the three projects.
- If the cut-off period is two years, then which projects should be accepted?
- Projects with positive NPVs if the opportunity cost of capital is 10 percent.
- "Payback gives too much weight to cash flows that occur after the cut-off date". True or false?
- "If a firm used a single cut-off period for all projects, it is likely to accept too many short lived projects." True or false?
- P.V. Factor @ 10 %

| Year | 0 | 1 | 2 | 3 | 4 | 5 |
|------|-------|-------|-------|-------|-------|-------|
| P.V. | 1.000 | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 |

(PYP 10 Marks, May'19)

Answer 41

a) Payback Period of Projects

| Projects | C0(₹) | C1(₹) | C2(₹) | C3(₹) | Payback |
|----------|----------|-------|-------|-------|---|
| A | (10,000) | 2000 | 2000 | 6,000 | 2,000+2,000+6,000 =10,000 i.e. 3 years |
| B | (2,000) | 0 | 2,000 | NA | 0+2,000 = 2,000 i.e. 2 years |
| C | (10,000) | 2000 | 2000 | 6,000 | 2,000+2,000+6,000 = 10,000 i.e. 3 years |

b) If standard payback period is 2 years, Project B is the only acceptable project.

c) Calculation of NPV

| Year | PVF @ 10% | Project A | | Project B | | Project C | |
|------|-----------|-----------------|----------------------|----------------|----------------------|----------------|----------------------|
| | | Cash Flow s (₹) | PV of cash flows (₹) | Cash Flows (₹) | PV of cash flows (₹) | Cash Flows (₹) | PV of cash flows (₹) |
| 0 | 1 | (10,000) | (10,000) | (2,000) | (2,000) | (10,000) | (10,000) |



| | | | | | | | |
|-----|-------|-------|----------|-------|-------|--------|-------|
| 1 | 0.909 | 2,000 | 1,818 | 0 | 0 | 2,000 | 1,818 |
| 2 | 0.826 | 2,000 | 1,652 | 2,000 | 1,652 | 2,000 | 1,652 |
| 3 | 0.751 | 6,000 | 4506 | 4,000 | 3004 | 6,000 | 4,506 |
| 4 | 0.683 | 0 | 0 | 6,000 | 4,098 | 10,000 | 6,830 |
| NPV | | | (-2,024) | | 6,754 | | 4,806 |

So, Projects with positive NPV are Project B and Project C

- d) False. Payback gives no weightage to cash flows after the cut-off date.
- e) True. The payback rule ignores all cash flows after the cutoff date, meaning that future years' cash inflows are not considered. Thus, payback is biased towards short-term projects.

Question 42

Explain any two steps involved in Decision Tree Analysis. (PYP 2 Marks, May'19)

Answer 42

Steps involved in Decision Tree analysis:

Step 1- Define Investment: Decision tree analysis can be applied to a variety of business decision-making scenarios.

Step 2- Identification of Decision Alternatives: It is very essential to clearly identify decision alternatives. For example, if a company is planning to introduce a new product, it may be local launch, national launch or international launch.

Step 3- Drawing a Decision Tree: After identifying decision alternatives, at the relevant data such as the projected cash flows, probability distribution expected present value etc. should be put in diagrammatic form called decision tree.

Step 4- Evaluating the Alternatives: After drawing out the decision the next step is the evaluation of alternatives.

Question 43

PD Ltd. an existing company, is planning to introduce a new product with projected life of 8 years. Project cost will be Rs.2,40,00,000. At the end of 8 years no residual value will be realized. Working capital of Rs.30,00,000 will be needed. The 100% capacity of the project is 2,00,000 units p.a. but the Production and Sales Volume is expected are as under:

| Year | Number of Units |
|------|-----------------|
| 1 | 60,000 units |
| 2. | 80,000 units |
| 3-5 | 1,40,000 units |
| 6-8 | 1,20,000 units |

Other Information:

- (i) Selling price per unit Rs.200
- (ii) Variable cost is 40 of sales.
- (iii) Fixed cost p.a. Rs.30,00,000.
- (iv) In addition to these advertisement expenditures will have to be incurred as under:

| Year | 1 | 2 | 3-5 | 6-8 |
|------|---|---|-----|-----|
|------|---|---|-----|-----|

| Expenditure (₹) | 50,00,000 | 25,00,000 | 10,00,000 | 5,00,000 |
|-----------------|-----------|-----------|-----------|----------|
|-----------------|-----------|-----------|-----------|----------|

- (v) Income Tax is 25%.
- (vi) Straight line method of depreciation is permissible for tax purpose.
- (vii) Cost of capital is 10%.
- (viii) Assume that loss cannot be carried forward.

Present Value Table

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|---------|-------|-------|-------|-------|-------|-------|-------|-------|
| PVF@ 10 | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 | 0.564 | 0.513 | 0.467 |

Advise about the project acceptability. (PYP 10 Marks, Nov'18)

Answer 43
Computation of initial cash outlay (COF)

| | (₹ in lakhs) |
|-----------------|--------------|
| Project Cost | 240 |
| Working Capital | 30 |
| | 270 |

Calculation of Cash Inflows(CIF):

| Years | 1 | 2 | 3-5 | 6-8 |
|---|-------------|-----------|-------------|-------------|
| Sales in units | 60,000 | 80,000 | 1,40,000 | 1,20,000 |
| | ₹ | ₹ | ₹ | ₹ |
| Contribution (Rs.200 x 60% x No. of Unit) | 72,00,000 | 96,00,000 | 1,68,00,000 | 1,44,00,000 |
| Less: Fixed cost | 30,00,000 | 30,00,000 | 30,00,000 | 30,00,000 |
| Less: Advertisement | 50,00,000 | 25,00,000 | 10,00,000 | 5,00,000 |
| Less: Depreciation (24000000/8) = 30,00,000 | 30,00,000 | 30,00,000 | 30,00,000 | 30,00,000 |
| Profit /(loss) | (38,00,000) | 11,00,000 | 98,00,000 | 79,00,000 |
| Less: Tax @ 25% | NIL | 2,75,000 | 24,50,000 | 19,75,000 |
| Profit/(Loss) after tax | (38,00,000) | 8,25,000 | 73,50,000 | 59,25,000 |
| Add: Depreciation | 30,00,000 | 30,00,000 | 30,00,000 | 30,00,000 |
| Cash inflow | (8,00,000) | 38,25,000 | 1,03,50,000 | 89,25,000 |

(Note: Since variable cost is 40%, Contribution shall be 60% of sales)

Computation of PV of CIF

| Year | CIF | PV Factor | ₹ |
|------|-------------|-----------|------------|
| | ₹ | @ 10% | |
| 1 | (8,00,000) | 0.909 | (7,27,200) |
| 2 | 38,25,000 | 0.826 | 31,59,450 |
| 3 | 1,03,50,000 | 0.751 | 77,72,850 |
| 4 | 1,03,50,000 | 0.683 | 70,69,050 |
| 5 | 1,03,50,000 | 0.621 | 64,27,350 |
| 6 | 89,25,000 | 0.564 | 50,33,700 |
| 7 | 89,25,000 | 0.513 | 45,78,525 |

| | | | |
|-----------------|-----------|-------|-------------|
| 8 | 89,25,000 | 0.467 | 55,68,975 |
| Working Capital | 30,00,000 | | |
| | | | 3,88,82,700 |
| | PV of COF | | 2,70,00,000 |
| | | NPV | 1,18,82,700 |

Recommendation: Accept the project in view of positive NPV.

Question 44

A company is evaluating a project that requires initial investment of Rs.60 lakhs in fixed assets and Rs.12 lakhs towards additional working capital.

The project is expected to increase annual real cash inflow before taxes by Rs.24,00,000 during its life. The fixed assets would have zero residual value at the end of life of 5 years. The company follows straight line method of depreciation which is expected for tax purposes also. Inflation is expected to be 6% per year. For evaluating similar projects, the company uses discounting rate of 12% in real terms. Company's tax rate is 30%. Advise whether the company should accept the project, by calculating NPV in real terms.

| PVIF (12%, 5 years) | | PVIF (12%, 5 years) | |
|---------------------|-------|---------------------|-------|
| Year 1 | 0.893 | Year 1 | 0.943 |
| Year 2 | 0.797 | Year 2 | 0.890 |
| Year 3 | 0.712 | Year 3 | 0.840 |
| Year 4 | 0.636 | Year 4 | 0.792 |
| Year 5 | 0.567 | Year 5 | 0.747 |

(PYP 10 Marks May '18)

Answer 44

(i) Equipment's initial cost = Rs.60,00,000 + Rs.12,00,000

= ₹ 72,00,000

(ii) Annual straight line depreciation = Rs.60,00,000/5

= Rs.12,00,000.

(iii) Net Annual cash flows can be calculated as follows:

= Before Tax CFs × (1 – Tc) + Tc × Depreciation (Tc = Corporate tax i.e. 30%)

= Rs.24,00,000 × (1 – 0.3) + (0.3 × Rs.12,00,000)

= Rs.16,80,000 + Rs.3,60,000 = Rs.20,40,000

So, Total Present Value = PV of inflow + PV of working capital released

= (Rs.20,40,000 × PVIF 12%, 5 years) + (Rs.12,00,000 × 0.567)

= (Rs.20,40,000 × 3.605) + Rs.6,80,400

= ₹ 73,54,200 + Rs.6,80,400

= Rs.80,34,600

So NPV = PV of Inflows – Initial Cost

= Rs.80,34,600 – ₹ 72,00,000

= Rs.8,34,600

Advice: Company should accept the project as the NPV is Positive

Question 45



Stand Ltd. is contemplating replacement of one of its machines which has become outdated and inefficient. Its financial manager has prepared a report outlining two possible replacement machines. The details of each machine are as follows:

| Initial investment Estimated useful life | Machine 1 ₹ 12,00,000 3 years | Machine 2 ₹ 16,00,000 5 years |
|--|-------------------------------------|-------------------------------------|
| Residual value | ₹ 1,20,000 | ₹ 1,00,000 |
| Contribution per annum | ₹ 11,60,000 | ₹ 12,00,000 |
| Fixed maintenance costs per annum | ₹ 40,000 | ₹ 80,000 |
| Other fixed operating costs per annum | ₹ 7,20,000 | ₹ 6,10,000 |

The maintenance costs are payable annually in advance. All other cash flows apart from the initial investment assumed to occur at the end of each year. Depreciation has been calculated by straight line method and has been included in other fixed operating costs. The expected cost of capital for this project is assumed as 12% p.a.

Required:

- Which machine is more beneficial, using Annualized Equivalent Approach? Ignore tax.
- Calculate the sensitivity of your recommendation in part (i) to changes in the contribution generated by machine 1.

| Year | 1 | 2 | 3 | 4 | 5 | 6 |
|--------------------------|-------|-------|-------|-------|-------|-------|
| PVIF _{0.12, t} | 0.893 | 0.797 | 0.712 | 0.636 | 0.567 | 0.507 |
| PVIFA _{0.12, t} | 0.893 | 1.690 | 2.402 | 3.038 | 3.605 | 4.112 |

(PYP 10 Marks Dec '21)

Answer 45

- Calculation of Net Cash Flows Machine 1

Other fixed operating costs (excluding depreciation) = $7,20,000 - [(12,00,000 - 1,20,000)/3] = ₹ 3,60,000$

| Year | Initial Investment (₹) | Contribution (₹) | Fixed maintenance costs (₹) | Other fixed operating costs (excluding depreciation) (₹) | Residual Value (₹) | Net cash flow (₹) |
|------|------------------------|------------------|-----------------------------|--|--------------------|-------------------|
| 0 | (12,00,000) | | (40,000) | | | (12,40,000) |
| 1 | | 11,60,000 | (40,000) | (3,60,000) | | 7,60,000 |
| 2 | | 11,60,000 | (40,000) | (3,60,000) | | 7,60,000 |
| 3 | | 11,60,000 | | (3,60,000) | 1,20,000 | 9,20,000 |

Machine 2

Other fixed operating costs (excluding depreciation) = $6,10,000 - [(16,00,000 - 1,00,000)/5] = ₹ 3,10,000$

| Year | Initial Investment (₹) | Contribution (₹) | Fixed maintenance costs (₹) | Other fixed operating costs (excluding depreciation) (₹) | Residual Value (₹) | Net cash flow (₹) |
|------|---------------------------|---------------------|--------------------------------|---|-----------------------|----------------------|
| 0 | (16,00,000) | | (80,000) | | | (16,80,000) |
| 1 | | 12,00,000 | (80,000) | (3,10,000) | | 8,10,000 |
| 2 | | 12,00,000 | (80,000) | (3,10,000) | | 8,10,000 |
| 3 | | 12,00,000 | (80,000) | (3,10,000) | | 8,10,000 |
| 4 | | 12,00,000 | (80,000) | (3,10,000) | | 8,10,000 |
| 5 | | 12,00,000 | | (3,10,000) | 1,00,000 | 9,90,000 |

Calculation of Net Present Value

| Year | 12% discount factor | Machine 1 | | Machine 2 | |
|--|---------------------|-------------------|---------------------|-------------------|---------------------|
| | | Net cash flow (₹) | Present value (₹) | Net cash flow (₹) | Present value (₹) |
| 0 | 1.000 | (12,40,000) | (12,40,000) | (16,80,000) | (16,80,000) |
| 1 | 0.893 | 7,60,000 | 6,78,680 | 8,10,000 | 7,23,330 |
| 2 | 0.797 | 7,60,000 | 6,05,720 | 8,10,000 | 6,45,570 |
| 3 | 0.712 | 9,20,000 | 6,55,040 | 8,10,000 | 5,76,720 |
| 4 | 0.636 | | | 8,10,000 | 5,15,160 |
| 5 | 0.567 | | | 9,90,000 | 5,61,330 |
| NPV @ 12% | | | 6,99,440 | | 13,42,110 |
| PVAF @ 12% | | | 2.402 | | 3.605 |
| Equivalent Annualized Criterion | | | 2,91,190.674 | | 3,72,291.262 |

Recommendation: Machine 2 is more beneficial using Equivalent Annualized Criterion.

- (ii) **Calculation of sensitivity of recommendation in part (i) to changes in the contribution generated by machine 1**

Difference in Equivalent Annualized Criterion of Machines required for changing the recommendation in part (i) = $3,72,291.262 - 2,91,190.674 = ₹ 81,100.588$

$$\therefore \text{Sensitivity relating to Contribution} = \frac{\text{Rs. } 81,100.588}{\text{Rs. } 11,60,000.00} \times 100 = 6.991 \text{ or } 7\% \text{ yearly}$$

Alternatively,

The annualized equivalent cash flow for machine 1 is lower by ₹ $(3,72,291.262 - 2,91,190.674) = ₹ 81,100.588$ than for machine 2. Therefore, it would need to increase contribution for complete 3 years before the decision would be to invest in this machine.

$$\text{Sensitivity w.r.t contribution} = 81,100.588 / (11,60,000 \times 2.402) \times 100 = 2.911\%$$

Question 46

Alpha Limited is a manufacturer of computers. It wants to introduce artificial intelligence while making computers. The estimated annual saving from introduction of the artificial intelligence (AI) is as follows:



- reduction of five employees with annual salaries of ₹ 3,00,000 each
- reduction of ₹ 3,00,000 in production delays caused by inventory problem
- reduction in lost sales ₹ 2,50,000 and
- Gain due to timely billing ₹ 2,00,000

The purchase price of the system for installation of artificial intelligence is ₹ 20,00,000 and installation cost is ₹ 1,00,000. 80% of the purchase price will be paid in the year of purchase and remaining will be paid in next year.

The estimated life of the system is 5 years and it will be depreciated on a straight -line basis.

However, the operation of the new system requires two computer specialists with annual salaries of ₹ 5,00,000 per person.

In addition to above, annual maintenance and operating cost for five years are as below:

(Amount in ₹)

| Year | 1 | 2 | 3 | 4 | 5 |
|------------------------------|----------|----------|----------|----------|----------|
| Maintenance & Operating Cost | 2,00,000 | 1,80,000 | 1,60,000 | 1,40,000 | 1,20,000 |

Maintenance and operating cost are payable in advance.

The company's tax rate is 30% and its required rate of return is 15%.

| Year | 1 | 2 | 3 | 4 | 5 |
|--------------|-------|-------|-------|-------|-------|
| PVIF 0.10, t | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 |
| PVIF 0.12, t | 0.893 | 0.797 | 0.712 | 0.636 | 0.567 |
| PVIF 0.15, t | 0.870 | 0.756 | 0.658 | 0.572 | 0.497 |

Evaluate the project by using Net Present Value and Profitability Index. (PYP 10 Marks May'22)

Answer 46

| Computation of Annual Cash Flow after Tax | | | | | | |
|---|--------|-------------|-------------|-------------|-------------|-------------|
| Particulars | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| Savings in Salaries | | 15,00,000 | 15,00,000 | 15,00,000 | 15,00,000 | 15,00,000 |
| Reduction in Production Delays | | 3,00,000 | 3,00,000 | 3,00,000 | 3,00,000 | 3,00,000 |
| Reduction in Lost Sales | | 2,50,000 | 2,50,000 | 2,50,000 | 2,50,000 | 2,50,000 |
| Gain due to Timely Billing | | 2,00,000 | 2,00,000 | 2,00,000 | 2,00,000 | 2,00,000 |
| Salary to Computer Specialist | | (10,00,000) | (10,00,000) | (10,00,000) | (10,00,000) | (10,00,000) |
| Maintenance and Operating Cost (payable in advance) | | (2,00,000) | (1,80,000) | (1,60,000) | (1,40,000) | (1,20,000) |
| Depreciation (21 lakhs/5) | | (4,20,000) | (4,20,000) | (4,20,000) | (4,20,000) | (4,20,000) |
| Gain Before Tax | | 6,30,000 | 6,50,000 | 6,70,000 | 6,90,000 | 7,10,000 |
| Less: Tax (30%) | | 1,89,000 | 1,95,000 | 2,01,000 | 2,07,000 | 2,13,000 |
| Gain After Tax | | 4,41,000 | 4,55,000 | 4,69,000 | 4,83,000 | 4,97,000 |



| | | | | | | |
|---|------------|------------|------------|------------|------------|-----------|
| Add: Depreciation | | 4,20,000 | 4,20,000 | 4,20,000 | 4,20,000 | 4,20,000 |
| Add: Maintenance and Operating Cost (payable in advance) | | 2,00,000 | 1,80,000 | 1,60,000 | 1,40,000 | 1,20,000 |
| Less: Maintenance and Operating Cost (payable in advance) | (2,00,000) | (1,80,000) | (1,60,000) | (1,40,000) | (1,20,000) | - |
| Net CFAT | (2,00,000) | 8,81,000 | 8,95,000 | 9,09,000 | 9,23,000 | 10,37,000 |

Note: Annual cash flows can also be calculated Considering tax shield on depreciation & maintenance and operating cost. There will be no change in the final cash flows after tax.

| Computation of NPV | | | | |
|-------------------------------------|------|----------------|-------|---------------|
| Particulars | Year | Cash Flows (₹) | PVF | PV (₹) |
| Initial Investment (80% of 20 Lacs) | 0 | 16,00,000 | 1 | 16,00,000 |
| Installation Expenses | 0 | 1,00,000 | 1 | 1,00,000 |
| Instalment of Purchase Price | 1 | 4,00,000 | 0.870 | 3,48,000 |
| PV of Outflows (A) | | | | 20,48,000 |
| CFAT | 0 | (2,00,000) | 1 | (2,00,000) |
| CFAT | 1 | 8,81,000 | 0.870 | 7,66,470 |
| CFAT | 2 | 8,95,000 | 0.756 | 6,76,620 |
| CFAT | 3 | 9,09,000 | 0.658 | 5,98,122 |
| CFAT | 4 | 9,23,000 | 0.572 | 5,27,956 |
| CFAT | 5 | 10,37,000 | 0.497 | 5,15,389 |
| PV of Inflows (B) | | | | 28,84,557 |
| NPV (B-A) | | | | 8,36,557 |
| Profitability Index (B/A) | | | | 1.408 or 1.41 |

Evaluation: Since the NPV is positive (i.e. ₹ 8,36,557) and Profitability Index is also greater than 1 (i.e. 1.41), Alpha Ltd. may introduce artificial intelligence (AI) while making computers.

Question 47

Identify the limitations of Internal Rate of Return. (PYP 4 Marks May'22)

Answer 47

Limitations of Internal Rate of Return (IRR)

- The calculation process is tedious if there is more than one cash outflow interspersed between the cash inflows; there can be multiple IRR, the interpretation of which is difficult.
- The IRR approach creates a peculiar situation if we compare two projects with different inflow/outflow patterns.
- It is assumed that under this method all the future cash inflows of a proposal are reinvested at a rate equal to the IRR. It ignores a firm's ability to re-invest in portfolio of different rates.
- If mutually exclusive projects are considered as investment options which have considerably different cash outlays. A project with a larger fund commitment but lower IRR contributes more in terms of absolute NPV and increases the shareholders' wealth. In such situation decisions based only on IRR criterion may not be correct.

Question 48

A company has Rs.1,00,000 available for investment and has identified the following four investments in



which to invest.

| Project | Investment (Rs.) | NPV (Rs.) |
|---------|------------------|-----------|
| C | 40,000 | 20,000 |
| D | 1,00,000 | 35,000 |
| E | 50,000 | 24,000 |
| F | 60,000 | 18,000 |

You are required to optimize the returns from a package of projects within the capital spending limit if-

(i) The projects are independent of each other and are divisible.

(ii) The projects are not divisible. (PYP 5 Marks, Nov'19)

Answer 48

(i) Optimizing returns when projects are independent and divisible. Computation of NPVs per Re. 1 of Investment and Ranking of the Projects

| Project | Investment (Rs.) | NPV (Rs.) | NPV per Re. 1 invested (Rs.) | Ranking |
|---------|------------------|-----------|------------------------------|---------|
| C | 40,000 | 20,000 | 0.50 | 1 |
| D | 1,00,000 | 35,000 | 0.35 | 3 |
| E | 50,000 | 24,000 | 0.48 | 2 |
| F | 60,000 | 18,000 | 0.30 | 4 |

Building up of a Package of Projects based on their Rankings

| Project | Investment (Rs.) | NPV (Rs.) |
|--------------------------|------------------|-----------|
| C | 40,000 | 20,000 |
| E | 50,000 | 24,000 |
| D (1/10th of Project) | 10,000 | 3,500 |
| Total | 1,00,000 | 47,500 |

The company would be well advised to invest in Projects C, E and D (1/10 the) and reject Project F to optimize return within the amount of Rs.1,00,000 available for investment.

(ii) **Optimizing returns when projects are indivisible.**

| Package of Project | Investment (Rs.) | Total NPV (Rs.) |
|--------------------|-------------------------------|-----------------------------|
| C and E | 90,000 (40,000 + 50,000) | 44,000 (20,000 + 24,000) |
| C and F | 1,00,000 (40,000 + 60,000) | 38,000 (20,000 + 18,000) |
| Only D | 1,00,000 | 35,000 |

The company would be well advised to invest in Projects C and E to optimize return within the amount of Rs.1,00,000 available for investment.

Question 49

Explain the steps while using the equivalent annualized criterion. (PYP 3 Marks, Nov'19)

Answer 49



Equivalent Annualized Criterion: This method involves the following steps-

- (i) Compute NPV using the WACC or discounting rate.
Compute Present Value Annuity Factor (PVAF) of discounting factor used above for the period of each project.
- (ii) Divide NPV computed under step (i) by PVAF as computed under step (ii) and compare the values.

Question 50

A firm is in need of a small vehicle to make deliveries. It is in tending to choose between two options. One option is to buy a new three wheeler that would cost ₹ 1,50,000 and will remain in service for 10 years. The other alternative is to buy a second hand vehicle for ₹ 80,000 that could remain in service for 5 years. Thereafter the firm, can buy another second hand vehicle for ₹ 60,000 that will last for another 5 years. The scrap value of the discarded vehicle will be equal to it written down value (WDV). The firm pays 30% tax and is allowed to claim depreciation on vehicles @ 25% on WDV basis.

The cost of capital of the firm is 12%.

You are required to advise the best option. Given:

| t | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|--------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| PVIF (t,12%) | 0.892 | 0.797 | 0.711 | 0.635 | 0.567 | 0.506 | 0.452 | 0.403 | 0.360 | 0.322 |

(PYP 10 Marks Nov '22)

Answer 50

Selection of Investment Decision

| Tax shield on Purchase of New vehicle | | | |
|---------------------------------------|----------|-------------|------------------|
| Year | WDV | Dep. @ 25% | Tax shield @ 30% |
| 1 | 1,50,000 | 37,500 | 11,250 |
| 2 | 1,12,500 | 28,125 | 8,437 |
| 3 | 84,375 | 21,094 | 6,328 |
| 4 | 63,281 | 15,820 | 4,746 |
| 5 | 47,461 | 11,865 | 3,560 |
| 6 | 35,596 | 8,899 | 2,670 |
| 7 | 26,697 | 6,674 | 2,002 |
| 8 | 20,023 | 5,006 | 1,502 |
| 9 | 15,017 | 3,754 | 1,126 |
| 10 | 11,263 | 2,816 | 845 |
| 11 | 8,447 | Scrap value | |

Tax shield on Purchase of Second hand vehicles

| Year | WDV | Dep. @ 25% | Tax shield @ 30% | |
|------|--------|------------|------------------|------------------------|
| 1 | 80,000 | 20,000 | 6,000 | |
| 2 | 60,000 | 15,000 | 4,500 | |
| 3 | 45,000 | 11,250 | 3,375 | |
| 4 | 33,750 | 8,437 | 2,531 | |
| 5 | 25,313 | 6,328 | 1,898 | Scrap value = ₹ 18,985 |
| 6 | 60,000 | 15,000 | 4,500 | |
| 7 | 45,000 | 11,250 | 3,375 | |



| | | | | |
|----|--------|-------|-------|------------------------|
| 8 | 33,750 | 8,437 | 2,531 | |
| 9 | 25,313 | 6,328 | 1,898 | |
| 10 | 18,985 | 4,746 | 1,424 | Scrap value = ₹ 14,239 |

Calculation of PV of Net outflow of New Vehicle

| Year | Cash OF/IF | PV Factor | PV of OF/IF |
|------|--------------|-----------|-------------|
| 0 | 1,50,000 | 1 | 1,50,000 |
| 1 | (11,250) | 0.892 | (10,035) |
| 2 | (8,437) | 0.797 | (6,724) |
| 3 | (6,328) | 0.711 | (4,499) |
| 4 | (4,746) | 0.635 | (3,014) |
| 5 | (3,560) | 0.567 | (2,018) |
| 6 | (2,670) | 0.506 | (1,351) |
| 7 | (2,002) | 0.452 | (905) |
| 8 | (1,502) | 0.403 | (605) |
| 9 | (1,126) | 0.360 | (405) |
| 10 | (845 + 8447) | 0.322 | (2,992) |
| | | PVNOF | 1,17,452 |

Calculation of PV of Net outflow of Second hand Vehicles

| Year | Cash OF/IF | PV Factor | PV of OF/IF |
|------|-----------------------------------|-----------|-------------|
| 0 | 80,000 | 1 | 80,000 |
| 1 | (6,000) | 0.892 | (5,352) |
| 2 | (4,500) | 0.797 | (3,587) |
| 3 | (3,375) | 0.711 | (2,400) |
| 4 | (2,531) | 0.635 | (1,607) |
| 5 | $(60000 - 18985 - 1898) = 39,117$ | 0.567 | 22,179 |
| 6 | (4,500) | 0.506 | (2,277) |
| 7 | (3,375) | 0.452 | (1,525) |
| 8 | (2,531) | 0.403 | (1,020) |
| 9 | (1,898) | 0.360 | (683) |
| 10 | $(1424 + 14239) = (15,663)$ | 0.322 | (5,043) |
| | | PVNOF | 78,686 |

Advise: The PV of net outflow is low in case of buying the second hand vehicles. Therefore, it is advisable to buy second hand vehicles.

Question 51

A hospital is considering to purchase a diagnostic machine costing ₹ 80,000. The projected life of the machine is 8 years and has an expected salvage value of ₹ 6,000 at the end of 8 years. The annual operating cost of the machine is ₹ 7,500. It is expected to generate revenues of ₹ 40,000 per year for eight years. Presently, the hospital is outsourcing the diagnostic work and is earning commission income of ₹ 12,000 per annum.

Consider tax rate of 30% and Discounting Rate as 10%. Advise:

Whether it would be profitable for the hospital to purchase the machine?

Give your recommendation as per Net Present Value method and Present Value Index method under below mentioned two situations:

(i) If Commission income of ₹ 12,000 p.a. is before taxes.

(ii) If Commission income of ₹ 12,000 p.a. is net of taxes.

Given:

| t | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|---------------|-------|-------|-------|-------|-------|-------|-------|-------|
| PVIF (t, 10%) | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 | 0.564 | 0.513 | 0.467 |

(PYP 10 Marks Nov '22, Old & New SM)

Answer 51

Analysis of Investment Decisions

| Determination of Cash inflows | Situation-(i) Commission Income before taxes | Situation-(ii) Commission Income after taxes |
|--|---|---|
| Cash flow up-to 7th year: | | |
| Sales Revenue | 40,000 | 40,000 |
| Less: Operating Cost | (7,500) | (7,500) |
| | 32,500 | 32,500 |
| Less: Depreciation $(80,000 - 6,000) \div 8$ | (9,250) | (9,250) |
| Net Income | 23,250 | 23,250 |
| Tax @ 30% | (6,975) | (6,975) |
| Earnings after Tax (EAT) | 16,275 | 16,275 |
| Add: Depreciation | 9,250 | 9,250 |
| Cash inflow after tax per annum | 25,525 | 25,525 |
| Less: Loss of Commission Income | (8,400) | (12,000) |
| Net Cash inflow after tax per annum | 17,125 | 13,525 |
| In 8th Year: | | |
| Net Cash inflow after tax | 17,125 | 13,525 |
| Add: Salvage Value of Machine | 6,000 | 6,000 |
| Net Cash inflow in year 8 | 23,125 | 19,525 |

Calculation of Net Present Value (NPV) and Profitability Index (PI)

| | Particulars | PV factor @10% | Situation-(i) [Commission Income before taxes] | Situation-(ii) [Commission Income after taxes] |
|---|--|-------------------|---|---|
| A | Present value of cash inflows (1 st to 7th year) | 4.867 | 83,347.38 (17,125 × 4.867) | 65,826.18 (13,525 × 4.867) |
| B | Present value of cash inflow at 8 th year | 0.467 | 10,799.38 (23,125 × 0.467) | 9,118.18 (19,525 × 0.467) |
| C | PV of cash inflows | 1.00 | 94,146.76 | 74,944.36 |
| D | Less: Cash Outflow | | (80,000) | (80,000) |
| E | Net Present Value (NPV) | | 14,146.76 | (5,055.64) |
| F | PI = $(C \div D)$ | | 1.18 | 0.94 |

Recommendation: The hospital may consider purchasing of diagnostic machine in situation(i) where commission income is 12,000 before tax as NPV is positive and PI is also greater than 1. Contrary to situation (i), in situation (ii) where the commission income is net of tax, the recommendation is reversed to not purchase the machine as NPV is negative and PI is also less than 1.

Question 52

Four years ago, Z Ltd. had purchased a machine of ₹ 4,80,000 having estimated useful life of 8 years with zero salvage value. Depreciation is charged using SLM method over the useful life. The company want to replace this machine with a new machine. Details of new machine are as below:

- Cost of new machine is ₹ 12,00,000, Vendor of this machine is agreed to take old machine at a value of ₹ 2,40,000. Cost of dismantling and removal of old machine will be ₹ 40,000. 80% of net purchase price will be paid on spot and remaining will be paid at the end of one year.
- Depreciation will be charged @ 20% p.a. under WDV method.
- Estimated useful life of new machine is four years and it has salvage value of ₹ 1,00,000 at the end of year four.
- Incremental annual sales revenue is ₹ 12,25,000.
- Contribution margin is 50%.
- Incremental indirect cost (excluding depreciation) is ₹ 1,18,750 per year.
- Additional working capital of ₹ 2,50,000 is required at the beginning of year and ₹ 3,00,000 at the beginning of year three. Working capital at the end of year four will be nil.
- Tax rate is 30%.
- Ignore tax on capital gain.

Z Ltd. will not make any additional investment, if it yields less than 12% Advice, whether existing machine should be replaced or not.

| Year | 1 | 2 | 3 | 4 | 5 |
|-------------------------|-------|-------|-------|-------|-------|
| PVIF _{0.12, t} | 0.893 | 0.797 | 0.712 | 0.636 | 0.567 |

(PYP 10 Marks May '23)

Answer 52

Working Notes:

(i) Calculation of Net Initial Cash Outflow

| Particulars | ₹ |
|---|-----------|
| Cost of New Machine | 12,00,000 |
| Less: Sale proceeds of existing machine | 2,00,000 |
| Net Purchase Price | 10,00,000 |
| Paid in year 0 | 8,00,000 |
| Paid in year 1 | 2,00,000 |

(ii) Calculation of Additional Depreciation

| Year | 1 | 2 | 3 | 4 |
|------|---|---|---|---|
| | ₹ | ₹ | ₹ | ₹ |



| | | | | |
|--|-----------------|-----------------|---------------|---------------|
| Opening WDV of machine | 10,00,000 | 8,00,000 | 6,40,000 | 5,12,000 |
| Depreciation on new machine @ 20% | 2,00,000 | 1,60,000 | 1,28,000 | 1,02,400 |
| Closing WDV | 8,00,000 | 6,40,000 | 5,12,000 | 4,09,600 |
| Depreciation on old machine (4,80,000/8) | 60,000 | 60,000 | 60,000 | 60,000 |
| Incremental depreciation | 1,40,000 | 1,00,000 | 68,000 | 42,400 |

(iii) **Calculation of Annual Profit before Depreciation and Tax (PBDT)**

| Particulars | Incremental Values (₹) |
|---|------------------------|
| Sales | 12,25,000 |
| Contribution | 6,12,500 |
| Less: Indirect Cost | 1,18,750 |
| Profit before Depreciation and Tax (PBDT) | 4,93,750 |

Calculation of Incremental NPV

| Year | PVF @ 12% | PBTD (₹) | Incremental Depreciation (₹) | PBT (₹) | Tax @ 30% (₹) | Cash Inflows (₹) | PV of Cash Inflows (₹) |
|---|-----------|----------|------------------------------|----------|------------------|-----------------------|------------------------|
| | (1) | (2) | (3) | (4) | (5) = (4) x 0.30 | (6) = (4) - (5) + (3) | (7) = (6) x (1) |
| 1 | 0.893 | 4,93,750 | 1,40,000 | 3,53,750 | 106,125 | 3,87,625 | 3,46,149.125 |
| 2 | 0.797 | 4,93,750 | 1,00,000 | 3,93,750 | 1,18,125 | 3,75,625 | 2,99,373.125 |
| 3 | 0.712 | 4,93,750 | 68,000 | 4,25,750 | 1,27,725 | 3,66,025 | 2,60,609.800 |
| 4 | 0.636 | 4,93,750 | 42,400 | 4,51,350 | 1,35,405 | 3,58,345 | 2,27,907.420 |
| * * * | | | | | | | 11,34,039.470 |
| Add: PV of Salvage (₹ 1,00,000 x 0.636) | | | | | | | 63,600 |
| Less: Initial Cash Outflow - Year 0 | | | | | | | 8,00,000 |
| Year 1 (₹ 2,00,000 x 0.893) | | | | | | | 1,78,600 |
| Less: Working Capital - Year 0 | | | | | | | 2,50,000 |
| Year 2 (₹ 3,00,000 x 0.797) | | | | | | | 2,39,100 |
| Add: Working Capital released - Year 4 (₹ 5,50,000 x 0.636) | | | | | | | 3,49,800 |
| Incremental Net Present Value | | | | | | | 79,739.470 |

Since the incremental NPV is positive, existing machine should be replaced.

Alternative Presentation

Computation of Outflow for new Machine:

| | ₹ |
|------------------------------|-----------|
| Cost of new machine | 12,00,000 |
| Replaced cost of old machine | 2,40,000 |



| | |
|--------------------|-----------|
| Cost of removal | 40,000 |
| Net Purchase price | 10,00,000 |
| Outflow at year 0 | 8,00,000 |
| Outflow at year 1 | 2,00,000 |

Computation of additional depreciation

| Year | 1 | 2 | 3 | 4 |
|--|-----------|----------|----------|----------|
| | ₹ | ₹ | ₹ | ₹ |
| Opening WDV of machine | 10,00,000 | 8,00,000 | 6,40,000 | 5,12,000 |
| Depreciation on new machine @ 20% | 2,00,000 | 1,60,000 | 1,28,000 | 1,02,400 |
| Closing WDV | 8,00,000 | 6,40,000 | 5,12,000 | 4,09,600 |
| Depreciation on old machine (4,80,000/8) | 60,000 | 60,000 | 60,000 | 60,000 |
| Incremental depreciation | 1,40,000 | 1,00,000 | 68,000 | 42,400 |

Computation of NPV

| | Year | 0 | 1 | 2 | 3 | 4 |
|-----|---|-------------|--------------|------------|--------------|--------------|
| | | ₹ | ₹ | ₹ | ₹ | ₹ |
| 1. | Increase in sales revenue | | 12,25,000 | 12,25,000 | 12,25,000 | 12,25,000 |
| 2. | Contribution | | 6,12,500 | 6,12,500 | 6,12,500 | 6,12,500 |
| 3. | Increase in fixed cost | | 1,18,750 | 1,18,750 | 1,18,750 | 1,18,750 |
| 4. | Incremental Depreciation | | 1,40,000 | 1,00,000 | 68,000 | 42,400 |
| 5. | Net profit before tax [1-(2+3+4)] | | 3,53,750 | 3,93,750 | 4,25,750 | 4,51,350 |
| 6. | Net Profit after tax (5 x 70%) | | 2,47,625 | 2,75,625 | 2,98,025 | 3,15,945 |
| 7. | Add: Incremental depreciation | | 1,40,000 | 1,00,000 | 68,000 | 42,400 |
| 8. | Net Annual cash inflows (6 + 7) | | 3,87,625 | 3,75,625 | 3,66,025 | 3,58,345 |
| 9. | Release of salvage value | | | | | 1,00,000 |
| 10. | (investment)/disinvestment in working capital | (2,50,000) | | (3,00,000) | | 5,50,000 |
| 11. | Initial cost | (8,00,000) | (2,00,000) | | | |
| 12. | Total net cash flows | (10,50,000) | 1,87,625.0 | 75,625 | 3,66,025 | 10,08,345 |
| 13. | Discounting Factor | 1 | 0.893 | 0.797 | 0.712 | 0.636 |
| 14. | Discounted cash flows (12 x 13) | (10,50,000) | 1,67,549.125 | 60,273.125 | 2,60,609.800 | 6,41,307.420 |

$$\text{NPV} = (1,67,549 + 60,273 + 2,60,610 + 6,41,307) - 10,50,000 = ₹ 79,739$$

Since the NPV is positive, existing machine should be replaced.



Chapter 8 Dividend Decisions

Question 1

A&R Ltd. is a large-cap multinational company listed in BSE in India with a face value of ₹ 100 per share. The company is expected to grow @ 15% p.a. for next four years then 5% for an indefinite period. The shareholders expect 20% return on their share investments. Company paid ₹ 120 as dividend per share for the FY 2020-21. The shares of the company traded at an average price of ₹ 3,122 on last day. FIND out the intrinsic value of per share and state whether shares are overpriced or underpriced. (Old & New SM) (MTP 5 Marks Oct '23)

Answer 1

As per Dividend discount model, the price of share is calculated as follows:

$$P = \frac{D_1}{(1+K_e)^1} + \frac{D_2}{(1+K_e)^2} + \frac{D_3}{(1+K_e)^3} + \frac{D_4}{(1+K_e)^4} + \frac{D_5}{(1-g)} + \frac{1}{(1+K_e)^4}$$

Where,

P = Price per share

K_e = Required rate of return on equity

g = Growth rate

$$= \frac{Rs.120 \times 1.15}{(1+0.2)^1} + \frac{Rs.138 \times 1.15}{(1+0.2)^2} + \frac{Rs.158.7 \times 1.15}{(1+0.2)^3} + \frac{Rs.182 \times 1.15}{(1+0.2)^4} + \frac{Rs.209.88 \times 1.05}{(0.2-0.05)} + \frac{1}{(1+0.2)^4}$$

$$P = 115 + 110.2 + 105.6 + 101.2 + 708.50 = ₹1,140.50$$

Intrinsic value of share is ₹1,140.50 as compared to latest market price of ₹3,122. Market price of a share is overpriced by ₹1,981.50

Question 2

A company had paid dividend of ₹ 2 per share last year. The estimated growth of the dividends from the company is estimated to be 5% p.a. DETERMINE the estimated market price of the equity share if the estimated growth rate of dividends (i) rises to 8%, and (ii) falls to 3%. Also COMPUTE the present market price of the share, given that the required rate of return of the equity investors is 15.5%. (MTP 5 Marks, March'18, Old & New SM)

Answer 2

In this case the company has paid dividend of ₹2 per share during the last year. The growth rate (g) is 5%. Then, the current year dividend (D₁) with the expected growth rate of 5% will be ₹ 2.10

$$\text{The share price is} = P_0 = \frac{D_1}{K_e - g}$$

$$\frac{Rs.2.16}{0.115 - 0.05} = 20$$

- (i) In case the growth rate rises to 8% then the dividend for the current year (D₁) would be ₹ 2.16 and market price would be- $\frac{Rs.2.16}{0.115 - 0.08}$
= ₹ 28.80

- (ii) In case growth rate falls to 3% then the dividend for the current year (D₁) would be ₹2.06 and market price would be-

$$\frac{Rs.2.06}{0.115 - 0.03} = 16.48$$

So, the market price of the share is expected to vary in response to change in expected growth rate is dividends.

Question 3

Prakshal Shah | 171299 belongs to a risk class for which the capitalization rate is 10%. It has 25,000 outstanding shares



and the current market price is Rs. 100. It expects a net profit of Rs. 2,50,000 for the year and the Board is considering dividend of Rs. 5 per share.

M Ltd. requires to raise Rs. 5,00,000 for an approved investment expenditure. ANALYSE, how the MM approach affects the value of M Ltd. if dividends are paid or not paid (MTP 5 Marks, Aug'18, Old & New SM) (Same concept different figures MTP 5 Marks Oct'21, Old & New SM)

Answer 3

| |
|--|
| A When dividend is paid |
| (a) Price per share at the end of year 1 |
| $100 = 1/1.10 = (\text{Rs. } 5 + P_1)$ |
| $110 = \text{Rs. } 5 + P_1$ |
| $P_1 = 105$ |
| (b) Amount required to be raised from issue of new shares |
| $\text{Rs. } 5,00,000 - (\text{Rs. } 2,50,000 - \text{Rs. } 1,25,000)$ |
| $\text{Rs. } 5,00,000 - \text{Rs. } 1,25,000 = \text{Rs. } 3,75,000$ |
| (c) Number of additional shares to be issued |
| $3,75,000/105 = 75,000/11$ shares or say 3,572 shares |
| (d) Value of M Ltd. |
| (Number of shares \times Expected Price per share) |
| i.e., $(25,000 + 3,572) \times \text{Rs. } 105 = \text{Rs. } 30,00,060$ |
| B When dividend is not paid |
| (a) Price per share at the end of year 1 |
| $= P_1 100 = \frac{P_1}{1.10}$ |
| $P_1 = 110$ |
| (b) Amount required to be raised from issue of new shares $\text{Rs. } 5,00,000 - 2,50,000 = 2,50,000$ |
| (c) Number of additional shares to be issued |
| $2,50,000 / 110 = 25,000 / 11 = \text{Shares or Say } 2,273 \text{ Shares}$ |
| (d) Value of M Ltd., |
| $(25,000 + 2273) \times \text{Rs. } 110$ |
| $= \text{Rs. } 30,00,030$ |
| Whether dividend is paid or not, the value remains the same. |

Question 4

STATE two advantages of Walter Model of Dividend Decision. (MTP 2 Marks, Aug'18)

Answer 4

Advantages of Walter Model

1. The formula is simple to understand and easy to compute.
2. It can envisage different possible market prices in different situations and considers internal rate of return, market capitalization rate and dividend payout ratio in the determination of market value of shares.

Question 5

RST Ltd. has a capital of Rs. 10,00,000 in equity shares of Rs. 100 each. The shares are currently quoted at par. The company proposes to declare a dividend of Rs. 10 per share at the end of the current financial year. The capitalization rate for the risk class of which the company belongs is 12%. COMPUTE the market price of the share at the end of the year, if

(i) a dividend is not declared?



- (ii) a dividend is declared?
 (iii) assuming that the company pays the dividend and has net profits of Rs.5,00,000 and makes new investments of Rs.10,00,000 during the period, how many new shares must be issued? Use the MM model. (MTP 5 Marks, Oct'18, Old & New SM) (Same concept different figures MTP 5 Marks Mar'23)

Answer 5

As per MM model, the current market price of equity share is:

$$=p_0 \frac{1}{1+k_e} \times (D_1 + P_1)$$

- (i) If the dividend is not declared:

$$100 = \frac{1}{1+0.12} = (0 + P_1)$$

$$=100 = \frac{P_1}{1.12} = P_1 = \text{Rs.}112$$

The Market price of the equity share at the end of the year would be Rs.112.

- (ii) If the dividend is declared:

$$100 = \frac{1}{1+0.12} = (0 + P_1)$$

$$100 = \frac{10 + P_1}{1.12} \times (10 + P_1)$$

$$112 = 10 + P_1$$

$$P_1 = 112 - 10 = \text{Rs.}102$$

The market price of the equity share at the end of the year would be Rs.102.

- (iii) In case the firm pays dividend of Rs.10 per share out of total profits of Rs. 5,00,000 and plans to make new investment of Rs. 10,00,000, the number of shares to be issued may be found as follows:

| | |
|---------------------------|-------------|
| Total Earnings | Rs.5,00,000 |
| - Dividends paid | (1,00,000) |
| Retained earnings | 4,00,000 |
| Total funds required | 10,00,000 |
| Fresh funds to be raised | 6,00,000 |
| Market price of the share | 102 |

Number of shares to be issued (Rs.6,00,000 / 102) 5,882.35 or, the firm would issue 5,883 shares at the rate of Rs.102

Question 6

LIST the factors determining the dividend policy of a company. [MTP 3 Marks, March'19]

Answer 6

Factors Determining the Dividend Policy of a Company

- (i) **Liquidity:** In order to pay dividends, a company will require access to cash. Even very profitable companies might sometimes have difficulty in paying dividends if resources are tied up in other forms of assets.
- (ii) **Repayment of debt:** Dividend payout may be made difficult if debt is scheduled for repayment.
- (iii) **Stability of Profits:** Other things being equal, a company with stable profits is more likely to pay out a higher percentage of earnings than a company with fluctuating profits.
- (iv) **Control:** The use of retained earnings to finance new projects preserves the company's ownership and control. This can be advantageous in firms where the present disposition of shareholding is of importance.
- (v) **Legal consideration:** The legal provisions lay down boundaries within which a company can declare dividends.

- (vi) Likely effect of the declaration and quantum of dividend on market prices.
- (vii) Tax considerations and Others such as dividend policies adopted by units similarly placed in the industry, management attitude on dilution of existing control over the shares, fear of being branded as incompetent or inefficient, conservative policy Vs non-aggressive one.
- (viii) **Inflation:** Inflation must be taken into account when a firm establishes its dividend policy.

Question 7

With the help of following figures CALCULATE the market price of a share of a company by using:

- (i) **Walter's formula**
- (ii) **Dividend growth model (Gordon's formula)**

| | |
|---------------------------------------|--------|
| Earnings per share (EPS) | Rs. 10 |
| Dividend per share (DPS) | Rs. 6 |
| Cost of capital (k) | 20% |
| Internal rate of return on investment | 25% |
| Retention Ratio | 60% |

[MTP 5 Marks, March'19] (Same concept different figures Old & New SM)

Answer 7

Market price per share by

(i) **Walter's formula:**
$$P = \frac{6 + \frac{0.25}{0.20}(10-6)}{0.20}$$

$$p = \text{Rs. } 55$$

- (ii) **Gordon's formula (Dividend Growth model):** When the growth is incorporated in earnings and dividend, the present value of market price per share (P_0) is determined as follows:

Gordon's theory:

$$P_0 = \frac{E_1(1-b)}{k_e - r}$$

Where,

P_0 = Price per share

E_1 = Earnings per share

b = Retention ratio; $(1 - b)$ = Payout ratio

k_e = Cost of capital r = IRR

br = Growth rate (g)

$P_0 =$

$$\frac{10(1-0.60)}{0.20 - (0.60 \times 0.25)} = \frac{4}{0.05} = \text{Rs. } 80$$

Question 8

ZX Ltd. has a paid-up share capital of Rs.1,00,00,000, face value of Rs.100 each. The current market price of the shares is Rs.100 each. The Board of Directors of the company has an agenda of meeting to pay a dividend of 50% to its shareholders. The company expects a net income of Rs.75,00,000 at the end of the current financial year. Company also plans for a capital expenditure for the next financial year for a cost of Rs.95,00,000, which can be financed through retained earnings and issue of new equity shares.

Company's desired rate of investment is 15%.

Required:

Following the Modigliani- Miller (MM) Hypothesis, DETERMINE value of the company when:

- (i) It does not pay dividend and
- (ii) It does pay dividend [MTP 10 Marks, May'20 & Sep '23]

Answer 8

As per MM Hypothesis, value of firm/ company is calculated as below:



$$V_f \text{ or } nP_0 = \frac{(n+\Delta n)p_1 - I + E}{(1+k_e)}$$

- V_f = Value of firm in the beginning of the period
 n = number of shares in the beginning of the period
 Δn = number of shares issued to raise the funds required
 I = Amount required for investment

- (i) Value of the ZX Ltd. when dividends are not paid.

$$\begin{aligned}
 V_f \text{ or } nP_0 &= \frac{(n+\Delta n)p_1 - I + E}{(1+k_e)} \\
 &= \frac{\left[1,00,000 + \frac{20,00,000}{115}\right] \times Rs.115 - Rs.95,00,000 + Rs.75,00,000}{(1+0.15)} \\
 &= \frac{Rs.1,35,00,000 - Rs.95,00,000 + Rs.75,00,000}{(1+0.15)} = Rs.1,00,00,000
 \end{aligned}$$

Working notes:

1. Price of share at the end of the period (P_1)

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$100 = \frac{P_1 + 0}{1 + 0.15} = \text{or, } P_1 = 115$$

2. Calculation of funds required for investment

| | |
|-------------------------------|--------------|
| Earnings | Rs.75,00,000 |
| Dividend distributed | Nil |
| Fund available for investment | Rs.75,00,000 |
| Total Investment | Rs.95,00,000 |
| Balance Funds required | Rs.20,00,000 |

3. Calculation of no. of shares required to be issued for balance fund

$$\begin{aligned}
 \text{No. of shares } (\Delta n) &= \frac{\text{Funds required}}{\text{Price at end } p_1} = \frac{2,00,000}{115} = \text{Shares} \\
 V_f \text{ or } nP_0 &= \frac{(n+\Delta n)p_1 - I + E}{(1+k_e)} \\
 &= \frac{\left[1,00,000 + \frac{70,00,000}{65}\right] \times Rs.65 - Rs.95,00,000 + Rs.75,00,000}{(1+0.15)} \\
 &= \frac{Rs.1,35,00,000 - Rs.95,00,000 + Rs.75,00,000}{(1+0.15)} = Rs.1,00,00,000
 \end{aligned}$$

Working notes:

- Price of share at the end of the period (P_1)

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$100 = \frac{P_1 + 50}{1 + 0.15} = \text{or, } P_1 = 65$$

- Calculation of funds required for investment

| | |
|-------------------------------|--------------|
| Earnings | Rs.75,00,000 |
| Dividend distributed | Rs.50,00,000 |
| Fund available for investment | Rs.25,00,000 |
| Total Investment | Rs.95,00,000 |
| Balance Funds required | Rs.70,00,000 |

- Calculation of no. of shares required to be issued for balance fund

$$\text{No. of shares } (\Delta n) = \frac{\text{Funds required}}{\text{Price at end } p_1} = \frac{70,00,000}{65} = 1,07,693 \text{ shares (approx.)}$$

Note- As per MM-hypothesis of dividend irrelevance, value of firm remains same irrespective of dividend paid. In the solution, there may be variation in value, which is due to rounding off error.

Question 9

The following information is given:

| | |
|--|--------------|
| Dividend per share (DPS) | Rs. 9 |
| Cost of capital (Ke) | 19% |
| Internal rate of return on investment | 24% |
| Retention Ratio | 25% |

CALCULATE the market price per share by using:

- Walter's formula
- Gordon's formula (Dividend Growth model) (MTP 5 Marks, March 21)

Answer 9

(a) Working:

Calculation of Earnings per share (EPS):

$$EPS = \frac{DPS}{\text{Divident Payout Retio}}$$

$$EPS = \frac{Rs.9}{1-0.25} = Rs.12$$

Market price per share by

(i) Walter's model:

$$P = \frac{D + \frac{r}{K_e}(E-D)}{\frac{K_e}{Rs.9 + \frac{0.24}{0.19}(Rs.12 - Rs.9)}}$$

$$= \frac{Rs.9 + \frac{0.24}{0.19}(Rs.12 - Rs.9)}{0.19}$$

$$= Rs. 67.31$$

(ii) Gordon's model (Dividend Growth model): $P_0 =$

$$= \frac{D_0(1+g)}{K_e - g}$$

Where,

P_0 = Present market price per share.

g = Growth rate (br) = $0.25 \times 0.24 = 0.06$ b = Retention ratio

k = Cost of Capital

r = Internal rate of return (IRR) D_0 = Dividend per share

E = Earnings per share

$$= \frac{Rs.9(1+0.06)}{0.19-0.06}$$

$$\frac{Rs.9.54}{0.13} = Rs.73.38$$

Alternatively,

$$P_0 = \frac{E - (1-b)}{\frac{K-br}{Rs.12(1-0.25)}}$$

$$\frac{Rs.12(1-0.25)}{0.19-0.06} = Rs. 69.23$$

Question 10

The following data is available in respect of N Ltd. for the year ended 31st March, 2021:

| | |
|--|-----------------------|
| | Rs. (in Crore) |
|--|-----------------------|



| | |
|------------------------------------|-------|
| Share capital (@ Rs. 10 per share) | 25.00 |
| Reserves | 15.00 |
| Profit after tax (PAT) | 3.70 |
| Dividends paid | 3.00 |
| P/E ratio | 26.70 |

Using Walter's Model:

- COMMENT on the firm's dividend policy;
- DETERMINE the optimum payout ratio and
- DETERMINE the P/E ratio at which dividend payout will have no effect on share price. (MTP 5 Marks, April'21)

Answer 10

$$1. \text{ Earnings per share (E)} = \frac{PAT}{\text{No of Shares}} = \frac{Rs.3.7 \text{ Crores}}{2.5 \text{ Crores shares}} = Rs. 1.48$$

$$2. \text{ Return on Investment (r)} =$$

$$= \frac{Pat}{\text{Net Worth}} \times 100 = \frac{Rs.3.7 \text{ Crores}}{Rs(25.15) \text{ Crores}} \times 100 = 9.25\%$$

$$\text{Dividend per share (D)} =$$

$$= \frac{\text{Dividend Paid}}{\text{No of shares}} = \frac{Rs. 3 \text{ Crores}}{2.5 \text{ Crores Shares}} = Rs. 1.2$$

$$\text{Dividend payout ratio} =$$

$$= \frac{\text{Dividend Paid}}{pat} \times 100 = \frac{Rs. 3 \text{ Crores}}{3.7 \text{ Crores}} \times 100 = 81.08\%$$

$$3. \text{ Current Market Price(Po)} = P/E \text{ Ratio} \times E = 26.7 \times Rs. 1.48 = Rs. 39.52$$

$$4. \text{ Growth rate (g)} = b \times r = (1 - 0.8108) \times 0.0925 = 1.75\%$$

$$5. \text{ Cost of Capital(Ke)} = \frac{D_{(1+g)}}{P_o} = \frac{Rs.1.2(1+0.0175)}{Rs.39.52} + 0.0175 = 4.84\%$$

- I. The value of the share as per Walter's model:

$$= \frac{D + \frac{r}{k_e}(E-D)}{k_e} = \frac{1.2 + \frac{0.0925}{0.0484}(1.48-1.2)}{0.0484} = Rs. 35.58$$

The firm has a dividend payout of 81.08% (i.e., Rs. 3 crores) out of Profit after tax of Rs. 3.7 crores with value of the share at Rs. 35.85. The rate of return on investment (r) is 9.25% and it is more than the Ke of 4.84%, therefore, by distributing 81.08% of earnings, the firm is not following an optimal dividend policy.

- II. Under Walter's model, when return on investment is more than cost of capital ($r > K_e$), the market share price will be maximum if 100% retention policy is followed. So, the optimal payout ratio would be to pay zero dividend and in such a situation, the market price would be:

$$P = \frac{0 + \frac{0.0925}{0.0484}(1.48-0)}{0.0484} = Rs. 58.44$$

- III. The P/E ratio at which dividend payout will have no effect on share price is at which the Ke would be equal to the rate of return (r) of the firm i.e. 9.25%.

$$6. \text{ So, } K_e = \frac{D_{(1+g)}}{P_o} = \frac{Rs.1.2(1+0.0175)}{p_o} + 0.0175$$

$$p_o = Rs. 16.28$$

Therefore, at the P/E ratio of 11, the dividend payout will have no effect on share price.

$$\frac{p_o}{e} = \frac{\text{Rs. } 16.28}{\text{Rs. } 1.48} = 11 \text{ times}$$

Question 11

In March, 2021 Tiruv Ltd.'s share was sold for Rs. 219 per share. A long term earnings growth rate of 11.25% is anticipated. Tiruv Ltd. is expected to pay dividend of Rs. 5.04 per share.

- (i) DETERMINE the rate of return an investor can expect to earn assuming that dividends are expected to grow along with earnings at 11.25% per year in perpetuity?
- (ii) It is expected that Tiruv Ltd. will earn about 15% on book equity and shall retain 60% of earnings. In this case, whether, there would be any change in growth rate and cost of equity? ANALYSE.(MTP 5 Marks, April'21)(Same concept different figures Old & New SM)

Answer 11

- (i) According to Dividend Discount Model approach the firm's expected or required return on equity is computed as follows:

$$K_e = \frac{D_1}{p_0} + g$$

Where,

K_e = Cost of equity share capital

D_1 = Expected dividend at the end of year 1 p_0 = Current market price of the share.

g = Expected growth rate of dividend.

Therefore, K_e

$$= \frac{5.04}{219} + 0.1125 = 13.55\%$$

- (ii) With rate of return on retained earnings (r) of 15% and retention ratio (b) of 60%, new growth rate will be as follows:

$$g = br = 0.60 \times 0.15 = 0.09 \text{ or } 9\%$$

Accordingly, dividend will also get changed and to calculate this, first we shall calculate previous retention ratio (b_1) and then EPS assuming that rate of return on retained earning (r) is same.

With previous Growth Rate of 11.25% and $r = 15\%$, the retention ratio comes out to be: $0.1125 = b_1 \times 0.15$

$$b_1 = 0.75 \text{ and payout ratio} = 0.25$$

With 0.25 payout ratio, the EPS will be as follows:

$$\text{EPS} = \frac{5.04}{0.25} = \text{Rs. } 20.16$$

With new payout ratio of 40% ($1 - 0.60$) the new dividend will be: $D_1 = \text{Rs. } 20.16 \times 0.40 = \text{Rs. } 8.064$

Accordingly new K_e will be:

$$= k_e \frac{8.064}{219} + 0.09 = 12.68\%$$

Question 12

The following information is supplied to you:

| Particulars | ₹ |
|-------------------------------|-----------|
| Total Earnings | 5,00,000 |
| Equity shares (of ₹ 100 each) | 50,00,000 |
| Dividend paid | 3,75,000 |
| Price/ Earnings ratio | 12.5 |

Applying Walter's Model:

- (i) ANALYSE whether the company is following an optimal dividend policy.

- (ii) COMPUTE P/E ratio at which the dividend policy will have no effect on the value of the share.
- (iii) Will your decision change, if the P/E ratio is 8 instead of 12.5? ANALYSE. (MTP 5 Marks Nov'21 & April '19, RTP May '21) (Same concept different figures Old & New SM)

Answer 12

- (i) The EPS of the firm is ₹ 10 (i.e. ₹ 5,00,000/ 50,000). $r = 5,00,000 / 50,00,000 = 10\%$.
 The P/E Ratio is given at 12.5 and the cost of capital, K_e , may be taken at the inverse of P/E ratio. Therefore, K_e is 8 (i.e., $1/12.5$). The firm is distributing total dividends of ₹ 3,75,000 among 50,000 shares, giving a dividend per share of ₹ 7.50. The value of the share as per Walter's model may be found as follows:

$$p = \frac{D + \frac{r}{K_e}(E - D)}{K_e} = \frac{7.5 + \frac{0.1}{0.08}(10 - 7.5)}{0.08} = 132.81$$

The firm has a dividend payout of 75% (i.e., ₹ 3,75,000) out of total earnings of ₹ 5,00,000. Since, the rate of return of the firm, r , is 10% and it is more than the K_e of 8%, therefore, by distributing 75% of earnings, the firm is not following an optimal dividend policy. The optimal dividend policy for the firm would be to pay zero dividend and in such a situation, the market price would be,

$$\frac{0 + \frac{0.1}{0.08}(10 - 0)}{0.08} = 156.21$$

So, theoretically, the market price of the share can be increased by adopting a zero payout.

- (ii) The P/E ratio at which the dividend policy will have no effect on the value of the share is such at which the K_e would be equal to the rate of return, r , of the firm. The K_e would be 10% ($= r$) at the P/E ratio of 10. Therefore, at the P/E ratio of 10, the dividend policy would have no effect on the value of the share.
- (iii) If the P/E is 8 instead of 12.5, then the K_e which is the inverse of P/E ratio, would be 12.5 and in such a situation $K_e > r$ and the market price, as per Walter's model would be:

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e} = \frac{7.5 + \frac{0.1}{0.125}(10 - 7.5)}{0.125} = 76$$

Question 13

Following information is given for WN Ltd.:

| | |
|---------------------------------------|----------------|
| Earnings | ₹ 30 per share |
| Dividend | ₹ 9 per share |
| Cost of capital | 15% |
| Internal Rate of Return on investment | 20% |

You are required to CALCULATE the market price per share using-

- (i) Gordon's formula
- (ii) Walter's formula (MTP 5 Marks Sep'22, RTP Nov '20)

Answer 13

As per Gordon's Model, Price per share is computed using the formula:

$$= P_0 = \frac{E_1(1 - b)}{1 - br}$$

Where,

P_0 = Price per share

E_1 = Earnings per share

b = Retention ratio; ($1 - b$ = Pay-out ratio)



K_e = Cost of capital r = IRR

br = Growth rate (g)

Applying the above formula, price per share

$$P_0 = \frac{30 \times 0.3^*}{0.15 - 0.70 \times 0.2} = \frac{9}{0.01}$$

*Dividend pay-out ratio $\frac{\text{₹}9}{\text{₹}30} = 0.3$ or 30%

As per Walter's Model, Price per share is computed using the formula:

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e}$$

Where,

P = Market Price of the share E = Earnings per share

D = Dividend per share

K_e = Cost of equity/ rate of capitalization/ discount rate r = Internal rate of return/ return on investment

Applying the above formula, price per share

$$P = \frac{9 + \frac{0.20}{0.15}(30 - 9)}{0.15} = \frac{\text{₹}37}{0.15} = \text{₹}246.67$$

Question 14

The annual report of XYZ Ltd. provides the following information for the Financial Year 2019-20:

| Particulars | Amount (₹) |
|-----------------------------------|------------|
| Net Profit | 78 lakhs |
| Outstanding 15% preference shares | 120 lakhs |
| No. of equity shares | 6 lakhs |
| Return on Investment | 20% |
| Cost of capital i.e. (K_e) | 16% |

CALCULATE price per share using Gordon's Model when dividend pay-out is-

- (i) 30%;
- (ii) 50%;
- (iii) 100%.

(MTP 5 Marks Oct'22, RTP May '19, Old & New SM))(Same concept but different figures Oct'19, Oct'20, Old & New SM)

Answer 14

Price per share according to Gordon's Model is calculated as follows:

| Particulars | Amount in ₹ |
|---|------------------------------|
| Net Profit | 78 lakhs |
| Less: Preference dividend (120 lakhs @ 15%) | 18 lakhs |
| Earnings for equity shareholders | 60 lakhs |
| Earnings Per Share | 60 lakhs / 6 lakhs = ₹ 10.00 |

Price per share according to Gordon's Model is calculated as follows:

$$P_0 = \frac{E_1(1-b)}{K_e - br}$$

Here, $E_1 = 10$, $K_e = 16\%$

- (i) When dividend pay-out is 30%



$$P_0 = \frac{10 \times 0.3}{0.16 - (0.70 \times 0.2)} = \frac{3}{0.16 - 0.14} = ₹150$$

(ii) When dividend pay-out is 50%

$$P_0 = \frac{10 \times 0.5}{0.16 - (0.5 \times 0.2)} = \frac{5}{0.16 - 0.10} = ₹83.33$$

(iii) When dividend pay-out is 100%

$$P_0 = \frac{10 \times 1}{0.16 - (0 \times 0.2)} = \frac{10}{0.16} = ₹62.5$$

Question 15

STATE the advantages of Stock-Splits. (MTP 2 Marks, Oct'18)

Answer 15

Various advantages of Stock Splits are as follows:

- It makes the share affordable to small investors.
- Number of shares may increase the number of shareholders; hence the potential of investment may increase.

Question 16

Rex Ltd has 20 lakh equity shares outstanding at the start of the accounting year 2023. The existing market price per share is ₹ 300. Expected dividend is ₹ 20 per share. The rate of capitalization appropriate to the risk class to which the company belongs is 20%.

CALCULATE the market price per share when expected dividends are: (a) declared, and (b) not declared, based on the Miller – Modigliani approach.

CALCULATE number of shares to be issued by the company at the end of the accounting year on the assumption that the net income for the year is ₹ 5 crore; investment budget is ₹ 8 crores, when (a) Dividends are declared, and (b) Dividends are not declared.

PROVE that the market value of the shares at the end of the accounting year will remain unchanged irrespective of whether (a) Dividends are declared, or (ii) Dividends are not declared.

WHAT is the implied growth rate in dividends as per Gordon's model, if expected dividend payment is considered imminent? (MTP 10 Marks April '23, RTP Nov '21) (Same concept different figures Old & New SM)

Answer 16

(i) Calculation of market price per share

According to Miller – Modigliani (MM) Approach:

$$P_0 = \frac{P_1 + D_1}{1 + k_e}$$

Where,

Existing market price (Po) = ₹ 300

Expected dividend per share (D1) = ₹ 20

Capitalization rate (ke) = 0.20 Market price at year end (P1) = ?

a. If expected dividends are declared, then

$$300 = (P_1 + 20) / (1 + 0.2)$$

$$300 \times 1.2 = P_1 + 20$$

$$P_1 = 340$$

- b. If expected dividends are not declared, then

$$300 = (P_1 + 0) / (1 + 0.2)$$

$$300 \times 1.2 = P_1$$

$$P_1 = 360$$

(ii) Calculation of number of shares to be issued

| | (a) | (b) |
|---|-------------------------------------|--|
| | Dividends are declared. (₹ lakh) | Dividends are not Declared (₹ lakh) |
| Net income | 500 | 500 |
| Total dividends | (400) | - |
| Retained earnings | 100 | 500 |
| Investment budget | 800 | 800 |
| Amount to be raised by new issues | 700 | 300 |
| Relevant market price (₹ per share) | 340 | 360 |
| No. of new shares to be issued (in lakh) (₹ 700 ÷ 340; ₹ 300 ÷ 360) | 2.0588 | 0.8333 |

(iii) Calculation of market value of the shares

| | (a) | (b) |
|---|---------------------------------------|---------------------------------------|
| Particulars | Dividends are declared | Dividends are not Declared |
| Existing shares (in lakhs) | 20.00 | 20.00 |
| New shares (in lakhs) | 2.0588 | 0.8333 |
| Total shares (in lakhs) | 22.0588 | 20.8333 |
| Market price per share (₹) | 340 | 360 |
| Total market value of shares at the end of the year (₹ in lakh) | 22.0588 × 340 = 7,500 (approx.) | 20.8333 × 360 = 7,500 (approx.) |

Hence, it is proved that the total market value of shares remains unchanged irrespective of whether dividends are declared, or not declared.

$$P_0 = D_1 / (K_e - g)$$

$$300 = 20 / (0.2 - g)$$

$$0.2 - g = 20 / 300$$

$$0.2 - g = 0.0667$$

$$G = 0.133333 \quad g = 13.3333\%$$

Question 17

EXPLAIN the determinants of dividend decisions. (MTP 5 Marks April '23)

Answer 17

The dividend policy is affected by the following factors:

1. **Availability of funds:** If the business is in requirement of funds, then retained earnings could be a good source. The reason being the saving of floatation cost and prevention of dilution of control which happens in case of new issue of equity shares to public.
2. **Cost of capital:** If the financing requirements are to be executed through debt (relatively cheaper source of finance), then it would be preferable to distribute more dividend. On the other hand, if the financing is to be done through fresh issue of equity shares, then it is better to use retained earnings as much as possible.
3. **Capital structure:** An optimum Debt Equity ratio should also be considered for the dividend decision.
4. **Stock price:** Stock price here means market price of the shares. Generally, higher dividends increase market value of shares and low dividends decrease the value.
5. **Investment opportunities in hand:** The dividend decision is also affected if there are investment opportunities in hand. In that situation, the company may prefer to retain more earnings.
6. **Internal rate of return (IRR):** If the internal rate of return (IRR) is more than the cost of retained earnings (Kr), it is better to distribute the earnings as much as possible.
7. **Trend of industry:** The investors depend on some industries for their regular dividend income. Therefore, in such cases, the firms have to pay dividend in order to survive in the market.
8. **Expectation of shareholders:** The shareholders can be categorised into two categories: (i) those who invests for regular income, & (ii) those who invests for growth. Generally, the investor prefers current dividend over the future growth.
9. **Legal constraints:** Section 123 of the Companies Act, 2013 which provides for declaration of dividend states that Dividend shall be declared or paid by a company for any financial year only:
 - (a) out of the profits of the company for that year arrived at after providing for depreciation in accordance with the relevant provisions, or
 - (b) out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with the relevant provisions and remaining undistributed, or
 - (c) out of both, or
 - (d) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

It may be noted that, while computing the profits for payment of dividends any amount representing unrealised gains, notional gains or revaluation of assets and any change in carrying amount of an asset or of a liability on measurement of the asset or the liability at fair value shall be excluded.

10. **Taxation:** Before 1st April 2020, as per Section 115-O of Income Tax Act, 1961, dividend was subject to dividend distribution tax (DDT) in the hands of the company. Dividend on which DDT was paid, was to be exempted in the hands of the shareholder u/s 10(34). However, as per amendment made by the Finance Act 2020, the exemption u/s 10(34) shall not apply to dividend received on or after 1st April 2020 and the dividend income from shares held as investment shall be taxable under the head of 'Other income' at the applicable slab rate.

Question 18

The following information relates to Navya Ltd:

| | |
|------------------------------|-------------|
| Earnings of the company | ₹ 20,00,000 |
| Dividend pay-out ratio | 60% |
| No. of Shares outstanding | 4,00,000 |
| Rate of return on investment | 15% |
| Equity capitalization rate | 12% |



Required:

- (i) **DETERMINE** what would be the market value per share as per Walter's model.
- (ii) **COMPUTE** optimum dividend pay-out ratio according to Walter's model and the market value of company's share at that pay-out ratio. (RTP May '18) (Same concept but different figures RTP Nov'19, RTP May'20, PYP 5 Marks July'21, PYP 5 Marks Nov'18)

Answer 18

Navya Ltd.

- (i) Walter's model is given by –

$$P = \frac{D + (E - D) \left(\frac{r}{K_e} \right)}{K_e}$$

Where,

P = Market price per share,

E = Earnings per share = ₹20,00,000 ÷ 4,00,000 = ₹ 5

D = Dividend per share = 60% of 5 = ₹ 3

r = Return earned on investment = 15% K_e = Cost of equity capital = 12%

$$\therefore P = \frac{3 + (5 - 3) \times \frac{0.15}{0.12}}{0.12} = \frac{3 + 2 \times \frac{0.15}{0.12}}{0.12} = \text{Rs. } 45.83$$

- (ii) According to Walter's model when the return on investment is more than the cost of equity capital, the price per share increases as the dividend pay-out ratio decreases. Hence, the optimum dividend pay-out ratio in this case is Nil. So, at a payout ratio of zero, the market value of the company's share will be:-

$$\frac{0 + (5 - 0) \times \frac{0.15}{0.12}}{0.12} = \text{Rs. } 52.08$$

Question 19

The earnings per share of a company is ₹ 10 and the rate of capitalization applicable to it is 10 per cent. The company has three options of paying dividend i.e. (i) 50%, (ii) 75% and (iii) 100%.

CALCULATE the market price of the share as per Walter's model if it can earn a return of 15, (b) 10 and (c) 5 per cent on its retained earnings. (RTP Nov '18)

Answer 19

Market Price (P) per share as per Walter's Model is:

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e}$$

Where, P = Price of Share

r = Return on investment or rate of earning

K_e = Rate of Capitalization or Cost of Equity

Calculation of Market Price (P) under the following dividend payout ratio and earning rates:

| | | (i) | (ii) | (iii) |
|--|---------------------|--------------|--------------|---------------|
| | Rate of Earning (r) | DP ratio 50% | DP ratio 75% | DP ratio 100% |



| | | | | |
|-----|-----|--|---|--|
| (a) | 15% | $\frac{5 + \left(\frac{0.15}{0.10}\right)(10-5)}{0.10} = \frac{12.5}{0.10} =$ Rs. 125 | $\frac{7.5 + \left(\frac{0.15}{0.10}\right)(10 - 7.5)}{0.10}$ $= \frac{11.25}{0.10} = \text{Rs. } 112.5$ | $\frac{10 + \left(\frac{0.15}{0.10}\right)(10 - 10)}{0.10}$ $= \frac{10}{0.10} = \text{Rs. } 100$ |
| (b) | 10% | $\frac{5 + \left(\frac{0.10}{0.10}\right)(10-5)}{0.10} = \frac{10}{0.10} =$ Rs. 100 | $\frac{7.5 + \left(\frac{0.10}{0.10}\right)(10 - 7.5)}{0.10}$ $= \frac{10}{0.10} = \text{Rs. } 100$ | $\frac{10 + \left(\frac{0.10}{0.10}\right)(10 - 10)}{0.10}$ $= \frac{10}{0.10} = \text{Rs. } 100$ |
| (c) | 5% | $\frac{5 + \left(\frac{0.05}{0.10}\right)(10-5)}{0.10} = \frac{7.5}{0.10} =$ Rs. 75 | $\frac{7.5 + \left(\frac{0.05}{0.10}\right)(10 - 7.5)}{0.10}$ $= \frac{8.75}{0.10} = \text{Rs. } 87.5$ | $\frac{10 + \left(\frac{0.05}{0.10}\right)(10 - 10)}{0.10}$ $= \frac{10}{0.10} = \text{Rs. } 100$ |

Question 20

The following figures have been collected from the annual report of ABC Ltd. for the current financial year:

| | |
|-----------------------------------|-------------|
| Net Profit | ₹ 75 lakhs |
| Outstanding 12% preference shares | ₹ 250 lakhs |
| No. of equity shares | 7.50 lakhs |
| Return on Investment | 20% |
| Cost of capital i.e. (Ke) | 16% |

- COMPUTE the approximate dividend pay-out ratio so as to keep the share price at ₹ 42 by using Walter's model?
- DETERMINE the optimum dividend pay-out ratio and the price of the share at such pay-out.
- PROVE that the dividend pay-out ratio as determined above in (b) is optimum by using random pay-out ratio. (RTP May 22) (Same concept different figures PYP 5 Marks Nov'20, Old & New SM, MTP 5 Marks Mar'22)

Answer 20

| | ₹ in lakhs |
|---------------------------------|---------------------|
| Net Profit | 75 |
| Less: Preference dividend | 30 |
| Earning for equity shareholders | 45 |
| Earning per share | $= 45/7.5 = ₹ 6.00$ |

- (a) Let, the dividend per share be D to get share price of ₹ 42

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e}$$

$$\text{Rs. } 42 = \frac{D + \frac{0.20}{0.16}(6 - D)}{0.16}$$

$$6.72 = \frac{0.16D + 1.2 - 0.20D}{0.16}$$

$$0.04D = 1.2 - 1.0752$$

$$D = 3.12$$

$$D/P \text{ ratio} = \frac{DPS}{EPS} \times 100 = \frac{3.12}{6} \times 100 = 52\%$$

So, the required dividend payout ratio will be = 52%

- (b) Since $r > K_e$, the optimum dividend pay-out ratio would 'Zero' (i.e. $D = 0$),

Accordingly, value of a share:

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e}$$

$$P = \frac{0 + \frac{0.20}{0.16}(6 - 0)}{0.16} = \text{Rs. } 46.875$$

- (c) The optimality of the above pay-out ratio can be proved by using 25%, 50%, 75% and 100% as pay-out ratio:

At 25% pay-out ratio

$$P = \frac{1.5 + \frac{0.20}{0.16}(6 - 1.5)}{0.16} = \text{Rs. } 44.531$$

At 50% pay-out ratio

$$P = \frac{3 + \frac{0.20}{0.16}(6 - 3)}{0.16} = \text{Rs. } 42.188$$

At 75% pay-out ratio

$$P = \frac{4.5 + \frac{0.20}{0.16}(6 - 4.5)}{0.16} = \text{Rs. } 39.844$$

At 100% pay-out ratio

$$P = \frac{6 + \frac{0.20}{0.16}(6 - 6)}{0.16} = \text{Rs. } 37.50$$

From the above it can be seen that price of share is maximum when dividend pay-out ratio is 'zero' as determined in (b) above.

Question 21

Ordinary shares of a listed company are currently trading at ₹ 10 per share with two lakh shares outstanding. The company anticipates that its earnings for next year will be ₹ 5,00,000. Existing cost of capital for equity shares is 15%. The company has certain investment proposals under discussion which will cause an additional 26,089 ordinary shares to be issued if no dividend is paid or an additional 47,619 ordinary shares to be issued if dividend is paid. Applying the MM hypothesis on dividend decisions, CALCULATE the amount of investment and dividend that is under consideration by the company. (RTP Nov'22)

Answer 21

$$P_0 = ₹ 10 \quad n = 2,00,000, \quad E = ₹ 5,00,000$$

$$K_e = 15\%, \quad \Delta n = 26,089, \quad I = ?$$

$$= P_0 = \frac{P_1}{(1 + K_e)}$$

$$= 10 = \frac{P_1}{1.15}$$

$$\therefore P_1 = 11.5$$

$$\Delta n = \frac{I - E + nD_1}{P_1}$$

$$26,089 = \frac{1 - 5,00,000}{11.5}$$

$$I = 8,00,024$$

Now,

$$P_0 = ₹ 10, n = ₹ 2,00,000,$$

$$E = ₹ 5,00,000, I = 8,00,024, K_e = 15\%, \Delta n = 47,619, D_1 = ?$$

$$= P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$= P_1 = \frac{P_1 + D_1}{1.15}$$

$$P_1 + D_1 = 11.5$$

$$\therefore P_1 = 11.5 - D_1 \dots\dots\dots 1$$

$$\therefore \Delta n = \frac{I - E + nD_1}{P_1}$$

$$47,619 = \frac{8,00,024 - 5,00,000 + 2,00,000D_1}{P_1}$$

$$47,619 P_1 = 2,00,000 D_1 + 3,00,024$$

From 1,

$$47,619 (11.5 - D_1) = 2,00,000 D_1 + 3,00,024$$

$$5,47,618.5 - 47,619 D_1 = 2,00,000 D_1 + 3,00,024$$

$$\therefore 2,47,594.5 = 2,00,000 D_1 + 47,619 D_1$$

$$\therefore 2,47,594.5 = 2,47,619 D_1$$

$$\therefore D_1 = \frac{2,47,594.5}{2,47,619} = 0.99 \approx ₹ 1$$

$$\therefore P_1 = 11.5 - D_1$$

$$P_1 = 11.5 - 1$$

$$P_1 = 10.5$$

$$\therefore n.P_0 = \frac{(\Delta n)P_1 - I + E}{1 + K_e}$$

$$= \frac{(2,00,000 + 47,619)(10.5) - 8,00,024 + 5,00,000}{1.15}$$

$$n.P_0 = ₹ 19,99,979 \approx ₹ 20,00,000$$

Using direct calculation,

$$n.P_0 = 2,00,000 \times 10 = ₹ 20,00,000$$

Question 22

Rambo Limited Has 1,00,000 equity shares outstanding for the year 2022. The current market price of the shares is ₹ 100 each. Company is planning to pay dividend of ₹ 10 per share. Required rate of



return is 15%. Based on Modigliani-Miller approach, calculate the market price of the share of the company when the recommended dividend is 1) declared and 2) not declared. How many new shares are to be issued by the company at the end of the year on the assumption that net income for the year is ₹ 40 Lac and the investment budget is ₹ 50,00,000 when dividend is declared, or dividend is not declared.

PROOF that the market value of the company at the end of the accounting year will remain same whether dividends are distributed or not distributed. (RTP May 23)

Answer 22

CASE 1: Value of the firm when dividends are not paid.

Step 1: Calculate price at the end of the period

$$K_e = 15\% \quad P_0 = \text{Rs. } 100 \quad D_1 = 0$$

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$\text{Rs. } 100 = \frac{P_1 + 0}{1 + 0.15}$$

$$P_1 = \text{Rs. } 115$$

Step 2: Calculation of funds required for investment

| | |
|-------------------------------|---|
| Earning | ₹ 40,00,000 |
| Dividend distributed | Nil |
| Fund available for investment | ₹ 40,00,000 |
| Total Investment | ₹ 50,00,000 |
| Balance Funds required | ₹ 50,00,000 - ₹ 40,00,000 = ₹ 10,00,000 |

Step 3: Calculation of No. of shares required to be issued for balance funds

$$\text{No. of shares} = \text{Funds required} / P_1$$

$$\Delta n = ₹ 10,00,000 / ₹ 115$$

Step 4: Calculation of value of firm

$$nP_0 = [(n + \Delta n)P_1 - I + E] / (1 + K_e)$$

$$nP_0 = [(100000 + 1000000 / ₹ 115) ₹ 115 - ₹ 5000000 + ₹ 4000000] / (1.15)$$

$$= ₹ 1,00,00,000$$

CASE 2: Value of the firm when dividends are paid.

Step 1: Calculate price at the end of the period

$$K_e = 15\% \quad P_0 = \text{Rs. } 100 \quad D_1 = 0$$

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$\text{Rs. } 100 = \frac{P_1 + 10}{1 + 0.15}$$

$$P_1 = \text{Rs. } 105$$

Step 2: Calculation of funds required for investment

| | |
|-------------------------------|-------------|
| Earning | ₹ 40,00,000 |
| Dividend distributed | 10,00,000 |
| Fund available for investment | ₹ 30,00,000 |
| Total Investment | ₹ 50,00,000 |

| | |
|------------------------|---|
| Balance Funds required | $\text{₹ } 50,00,000 - \text{₹ } 30,00,000 = \text{₹ } 20,00,000$ |
|------------------------|---|

Step 3: Calculation of No. of shares required to be issued for balance fund

No. of shares = Funds Required/ P_1

$\Delta n = \text{₹ } 20,00,000 / \text{₹ } 105$

Step 4: Calculation of value of firm

$nP_0 = [(n + \Delta n)P_1 - I + E] / (1 + K_e)$

$nP_0 = [(1,00,000 + 20,00,000 / \text{₹ } 105) \text{₹ } 105 - \text{₹ } 50,00,000 + \text{₹ } 40,00,000] / (1.15) = \text{₹ } 1,00,00,000$

Thus, it can be seen from the above calculations that the value of the firm remains the same in either case.

Question 23

HM Ltd. is listed on Bombay Stock Exchange which is currently been evaluated by Mr. A on certain parameters.

Mr. A collated following information:

- The company generally gives a quarterly interim dividend. ₹ 2.5 per share is the last dividend declared.
- The company's sales are growing by 20% on a 5-year Compounded Annual Growth Rate (CAGR) basis, however the company expects following retention amounts against probabilities mentioned as contention is dependent upon cash requirements for the company. Rate of return is 10% generated by the company.

| Situation | Prob. | Retention Ratio |
|-----------|-------|-----------------|
| A | 30% | 50% |
| B | 40% | 60% |
| C | 30% | 50% |

- The current risk-free rate is 3.75% and with a beta of 1.2 company is having a risk premium of 4.25%.

You are required to help Mr. A in calculating the current market price using Gordon's formula. (RTP Nov '23)

Answer 23

Market price using Gordon's formula

$$P_0 = \frac{D_0(1+g)}{K_e - g}$$

$D_0 = 2.5 \times 4 = 10$ per share (annual)

$g = \text{br or retention ratio} \times \text{rate of return}$

Calculation of expected retention ratio

| Situation | Prob. | Retention Ratio | Expected Retention Ratio |
|-----------|-------|-----------------|--------------------------|
| A | 30% | 50% | 0.15 |
| B | 40% | 60% | 0.24 |
| C | 30% | 50% | 0.15 |
| Total | | | 0.54 |

$g = 0.54 \times 0.10 = 0.054$ or 5.4%

$$P_0 = \frac{D_0(1+g)}{K_e - g}$$

$$P_0 = \frac{10(1+0.054)}{0.0885-0.054} = \frac{10.54}{0.0345} = 305.51$$

$$\begin{aligned} K_e &= \text{Risk free rate} + (\text{Beta} \times \text{Risk Premium}) \\ &= 3.75\% + (1.2 \times 4.25\%) = 8.85\% \end{aligned}$$

Question 24

The following information is taken from ABC Ltd.

| | |
|--|----------------|
| Net Profit for the year | Rs.30,00,000 |
| 12% Preference share capital | Rs.1,00,00,000 |
| Equity share capital (Share of Rs.10 each) | Rs.60,00,000 |
| Internal rate of return on investment | 22% |
| Cost of Equity Capital | 18% |
| Retention Ratio | 75% |

Calculate the market price of the share using:

- (1) Gordon's Model
- (2) Walter's Model (PYP 5 Marks, Jan'21)

Answer 24

Market price per share by-

- (1) Gordon's Model:

$$\text{Present market price per share } (P_0) = \frac{D_0(1+g)}{K_e - g}$$

OR

$$\text{Present market price per share } (P_0) = \frac{D_1}{K_e - g}$$

P_0 = Present market price per share.

g = Growth rate (br) = $0.75 \times 0.22 = 0.165$

b = Retention ratio (i.e., % of earnings retained) r = Internal rate of return (IRR)

$$D_0 = E \times (1 - b) = 3 \times (1 - 0.75) = 0.75$$

E = Earnings per share

$$\begin{aligned} P_0 &= \frac{0.75(1+0.165)}{0.18-0.165} = \frac{0.874}{0.015} = ₹ 58.27 \text{ approx.} \end{aligned}$$

$$\text{*Alternatively, } P_0 \text{ can be calculated as } = \frac{E(1-b)}{K-br} = ₹ 50.$$

- (2) Walter's Model:

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e}$$

$$\frac{0.75 + \frac{0.22}{0.18}(3 - 0.75)}{0.18} = ₹ 19.44$$

Workings:

1. Calculation of Earnings per share



| Particulars | Amount (Rs.) |
|--|------------------------------------|
| Net Profit for the year | 30,00,000 |
| Less: Preference dividend (12% of Rs.1,00,00,000) | (12,00,000) |
| Earnings for equity shareholders | 18,00,000 |
| No. of equity shares (Rs.60,00,000/₹10) | 6,00,000 |
| Therefore, Earnings per share Earning for equity shareholders / No. of equity shares | Rs.18,00,000/6,00,000 = Rs.3.00 |

2. Calculation of Dividend per share

| Particulars | |
|---|----------------------|
| Earnings per share | Rs.3 |
| Retention Ratio (b) | 75% |
| Dividend pay-out ratio (1-b) | 25% |
| Dividend per share (Earnings per share x Dividend pay-out ratio) | Rs.3 x 0.25 = ₹ 0.75 |

Question 25

Following figures and information were extracted from the company A Ltd.

| | |
|------------------------------|--------------|
| Earnings of the company | Rs.10,00,000 |
| Dividend paid | Rs.6,00,000 |
| No. of shares outstanding | 2,00,000 |
| Price Earnings Ratio | 10 |
| Rate of return on investment | 20% |

You are required to calculate:

Current Market price of the share

Capitalization rate of its risk class

What should be the optimum pay-out ratio?

What should be the market price per share at optimal pay-out ratio? (use Walter's Model) (PYP 5 Marks, Nov'19)

Answer 25

(i) Current Market price of shares (applying Walter's Model)

The EPS of the firm is ₹Rs.5 (i.e., Rs 10,00,000 / 2,00,000).

- Rate of return on Investment (r) = 20%.
- The Price Earnings (P/E) Ratio is given as 10, so capitalization rate (Ke), may be taken at the inverse of P/E Ratio. Therefore, Ke is 10% or .10 (i.e., 1/10).
- The firm is distributing total dividends of Rs.6,00,000 among 2,00,000 shares, giving a dividend per share of Rs.3.

The value of the share as per Walter's model may be found as follows: Walter's model is given by-

$$P = \frac{D + \frac{r}{k_e}(E - D)}{k_e}$$

Where,

P = Market price per share. E = Earnings per share = Rs. 5 D = Dividend per share = Rs.3

R = Return earned on investment = 20 % k_e = Cost of equity capital = 10% or .10

$$P = \frac{3 + \frac{0.20}{0.10}(5-3)}{0.10} = \text{Rs.70}$$

Current Market Price of shares can also be calculated as follows

$$\text{Price Earnings (P/E) Ratio} = \frac{\text{Market Price of Shares}}{\text{Earnings per Shares}}$$

$$\text{Or, } 10 = \frac{\text{Market Price of Shares}}{\text{Rs.10,00,000/2,00,000}}$$

$$\text{Or, } 10 = \frac{\text{Market Price of Shares}}{\text{Rs.5}}$$

Market Price of Share = ₹Rs.50

(ii) **Capitalization rate (k_e) of its risk class is 10% or .10 (i.e., 1/10).**

(iii) **Optimum dividend pay-out ratio**

According to Walter's model when the return on investment is more than the cost of equity capital (10%), the price per share increases as the dividend pay-out ratio decreases. Hence, the optimum dividend pay-out ratio in this case is nil or 0 (zero).

(iv) **Market price per share at optimum dividend pay-out ratio**

At a pay-out ratio of zero, the market value of the company's share will be:

$$P = \frac{0 + \frac{0.20}{0.10}(5-0)}{0.10} = \text{Rs.100}$$

Question 26

The following information is supplied to you:

| | |
|--|--------------------|
| Total Earning | Rs.40 Lakhs |
| No. of Equity Shares (of Rs.100 each) | 4,00,000 |
| Dividend Per Share | Rs.4 |
| Cost of Capital | 16% |
| Internal rate of return on investment | 20% |
| Retention ratio | 60% |

Calculate the market price of a share of a company by using:

Walter's Formula

Gordon's Formula (PYP 5 Marks, May'19)

Answer 26

$$\text{Earning Per share (E)} = \frac{40\text{Lakh}}{4,00,000} = \text{Rs.10}$$

Calculation of Market price per share by

i. **Walter's formula:** Market Price(P) = $P = \frac{D + \frac{r}{k_e}(E-D)}{k_e}$

Where,

P = Market Price of the share.

E = Earnings per share.

D = Dividend per share.

k_e = Cost of equity/ rate of capitalization/ discount rate. R = Internal rate of return/ return on investment

$$P = \frac{0 + \frac{0.20}{0.16}(10-4)}{0.16} = \frac{4+7.5}{0.16} = \text{Rs. } 71.88$$

- ii. Gordon's formula: When the growth is incorporated in earnings and dividend, the present value of market price per share (P_0) is determined as follows

Gordon's theory:

$$P_0 = \frac{E(1-b)}{K-br}$$

Where,

P_0 = Present market price per share.

E = Earnings per share

b = Retention ratio (i.e. % of earnings retained)

r = Internal rate of return (IRR)

Growth rate (g) = br

$$\text{Now } P_0 = \frac{10(1-60)}{.16(.60 \times .20)} = \frac{4}{.04} = \text{Rs. } 100$$

Question 27

X Ltd. is a multinational company. Current market price per share is ₹ 2,185. During the F.Y. 2020-21, the company paid ₹ 140 as dividend per share. The company is expected to grow @ 12% p.a. for next four years, then 5% p.a. for an indefinite period. Expected rate of return of shareholders is 18% p.a.

- (i) Find out intrinsic value per share.
 (ii) State whether shares are overpriced or underpriced.

| Year | 1 | 2 | 3 | 4 | 5 |
|--------------------------|-------|-------|-------|-------|-------|
| Discounting Factor @ 18% | 0.847 | 0.718 | 0.608 | 0.515 | 0.436 |

(PYP 5 Marks Dec '21)

Answer 27

As per Dividend discount model, the price of share is calculated as follows:

$$P = \frac{D_1}{(1+K_e)^1} + \frac{D_2}{(1+K_e)^2} + \frac{D_3}{(1+K_e)^3} + \frac{D_4}{(1+K_e)^4} + \frac{D_4(1+g)}{(K_e-g)^1} \times \frac{1}{(1+K_e)^4}$$

Where,

P = Price per share

k_e = Required rate of return on equity g =

Growth rate

$$P = \frac{\text{Rs. } 140 \times 1.12}{(1+0.18)^1} + \frac{\text{Rs. } 156.80 \times 1.12}{(1+0.18)^2} + \frac{\text{Rs. } 175.62 \times 1.12}{(1+0.18)^3} + \frac{\text{Rs. } 196.69 \times 1.12}{(1+0.18)^4} + \frac{\text{Rs. } 220.29 (1+0.05)}{(0.18-0.05)} \times \frac{1}{(1+0.18)^4}$$

$$P = 132.81 + 126.10 + 119.59 + 113.45 + 916.34 = \text{₹ } 1,408.29$$

Intrinsic value of share is ₹ 1,408.29 as compared to latest market price of ₹ 2,185. Market price of share is over-priced by ₹ 776.71.

Question 28

Briefly explain the assumptions of Walter's Model. (PYP 4 Marks May'22)

Answer 28
Assumptions of Walter's Model

- All investment proposals of the firm are to be financed through retained earnings only.
- 'r' rate of return & 'Ke' cost of capital are constant.
- Perfect capital markets: The firm operates in a market in which all investors are rational and information is freely available to all.
- No taxes or no tax discrimination between dividend income and capital appreciation (capital gain). It means there is no difference in taxation of dividend income or capital gain. This assumption is necessary for the universal applicability of the theory, since, the tax rates may be different in different countries.
- No floatation or transaction cost: Similarly, these costs may differ country to country or market to market.
- The firm has perpetual life.

Question 29

(a) Following information are given for a company:

| | |
|--|-------|
| Earnings per share | ₹ 10 |
| P/E ratio | 12.5 |
| Rate of return on investment | 12% |
| Market price per share as per Walter's Model | ₹ 130 |

You are required to calculate:

- Dividend payout ratio.
- Market price of share at optimum dividend payout ratio.
- P/E ratio, at which the dividend policy will have no effect on the price of share.
- Market price of share at this P/E ratio.
- Market price of share using Dividend growth model. (PYP 5 Marks May '23)

Answer 29

- i) The EPS of the firm is ₹ 10, $r = 12\%$. The P/E Ratio is given at 12.5 and the cost of capital (K_e) may be taken as the inverse of P/E ratio. Therefore, K_e is 8% (i.e., $1/12.5$). The value of the share is ₹ 130 which may be equated with Walter Model as follows:

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e} \text{ Or } P = \frac{D + \frac{12}{8\%}(10 - D)}{8\%}$$

$$\text{or } [D + 1.5(10 - D)] / 0.08 = 130$$

$$\text{or } D + 15 - 1.5D = 10.4$$

$$\text{or } -0.5D = -4.6$$

$$\text{So, } D = ₹ 9.2$$

The firm has a dividend pay-out of 92% (i.e., $9.2/10$).

- ii) Since the rate of return of the firm (r) is 12% and it is more than the K_e of 8% , therefore, by distributing 92% of earnings, the firm is not following an optimal dividend policy. The optimal

dividend policy for the firm would be to pay zero dividend and in such a situation, the market price would be:

$$P = \frac{0 + \frac{12}{8\%}(10 - 0)}{8\%}$$

$$P = ₹ 187.5$$

So, theoretically the market price of the share can be increased by adopting a zero pay-out.

iii) The P/E ratio at which the dividend policy will have no effect on the value of the share is such at which the K_e would be equal to the rate of return (r) of the firm. The K_e would be 12% ($= r$) at the P/E ratio of $1/12\% = 8.33$. Therefore, at the P/E ratio of 8.33, the dividend policy would have no effect on the value of the share.

iv) If the P/E is 8.33 instead of 12.5, then the K_e which is the inverse of P/E ratio, would be 12% and in such a situation $k_e = r$ and the market price, as per Walter's model would be:

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e} = \frac{9.2 + \frac{0.12}{0.12}(10 - 9.2)}{0.12} = 83.33$$

v) Dividend Growth Model applying growth on dividend

$$K_e = 8\%, r = 12\%, D_0 = 9.2, b = 0.08$$

$$g = b.r$$

$$g = 0.08 \times 0.12 = 0.96\%$$

$$D_1 = D_0 (1 + g) = 9.2 (1 + 0.0096) = ₹ 9.2883$$

$$P = \frac{D_1}{(K_e - g)} = 9.2883 / (0.08 - 0.0096) = 9.2883 / 0.0704 = ₹ 131.936$$

Alternative Alternatively, without applying growth on dividend

$$P = \frac{E(1 - b)}{K_e - b.r} = \frac{10(1 - 0.08)}{0.08 - (0.08 \times 0.12)} = 130.68$$

Chapter 9.1

Introduction to Working Capital Management

Question 1

DISCUSS the factors to be taken into consideration while determining the requirement of working capital.
(Old & New SM, MTP 2 Marks Oct'20)

Answer 1

Some of the factors which need to be considered while planning for working capital requirement are:

1. **Cash:** Identify the cash balance which allows for the business to meet day- to-day expenses but reduces cash holding costs (example - loss of interest on long term investment had the surplus cash invested therein).
2. **Inventory: Identify the level of inventory** which allows for uninterrupted production but reduces the investment in raw materials and hence increases cash flow. The techniques like Just in Time (JIT) and Economic order quantity (EOQ) are used for this.
3. **Receivables:** Identify the **appropriate credit policy**, i.e., credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence Return on Capital (or vice versa). The tools like Early Payment Discounts and allowances are used for this.
4. **Short-term Financing Options:** Inventory is ideally financed by credit granted by the supplier. However, depending on the cash conversion cycle, it may be necessary to utilize a bank loan (or overdraft), or to “convert debtors to cash” through “factoring” in order to finance working capital requirements.
5. **Nature of Business:** For e.g. in a business of restaurant, most of the sales are in Cash. Therefore, need for working capital is very less. On the other hand, there would be a higher inventory in case of a pharmacy or a bookstore.
6. **Market and Demand Conditions:** For e.g. if an item's demand far exceeds its production, the working capital requirement would be less as investment in finished goods inventory would be very less with continuous sales.
7. **Technology and Manufacturing Policies:** For e.g. in some businesses the **demand for goods is seasonal**, in that case a business may follow a policy for steady production throughout the whole year or rather may choose a policy of production only during the demand season.
8. **Operating Efficiency:** A company can reduce the working capital requirement by **eliminating waste, improving coordination, process improvements** etc.
9. **Price Level Changes & Exchange Rate Fluctuations:** For e.g. **rising prices necessitate the use of more funds** for maintaining an existing level of activity. For the same level of current assets, higher cash outlays are required. Therefore, the effect of rising prices is that a higher amount of working capital is required. Another example would be unfavorable exchange rate movement in case of imported raw materials would warrant additional cost of same.

Question 2

Cost sheet of A&R Ltd. provides the following particulars:

| | Amount per unit (Rs.) |
|---------------------------|-----------------------|
| Raw materials cost | 200.00 |
| Direct Labour cost | 75.00 |
| Overheads cost | 150.00 |
| Total cost | 425.00 |



| | |
|---------------|--------|
| Profit | 75.00 |
| Selling Price | 500.00 |

The Company keeps raw material in stock, on an average for four weeks; work-in-progress, on an average for one week; and finished goods in stock, on an average for two weeks.

The credit allowed by suppliers is three weeks and company allows four weeks' credit to its debtors. The lag in payment of wages is one week and lag in payment of overhead expenses is two weeks.

The Company sells one-fifth of the output against cash and maintains cash-in-hand and at bank put together at Rs.2,50,000.

Required:

PREPARE a statement showing estimate of Working Capital needed to finance an activity level of 2,60,000 units of production. Assume that production is carried on evenly throughout the year, and wages and overheads accrue similarly. Work-in-progress stock is 80% complete in all respects. (MTP 8 Marks, May'20 & Oct '23, RTP May '19)

Answer 2

Statement showing Estimate of Working Capital Needs

| | (Amount in Rs.) | (Amount in Rs.) |
|--|-----------------|-----------------|
| A Current Assets | | |
| (I) Inventories: | | |
| Raw material (4 weeks) $\left[\frac{2,60,000 \text{ units} \times \text{Rs. } 200}{52 \text{ weeks}} \times 4 \text{ weeks} \right]$ | 40,00,000 | |
| WIP Inventory (1 week) $\left[\frac{2,60,000 \text{ units} \times \text{Rs. } 425}{52 \text{ weeks}} \times 1 \text{ weeks} \right] \times 0.8$ | 17,00,000 | |
| Finished goods inventory (2 weeks) $\left[\frac{2,60,000 \text{ units} \times \text{Rs. } 425}{52 \text{ weeks}} \times 2 \text{ weeks} \right]$ | 42,50,000 | 99,50,000 |
| (ii) Receivables (Debtors) (4 weeks) $\left[\frac{2,60,000 \text{ units} \times \text{Rs. } 425}{52 \text{ weeks}} \times 2 \text{ weeks} \right] \times \frac{4}{5 \text{ th}}$ | | 68,00,000 |
| (iii) Cash and bank balance | | 2,50,000 |
| Total Current Assets | | 1,70,00,000 |
| B Current Liabilities: | | |
| (I) Payables (Creditors) for materials (3 weeks) $\left[\frac{2,60,000 \text{ units} \times \text{Rs. } 200}{52 \text{ weeks}} \times 3 \text{ weeks} \right]$ | | 30,00,000 |
| (ii) Outstanding wages (1 week) $\left[\frac{2,60,000 \text{ units} \times \text{Rs. } 75}{52 \text{ weeks}} \times 1 \text{ weeks} \right]$ | | 3,75,000 |



| | | |
|--|--|-------------|
| (iii) Outstanding overheads (2 weeks) | | |
| $\left[\frac{2,60,000 \text{ units} \times \text{Rs. } 150}{52 \text{ weeks}} \times 2 \text{ weeks} \right]$ | | 15,00,000 |
| Total Current Liabilities | | 48,75,000 |
| Net Working Capital Needs (A – B) | | 1,21,25,000 |

Question 3

The following information is provided by the P Ltd. for the year ending 31 st March, 2020.

| | |
|--|----------|
| Raw Material storage period | 52 days |
| Work in progress conversion period | 18 days |
| Finished Goods storage period | 20 days |
| Debt Collection period | 75 days |
| Creditors' payment period | 25 days |
| Annual Operating Cost | 45 crore |
| (Including depreciation of Rs.42,00,000) (1 year = 360 days) | |

You are required to CALCULATE Operating Cycle period and Number of Operating Cycles in a year. [MTP 2 Marks, May'20 & Oct '23]

Answer 3

Calculation of Operating Cycle Period and number of Operating Cycle in a Year

Operating Cycle Period = R + W + F + D – C

= 52 + 18 + 20 + 75 – 25 = 140 days

Number of Operating Cycle in a Year = $\frac{360}{\text{Operating Cycle Period}} = 360/140 = 2.57 \text{ times}$

Question 4

On 1st April, 2020, the Board of Director of ABC Ltd. wish to know the amount of working capital that will be required to meet the programmer they have planned for the year. From the following information, PREPARE a working capital requirement forecast and a forecast profit and loss account and balance sheet:

Issued share capital Rs.6,00,000

10% Debentures Rs.1,00,000

Fixed Assets Rs.4,50,000

Production during the previous year was 1,20,000 units; it is planned that this level of activity should be maintained during the present year.

The expected ratios of cost to selling price are: raw materials 60%, direct wages 10% overheads 20%

Raw materials are expected to remain in store for an average of two months before issue to production.

Each unit of production is expected to be in process for one month. The time lag in wage payment is one month.

Finished goods will stay in the warehouse awaiting dispatch to customers for approximately three months.

Credit allowed by creditors is two months from the date of delivery of raw materials. Credit given to debtors is three months from the date of dispatch.

Selling price is Rs.5 per unit.

There is a regular production and sales cycle and wages and overheads accrue evenly. (MTP 10 Marks Nov'21)

Answer 4

Forecast Profit and Loss Account for the period 01.04.2020 to 31.03.2021

| Particulars | Rs. | Particulars | ₹ |
|--------------------|----------|--------------------------|----------|
| Materials consumed | 3,60,000 | By Sales 1,20,000 @ Rs.5 | 6,00,000 |
| 1,20,000 @ Rs.3 | | | |
| Direct wages : | 60,000 | | |



| | | | |
|---|----------|---------------------|----------|
| 1,20,000 @ ₹ 0.50 | | | |
| Overheads : | 1,20,000 | | |
| 1,20,000 @ ₹ 1 | | | |
| Gross profit c/d | 60,000 | | |
| | 6,00,000 | | 6,00,000 |
| Debenture interest (10% of 1,00,000) | 10,000 | By gross profit b/d | 60,000 |
| Net profit c/d | 50,000 | | |
| | 60,000 | | 60,000 |

Working Capital Requirement Forecast for the year 01.04.2020 to 31.03.2021

| Particulars | Period (Months) | Total (₹) | Current Assets (₹) | | | | Current Liabilities (₹) |
|---------------------------------|--------------------|-----------|--------------------|----------------------|-------------------|----------|-------------------------------|
| | | | Raw materials | Work-in- progress | Finished goods | Debtors | Creditors |
| 1. Material | | | | | | | |
| In store | 2 | | 60,000 | | | | |
| In work-in- progress | 1 | | | 30,000 | | | |
| In finished goods | 3 | | | | 90,000 | | |
| Credit to debtors | 3 | | | | | 90,000 | |
| | 9 | | | | | | |
| Less : Credit from creditors | 2 | | | | | | 60,000 |
| Net block period | 7 | 2,10,000 | | | | | |
| 2. Wages: | | | | | | | |
| In work-in- progress | 1/2 | | | 2,500 | | | |
| In finished goods | 3 | | | | 15,000 | | |
| Credit to debtors | 3 | | | | | 15,000 | |
| | 6½ | | | | | | |
| Less: Time lag in payment | 1 | | | | | | 5,000 |
| Net block period | 5 ½ | 27,500 | | | | | |
| 3. Overhead s: | | | | | | | |
| In work-in- progress | ½ | | | 5,000 | | | |
| In finished goods | 3 | | | | 30,000 | | |
| Credit to debtors | 3 | | | | | 30,000 | |
| Net block period | 6½ | 65,000 | | | | | |
| 4. Profit | | | | | | | |
| Credit to debtors | 3 | | | | | 15,000 | |
| Net block period | 3 | 15,000 | | | | | |
| Total (₹) | | 3,17,500 | 60,000 | 37,500 | 1,35,000 | 1,50,000 | 65,000 |



Forecast Balance Sheet as on 31.03.2021

| | (₹) | | | (₹) |
|----------------------|----------|------------------|----------|----------|
| Issued share capital | 6,00,000 | Fixed Assets | | 4,50,000 |
| Profit and Loss A/c | 50,000 | Current Assets: | | |
| 10% Debentures | 1,00,000 | Stock: | | |
| Sundry creditors | 65,000 | Raw materials | 60,000 | |
| Bank overdraft- | | Work-in-progress | 37,500 | |
| Balancing figure | 17,500 | Finished goods | 1,35,000 | 2,32,500 |
| | | Debtors | | 1,50,000 |
| | | | | |
| | 8,32,500 | | | 8,32,500 |

The Total amount of working capital, thus, stands as follows:

Amount

Requirement as per working capital

3,17,500

Less: Bank overdraft as per balance sheet

17,500

Net requirement

3,00,000

Notes:

- Average monthly production: $1,20,000 \div 12 = 10,000$ units
- Average cost per month:
 - Raw Material $10,000 \times (\text{Rs.}5 \times 0.6) = \text{Rs.}30,000$
 - Direct wages $10,000 \times (\text{Rs.}5 \times 0.1) = \text{Rs.}5,000$
 - Overheads $10,000 \times (\text{Rs.}5 \times 0.2) = \text{Rs.}10,000$
- Average profit per month: $10,000 \times (\text{Rs.}5 \times 0.1) = \text{Rs.}5,000$
- Wages and overheads accrue evenly over the period and, hence, are assumed to be completely introduced for half the processing time.

Question 5

Following information is forecasted by Gween Limited for the year ending 31st March, 2022:

| | Balance as at 31st March, 2022 | Balance as at 31st March, 2021 |
|---|--------------------------------------|--------------------------------------|
| | (₹ in lakh) | (₹ in lakh) |
| Raw Material | 845 | 585 |
| Work-in-progress | 663 | 455 |
| Finished goods | 910 | 780 |
| Receivables | 1,755 | 1,456 |
| Payables | 923 | 884 |
| Annual purchases of raw material (all credit) | 5,200 | |
| Annual cost of production | 5,850 | |
| Annual cost of goods sold | 6,825 | |
| Annual operating cost | 4,225 | |



| | | |
|---------------------------|-------|--|
| Annual sales (all credit) | 7,605 | |
|---------------------------|-------|--|

Considering one year as equal to 365 days, CALCULATE:

- Net operating cycle period.
- Number of operating cycles in the year.
- Amount of working capital requirement. (MTP 10 Marks March 22) (Same concept different figures Old & New SM, RTP May '18)

Answer 5

Working Notes:

1. Raw Material Storage Period (R)

$$= \frac{\text{Average Stock of Raw Material}}{\text{Annual Consumption of Raw Material}} \times 365$$

$$= \frac{\frac{\text{Rs.585} + \text{Rs.845}}{2}}{\text{Rs.4,940}} \times 365 = 53 \text{ days}$$

$$\begin{aligned} \text{Annual Consumption of Raw Material} &= \text{Opening Stock} + \text{Purchases} - \text{Closing Stock} \\ &= ₹ 585 + ₹ 5,200 - ₹ 845 = ₹ 4,940 \text{ lakh} \end{aligned}$$

2. Work – in - Progress (WIP) Conversion Period (W)

$$= \frac{\text{Average Stock of WIP}}{\text{Annual Cost of Production}} \times 365$$

$$= \frac{\frac{\text{Rs.455} + \text{Rs.663}}{2}}{\text{Rs.5,850}} \times 365 = 35 \text{ days}$$

3. Finished Stock Storage Period (F)

$$= \frac{\text{Average Stock of Finished Goods}}{\text{Cost of Goods Sold}} \times 365$$

$$= \frac{\frac{\text{Rs.780} + \text{Rs.910}}{2}}{\text{Rs.6,825}} \times 365 = 45 \text{ days}$$

4. Receivables (Debtors) Collection Period (D)

$$= \frac{\text{Average Receivables}}{\text{Annual Credit Sales}} \times 365$$

$$= \frac{\frac{\text{Rs.1,456} + \text{Rs.1,755}}{2}}{\text{Rs.7,605}} \times 365 = 77 \text{ days}$$

5. Payables (Creditors) Payment Period (C)

$$= \frac{\text{Average Payables for Materials}}{\text{Annual Credit Purchases}} \times 365$$

$$= \frac{\frac{\text{Rs.884} + \text{Rs.923}}{2}}{\text{Rs.5,200}} \times 365 = 64 \text{ days}$$

(i) Net Operating Cycle Period

$$\begin{aligned} &= R + W + F + D - C \\ &= 53 + 35 + 45 + 77 - 64 = 146 \text{ days} \end{aligned}$$

(ii) Number of Operating Cycles in the Year



$$= \frac{365}{\text{Operating Cycle Period}} = \frac{365}{146} = 2.5 \text{ times}$$

(iii) Amount of Working Capital Required

$$= \frac{\text{Annual Operating Cost}}{\text{Number of Operating Cycles}} = \frac{\text{Rs.4,225}}{2.5} = \text{Rs. 1,690 lakh}$$

Note: Number of days may vary due to fraction.

Question 6

The following annual figures relate to manufacturing entity:

- A. Sales at one month credit 84,00,000
- B. Material consumption 60% of sales value
- C. Wages (paid in a lag of 15 days) 12,00,000
- D. Cash Manufacturing Expenses 3,00,000
- E. Administrative Expenses 2,40,000
- F. Creditors extend 3 months credit for payment.
- G. Cash manufacturing and administrative expenses are paid 1 months in arrear.

The company maintains stock of raw material equal to economic order quantity. The company incurs ₹ 100 as per ordering cost per order and opportunity cost of capital is 15% p.a. The optimum cash balance is determined using Baumol's model. The bank charges ₹ 10 for each cash withdrawal. Finished goods are held in stock for 1 month. The company maintains a bank balance of ₹12,00,000 on an average. Creditors are paid through net banking and all other expenses are incurred in cash which is withdrawn from bank. Assuming a 20% safety margin, you are required to ESTIMATE the amount of working capital that needs to be invested by the Company. (MTP 10 Marks April 22)

Answer 6

Statement of working capital Requirement

| Particular | (₹) | (₹) |
|--|-----------|-----------|
| A. Current Assets | | |
| Stock of Raw Material (W.N. 2) | 81,975 | |
| Stock of finished Goods $\left(65,40,000 \times \frac{1}{12}\right)$ | 5,45,000 | |
| Average Receivables (at Cost) $\left(67,80,000 \times \frac{1}{12}\right)$ | 5,65,000 | |
| Bank Balance | 12,00,000 | |
| Cash Balance (W.N. 3) | 15,232 | |
| Gross Working Capital | | 24,07,207 |
| B. Current Liabilities | | |
| Average Creditor for materials $\left(50,40,000 \times \frac{3}{12}\right)$ | 12,60,000 | |
| Outstanding Wages $\left(12,00,000 \times \frac{0.5}{12}\right)$ | 50,000 | |



| | | |
|--|--------|-----------|
| Outstanding Cash Manufacturing Expenses $\left(3,00,000 \times \frac{1}{12}\right)$ | 25,000 | |
| Outstanding administrative Expenses $\left(2,40,000 \times \frac{1}{12}\right)$ | 20,000 | |
| | | 13,55,000 |
| Net Working Capital (A-B) | | 10,52,207 |
| Add: Safety Margin @ 20% | | 2,10,441 |
| Total Working Capital Requirement | | 12,62,648 |

Working Notes:

1. Computation of annual cash Cost of Production & Sales

| | |
|-------------------------------------|-----------|
| Material Consumed (84,00,000 × 60%) | 50,40,000 |
| Wages | 12,00,000 |
| Manufacturing expenses | 3,00,000 |
| Cash Cost of production | 65,40,000 |
| (+) Administrative Expenses | 2,40,000 |
| Cash Cost of Sales | 67,80,000 |

2. Computation of stock of Raw Material A =

$$50,40,000$$

$$B = 100$$

$$C = 0.15$$

$$= ₹ 81,975$$

$$\therefore \text{EOQ} = \sqrt{\frac{2AB}{C}} = \sqrt{\frac{2 \times 50,40,000 \times 100}{0.15}} = \text{Rs. } 81,975$$

Calculation of Cash Balance

$$A = 12,00,000 + 3,00,000 + 2,40,000$$

$$A = 17,40,000$$

$$B = 10$$

$$C = 0.15$$

$$\text{Optimal Cash Balance} = \sqrt{\frac{2AB}{C}} = \sqrt{\frac{2 \times 17,40,000 \times 10}{0.15}} = \text{Rs. } 15,232$$

Question 7

Answer the following:

PREPARE a working capital estimate to finance an activity level of 52,000 units a year (52 weeks) based on the following data:

Raw Materials - ₹ 400 per unit Direct Wages - ₹ 150 per unit

Overheads (Manufacturing) - ₹200 per unit Overheads (Selling & Distribution) - ₹100perunit

Selling Price - ₹ 1,000 per unit, Raw materials & Finished Goods remain in stock for 4 weeks, Work in process takes 4 weeks. Debtors are allowed 8 weeks for payment whereas creditors allow us 4 weeks.

Minimum cash balance expected is ₹50,000. Receivables are valued at Selling Price. (MTP 5 Marks Oct '22, Old & New SM)

Answer 7

| Cost Structure for 52000 units | |
|------------------------------------|-------------|
| Particulars | Amount (₹) |
| Raw Material @ ₹ 400 | 2,08,00,000 |
| Direct Wages @ ₹ 150 | 78,00,000 |
| Manufacturing Overheads@ ₹ 200 | 1,04,00,000 |
| Selling and Distribution OH@ ₹ 100 | 52,00,000 |
| Total Cost | 4,42,00,000 |
| Sales@₹1000 | 5,20,00,000 |
| | |

| Particulars | Calculation | Amount (₹) |
|--|---|---------------|
| A. Current Assets: | | |
| Raw Material Stock | $2,08,00,000 \times \frac{4}{52}$ | 16,00,000 |
| Work in Progress (WIP) Stock | $2,08,00,000 + \frac{78,00,000}{2} \times \frac{4}{52}$ | 23,00,000 |
| Finished Goods Stock | $4,42,00,000 \times \frac{4}{52}$ | 34,00,000 |
| Receivables | $5,20,00,000 \times \frac{8}{52}$ | 80,00,000 |
| Cash | | <u>50,000</u> |
| | Total Current Assets | 1,53,50,000 |
| B. Current Liabilities: | | |
| Creditors | $20800000 \times \frac{4}{52}$ | 16,00,000 |
| C. Working Capital Estimates(A-B) | | 1,37,50,000 |

Question 8

A company is considering its working capital investment and financial policies for the next year. Estimated fixed assets and current liabilities for the next year are ₹ 2.60 crores and ₹ 2.34 crores respectively. Estimated Sales and EBIT depend on current assets investment, particularly inventories and book-debts. The Financial Controller of the company is examining the following alternative Working Capital Policies:

(₹ in crore)

| Working Capital Policy | Investment in Current Assets | Estimated Sales | EBIT |
|------------------------|------------------------------|-----------------|------|
| Conservative | 4.50 | 12.30 | 1.23 |
| Moderate | 3.90 | 11.50 | 1.15 |
| Aggressive | 2.60 | 10.00 | 1.00 |

After evaluating the working capital policy, the Financial Controller has advised the adoption of the moderate working capital policy. The company is now examining the use of long-term and short-term borrowings for financing its assets. The company will use ₹ 2.50 crores of the equity funds. The corporate tax rate is 35%. The company is considering the following debt alternatives.

| Financing Policy | Short-term Debt | Long-term Debt |
|-----------------------|-----------------|----------------|
| Conservative | 0.54 | 1.12 |
| Moderate | 1.00 | 0.66 |
| Aggressive | 1.50 | 0.16 |
| Interest rate-Average | 12% | 16% |

You are required to CALCULATE the following:

(i) Working Capital Investment for each policy:

- Net Working Capital position
- Rate of Return
- Current ratio

(ii) Financing for each policy:

- Net Working Capital position.
- Rate of Return on Shareholders' equity.
- Current ratio. (RTP May '19, Nov'18)

Answer 8

(i) Statement showing Working Capital Investment for each policy

(₹ in crore)

| | Working Capital Policy | | |
|--|------------------------|----------|------------|
| | Conservative | Moderate | Aggressive |
| Current Assets: (i) | 4.50 | 3.90 | 2.60 |
| Fixed Assets: (ii) | 2.60 | 2.60 | 2.60 |
| Total Assets: (iii) | 7.10 | 6.50 | 5.20 |
| Current liabilities: (iv) | 2.34 | 2.34 | 2.34 |
| Net Worth: (v) = (iii) - (iv) | 4.76 | 4.16 | 2.86 |
| Total liabilities: (iv) + (v) | 7.10 | 6.50 | 5.20 |
| Estimated Sales: (vi) | 12.30 | 11.50 | 10.00 |
| EBIT: (vii) | 1.23 | 1.15 | 1.00 |
| (a) Net working capital position: (i) - (iv) | 2.16 | 1.56 | 0.26 |
| (b) Rate of return: (vii) / (iii) | 17.32% | 17.69% | 19.23% |
| (c) Current ratio: (i) / (iv) | 1.92 | 1.67 | 1.11 |

(ii) Statement Showing Effect of Alternative Financing Policy (₹ in crore)

| Financing Policy | Conservative | Moderate | Aggressive |
|------------------|--------------|----------|------------|
|------------------|--------------|----------|------------|



| | | | |
|--|---------------------------|------------------------|------------------------|
| Current Assets (i) | 3.90 | 3.90 | 3.90 |
| Fixed Assets (ii) | 2.60 | 2.60 | 2.60 |
| Total Assets (iii) | 6.50 | 6.50 | 6.50 |
| Current Liabilities (iv) | 2.34 | 2.34 | 2.34 |
| Short term Debt (v) | 0.54 | 1.00 | 1.50 |
| Total current liabilities | 2.88 | 3.34 | 3.84 |
| (vi) = (iv) + (v) | | | |
| Long term Debt (vii) | 1.12 | 0.66 | 0.16 |
| Equity Capital (viii) | 2.50 | 2.50 | 2.50 |
| Total liabilities (ix) = (vi)+(vii)+(viii) | 6.50 | 6.50 | 6.50 |
| Forecasted Sales | 11.50 | 11.50 | 11.50 |
| EBIT (x) | 1.15 | 1.15 | 1.15 |
| Less: Interest on short-term debt | 0.06 (12% of ₹0.54) | 0.12 (12% of ₹ 1) | 0.18 (12% of ₹ 1.5) |
| Interest on long term debt | 0.18 (16% of ₹1.12) | 0.11 (16% of ₹0.66) | 0.03 (16% of ₹0.16) |
| Earnings before tax (EBT) (xi) | 0.91 | 0.92 | 0.94 |
| Taxes @ 35% (xii) | 0.32 | 0.32 | 0.33 |
| Earnings after tax: (xiii) = (xi) – (xii) | 0.59 | 0.60 | 0.61 |
| (a) Net Working Capital Position: (i) - [(iv) + (v)] | 1.02 | 0.56 | 0.06 |
| (b) Rate of return on shareholders' Equity capital : (xiii)/ (viii) | 23.6% | 24.0% | 24.4% |
| (c) Current Ratio (i) / (vi) | 1.35 | 1.17 | 1.02 |

Question 9

Following are cost information of KG Ltd., which has commenced a new project for an annual production of 24,000 units which is the full capacity:

| | Costs per unit (₹) |
|-------------------------------------|-----------------------|
| Materials | 80.00 |
| Direct labour and variable expenses | 40.00 |
| Fixed manufacturing expenses | 12.00 |
| Depreciation | 20.00 |
| Fixed administration expenses | 8.00 |
| | 160.00 |

The selling price per unit is expected to be ₹192 and the selling expenses ₹10 per unit, 80% of which is variable.

In the first two years of operations, production and sales are expected to be as follows:

| Year | Production (No. of units) | Sales (No. of units) |
|------|------------------------------|-------------------------|
|------|------------------------------|-------------------------|

| | | |
|---|--------|--------|
| 1 | 12,000 | 10,000 |
| 2 | 18,000 | 17,000 |

To assess the working capital requirements, the following additional information is available:

- (a) Stock of materials 2 months' average consumption
- (b) Work-in-process Nil
- (c) Debtors 2 month's average sales.
- (d) Cash balance ₹ 1,00,000
- (e) Creditors for supply of materials 1 month's average purchase during the year.
- (f) Creditors for expenses 1 month's average of all expenses during the year.

PREPARE, for the two years:

- (i) A projected statement of Profit/Loss (Ignoring taxation); and
- (ii) A projected statement of working capital requirements (RTP Nov '19) (Same concept different figures Old & New SM)

Answer 9

- (i) Projected Statement of Profit / Loss (Ignoring Taxation)

| | Year 1 | Year 2 |
|--------------------|--------|--------|
| Production (Units) | 12,000 | 18,000 |
| Sales (Units) | 10,000 | 17,000 |

| | (₹) | (₹) |
|---|------------|------------|
| Sales revenue (A) (Sales unit × ₹192) | 19,20,000 | 32,64,000 |
| Cost of production: | | |
| Materials cost (Units produced × ₹80) | 9,60,000 | 14,40,000 |
| Direct labour and variable expenses (Units produced × ₹40) | 4,80,000 | 7,20,000 |
| Fixed manufacturing expenses (Production Capacity: 24,000 units × ₹12) | 2,88,000 | 2,88,000 |
| Depreciation (Production Capacity : 24,000 units × ₹20) | 4,80,000 | 4,80,000 |
| Fixed administration expenses (Production Capacity : 24,000 units × ₹8) | 1,92,000 | 1,92,000 |
| Total Costs of Production | 24,00,000 | 31,20,000 |
| Add: Opening stock of finished goods (Year 1 : Nil; Year 2 : 2,000 units) | --- | 4,00,000 |
| Cost of Goods available for sale (Year 1: 12,000 units; Year 2: 20,000 units) | 24,00,000 | 35,20,000 |
| Less: Closing stock of finished goods at average cost (year 1: 2000 units, year 2 : 3000 units) (Cost of Production × Closing stock/ units produced) | (4,00,000) | (5,28,000) |
| Cost of Goods Sold | 20,00,000 | 29,92,000 |
| Add: Selling expenses – Variable (Sales unit × ₹8) | 80,000 | 1,36,000 |

| | | |
|--|--------------|------------|
| Add: Selling expenses -Fixed (24,000 units × ₹2) | 48,000 | 48,000 |
| Cost of Sales : (B) | 21,28,000 | 31,76,000 |
| Profit (+) / Loss (-): (A - B) | (-) 2,08,000 | (+) 88,000 |

Working Notes:
1. Calculation of creditors for supply of materials:

| | Year 1 (₹) | Year 2 (₹) |
|--|---------------|---------------|
| Materials consumed during the year | 9,60,000 | 14,40,000 |
| Add: Closing stock (2 month's average consumption) | 1,60,000 | 2,40,000 |
| | 11,20,000 | 16,80,000 |
| Less: Opening Stock | --- | 1,60,000 |
| Purchases during the year | 11,20,000 | 15,20,000 |
| Average purchases per month (Creditors) | 93,333 | 1,26,667 |

2. Creditors for expenses:

| | Year 1 (₹) | Year 2 (₹) |
|-------------------------------------|------------|------------|
| Direct labour and variable expenses | 4,80,000 | 7,20,000 |
| Fixed manufacturing expenses | 2,88,000 | 2,88,000 |
| Fixed administration expenses | 1,92,000 | 1,92,000 |
| Selling expenses (variable + fixed) | 1,28,000 | 1,84,000 |
| Total | 10,88,000 | 13,84,000 |
| Average per month | 90,667 | 1,15,333 |

(ii) Projected Statement of Working Capital requirements

| | Year 1 (₹) | Year 2 (₹) |
|--|------------|------------|
| Current Assets: | | |
| Inventories: | | |
| -Stock of materials (2 month's average consumption) | 1,60,000 | 2,40,000 |
| -Finished goods | 4,00,000 | 5,28,000 |
| Debtors (2 month's average sales) (including profit) | 3,20,000 | 5,44,000 |
| Cash | 1,00,000 | 1,00,000 |
| Total Current Assets/ Gross working capital (A) | 9,80,000 | 14,12,000 |
| Current Liabilities: | | |
| Creditors for supply of materials (Refer to working note 1) | 93,333 | 1,26,667 |
| Creditors for expenses (Refer to working note 2) | 90,667 | 1,15,333 |
| Total Current Liabilities: (B) | 1,84,000 | 2,42,000 |
| Estimated Working Capital Requirements: (A-B) | 7,96,000 | 11,70,000 |

Question 10

Day Ltd., a newly formed company has applied to the Private Bank for the first time for financing it's



Working Capital Requirements. The following information is available about the projections for the current year:

| | |
|--------------------------------|---|
| Estimated Level of Activity | Completed Units of Production 31,200 plus unit of work in progress 12,000 |
| Raw Material Cost | ₹ 40 per unit |
| Direct Wages Cost | ₹ 15 per unit |
| Overhead | ₹ 40 per unit (inclusive of Depreciation ₹10 per unit) |
| Selling Price | ₹ 130 per unit |
| Raw Material in Stock | Average 30 days consumption |
| Work in Progress Stock | Material 100% and Conversion Cost 50% |
| Finished Goods Stock | 24,000 Units |
| Credit Allowed by the supplier | 30 days |
| Credit Allowed to Purchasers | 60 days |
| Direct Wages (Lag in payment) | 15 days |
| Expected Cash Balance | ₹ 2,00,000 |

Assume that production is carried on evenly throughout the year (360 days) and wages and overheads accrue similarly. All sales are on the credit basis. You are required to **CALCULATE** the Net Working Capital Requirement on Cash Cost Basis. (RTP May '20, PYP 10 Marks May '18) (Same concept different figures MTP 10 Marks, March '18, Old & New SM)

Answer 10

Calculation of Net Working Capital requirement:

| | (₹) | (₹) |
|--|-----------|------------------|
| A. Current Assets: | | |
| Inventories: | | |
| Stock of Raw material (Refer to Working note (iii)) | 1,44,000 | |
| Stock of Work in progress (Refer to Working note (ii)) | 7,50,000 | |
| Stock of Finished goods (Refer to Working note (iv)) | 20,40,000 | |
| Debtors for Sales(Refer to Working note (v)) | 1,02,000 | |
| Cash | 2,00,000 | |
| Gross Working Capital | 32,36,000 | 32,36,000 |
| B. Current Liabilities: | | |
| Creditors for Purchases (Refer to Working note (vi)) | 1,56,000 | |
| Creditors for wages (Refer to Working note (vii)) | 23,250 | |
| | 1,79,250 | 1,79,250 |
| Net Working Capital (A - B) | | 30,56,750 |

Working Notes:

(i) Annual cost of production

| | (₹) |
|--|-----------|
| Raw material requirements {(31,200 × ₹ 40) + (12,000 × ₹ 40)} | 17,28,000 |
| Direct wages {(31,200 × ₹ 15) + (12,000 × ₹ 15 × 0.5)} | 5,58,000 |



| | |
|--|-------------|
| Overheads (exclusive of depreciation) {(31,200 × ₹ 30) + (12,000 × ₹ 30 × 0.5)} | 11,16,000 |
| Gross Factory Cost | 34,02,000 |
| Less: Closing W.I.P [12,000 (₹ 40 + ₹ 7.5 + ₹15)] | (7,50,000) |
| Cost of Goods Produced | 26,52,000 |
| Less: Closing Stock of Finished Goods (₹ 26,52,000 × 24,000/31,200) | (20,40,000) |
| Total Cash Cost of Sales* | 6,12,000 |

[*Note: Alternatively, Total Cash Cost of Sales = (31,200 units – 24,000 units) × (₹ 40 + ₹ 15 + ₹ 30) = ₹ 6,12,000]

(ii) Work in progress stock

| | (₹) |
|--|----------|
| Raw material requirements (12,000 units × ₹40) | 4,80,000 |
| Direct wages (50% × 12,000 units × ₹ 15) | 90,000 |
| Overheads (50% × 12,000 units × ₹ 30) | 1,80,000 |
| | 7,50,000 |

(iii) Raw material stock

It is given that raw material in stock is average 30 days consumption. Since, the company is newly formed; the raw material requirement for production and work in progress will be issued and consumed during the year. Hence, the raw material consumption for the year (360 days) is as follows:

| | (₹) |
|--------------------------------------|-----------|
| For Finished goods (31,200 × ₹ 40) | 12,48,000 |
| For Work in progress (12,000 × ₹ 40) | 4,80,000 |
| | 17,28,000 |

Raw material stock = $\frac{\text{Rs. } 17,28,000}{360 \text{ days}} \times 30 \text{ days} = \text{Rs. } 1,44,000$

(iv) Finished goods stock:

24,000 units @ ₹ (40+15+30) per unit = ₹20,40,000

Debtors for sale: Rs. 6,12,000 × $\frac{60 \text{ days}}{360 \text{ days}} = \text{Rs. } 1,02,000$

(v) Creditors for raw material Purchases [Working Note (iii)]:

Annual Material Consumed (₹12,48,000 + ₹4,80,000) ₹17,28,000

Add: Closing stock of raw material [(₹17,28,000 × 30 days) / 360 days] ₹ 1,44,000

₹18,72,000

Credit allowed by suppliers = $\frac{\text{Rs. } 18,72,000}{360 \text{ days}} \times 30 \text{ days} = \text{Rs. } 1,56,000$

(vi) Creditors for wages:

Outstanding wage payment = [(31,200 units × ₹ 15) + (12,000 units × ₹ 15 × .50)] × 15 days / 360 days

= $\frac{\text{Rs. } 5,58,000}{360 \text{ days}} \times 15 \text{ days} = \text{Rs. } 23,250$

Consider the following figures and ratios:

| | |
|---|---------------|
| (i) Sales for the year (all credit) | ₹ 1,05,00,000 |
| (ii) Gross Profit ratio | 35 percent |
| (iii) Fixed assets turnover (based on cost of goods sold) | 1.5 |
| (iv) Stock turnover (based on cost of goods sold) | 6 |
| (v) Liquid ratio | 1.5:1 |
| (vi) Current ratio | 2.5:1 |
| (vii) Receivables (Debtors) collection period | 1 month |
| (viii) Reserves and surplus to Share capital | 1:1.5 |
| (ix) Capital gearing ratio | 0.7875 |
| (x) Fixed assets to net worth | 1.3 : 1 |

You are required to PREPARE:

- Balance Sheet as on 31/3/2022 based on above details.
- The statement showing working capital requirement if the company wants to make a provision for contingencies @ 14 percent of net working capital. (RTP Nov '23 & Nov '20, Old & New SM)

Answer 11

Working Notes:

- Cost of Goods Sold = Sales – Gross Profit (35% of Sales)
 = ₹ 1,05,00,000 – ₹ 36,75,000
 = ₹ 68,25,000
- Closing Stock = Cost of Goods Sold / Stock Turnover
 = $\frac{₹ 68,25,000}{6} = ₹ 11,37,500$
- Fixed Assets = Cost of Goods Sold / Fixed Assets Turnover
 = $\frac{₹ 68,25,000}{1.5} = ₹ 45,50,000$
- Current Assets:
 Current Ratio = 2.5 and Liquid Ratio = 1.5
 Inventories (Stock) = 2.5 – 1.5 = 1
 Current Assets = Amount of Inventories(Stock) $\times \frac{2.5}{1}$
 = ₹ 11,37,500 $\times \frac{2.5}{1} = ₹ 28,43,750$
- Liquid Assets (Receivable and Cash)
 = Current Assets – Inventories (Stock)
 = ₹ 28,43,750 – ₹ 11,37,500
 = ₹ 17,06,250
- Receivables (Debtors) = Sales $\times \frac{\text{Debtors Collection Period}}{12}$
 = ₹ 1,05,00,000 $\times \frac{1}{12}$

$$= 8,75,000$$

(vii) Cash = liquid Assets – Receivables (Debtors)

$$= ₹ 17,06,250 - ₹ 8,75,000 = ₹ 8,31,250$$

$$(viii) \text{ Net worth} = \frac{\text{Fixed Assets}}{1.3} = \frac{₹ 45,50,000}{1.3} = ₹ 35,00,000$$

(ix) Reserves and Surplus

$$\text{Reserves and Share Capital} = \text{Net worth}$$

$$\text{Net worth} = 1+1.5 = 2.5$$

$$\text{Reserves and Surplus} = ₹ 35,00,000 \times \frac{1}{2.5}$$

(x) Share Capital = Net worth – Reserves and surplus

$$= ₹ 35,00,000 - ₹ 14,00,000$$

$$= ₹ 21,00,000$$

(xi) Current Liabilities = Current Assets / Current Ratio

$$= \frac{₹ 28,43,750}{2.5} = ₹ 11,37,500$$

(xii) Long-term Debts

$$\text{Capital Gearing Ratio} = \text{Long-term Debts} / \text{Equity Shareholders' Fund}$$

$$\text{Long-term Debts} = ₹ 35,00,000 \times 0.7875 = ₹ 27,56,250$$

(a) Balance Sheet

| Particulars | Figures as at 31-03-2022 (₹) | Figures as at 31-03-2021 (₹) |
|----------------------------------|------------------------------------|------------------------------------|
| I. EQUITY AND LIABILITIES | | |
| Shareholders' funds | | |
| (a) Share capital | 21,00,000 | - |
| (b) Reserves and surplus | 14,00,000 | - |
| Non-current liabilities | | |
| (a) Long-term borrowings | 27,56,250 | - |
| Current liabilities | 11,37,500 | - |
| TOTAL | 73,93,750 | - |
| II. ASSETS | | |
| Non-current assets | | |
| Fixed assets | 45,50,000 | - |
| Current assets | | |
| Inventories | 11,37,500 | - |
| Trade receivables | 8,75,000 | - |
| Cash and cash equivalents | 8,31,250 | - |
| TOTAL | 73,93,750 | - |

(b) Statement Showing Working Capital Requirement

| Particulars | (₹) | (₹) |
|---|-----|-----------|
| A. Current Assets | | |
| (i) Inventories (Stocks) | | 11,37,500 |
| (ii) Receivables (Debtors) | | 8,75,000 |
| (iii) Cash in hand & at bank | | 8,31,250 |
| Total Current Assets | | 28,43,750 |
| B. Current Liabilities: | | |
| Total Current Liabilities | | 11,37,500 |
| Net Working Capital (A – B) | | 17,06,250 |
| Add: Provision for contingencies (14% of Net Working Capital) | | 2,38,875 |
| Working capital requirement | | 19,45,125 |

Question 12

MT Ltd. has been operating its manufacturing facilities till 31.3.2021 on a single shift working with the following cost structure:

| | Per unit (₹) |
|---------------------------------------|--------------|
| Cost of Materials | 24 |
| Wages (out of which 60% variable) | 20 |
| Overheads (out of which 20% variable) | 20 |
| | 64 |
| Profit | 8 |
| Selling Price | 72 |

As at 31.3.2021 with the sales of ₹ 17,28,000, the company held:

| | (₹) |
|---|----------|
| Stock of raw materials (at cost) | 1,44,000 |
| Work-in-progress (valued at prime cost) | 88,000 |
| Finished goods (valued at total cost) | 2,88,000 |
| Sundry debtors | 4,32,000 |

In view of increased market demand, it is proposed to double production by working an extra shift. It is expected that a 10% discount will be available from suppliers of raw materials in view of increased volume of business. Selling price will remain the same. The credit period allowed to customers will remain unaltered. Credit availed from suppliers will continue to remain at the present level i.e. 2 months. Lag in payment of wages and overheads will continue to remain at one month. You are required to **CALCULATE** the additional working capital requirements, if the policy to increase output is implemented, to assess the impact of double shift for long term as a matter of production policy. (RTP May '21, Old & New SM)

Answer 12

Workings:

(1) Statement of cost at single shift and double shift working

| | 24,000 units | 48,000 Units |
|--|--------------|--------------|
|--|--------------|--------------|



| | Per unit (₹) | Total (₹) | Per unit (₹) | Total (₹) |
|---------------|-----------------|--------------|-----------------|--------------|
| Raw materials | 24 | 5,76,000 | 21.6 | 10,36,000 |
| Wages: | | | | |
| Variable | 12 | 2,88,000 | 12 | 5,76,000 |
| Fixed | 8 | 1,92,000 | 4 | 1,92,000 |
| Overheads: | | | | |
| Variable | 4 | 96,000 | 4 | 1,92,000 |
| Fixed | 16 | 3,84,000 | 8 | 3,84,000 |
| Total cost | 64 | 15,36,000 | 49.6 | 23,80,800 |
| Profit | 8 | 1,92,000 | 22.4 | 10,75,200 |
| Sales | 72 | 17,28,000 | 72 | 34,56,000 |

$$(2) \text{ Sales in units } 2020-21 = \frac{\text{Sales}}{\text{Unit selling price}} = \frac{\text{Rs.17,28,000}}{\text{Rs.72}} = 24,000 \text{ units}$$

(3) Stock of Raw Materials in units on 31.3.2021

$$= \frac{\text{Value of stock}}{\text{Cost per unit}} = \frac{\text{Rs.1,44,000}}{\text{Rs.24}} = 6,000 \text{ units}$$

(4) Stock of work-in-progress in units on 31.3.2021

$$= \frac{\text{Value of work-in-progress}}{\text{Prime Cost per unit}} = \frac{\text{Rs.88,000}}{\text{Rs.24+20}} = 2,000 \text{ units}$$

(5) Stock of finished goods in units 2020-21

$$= \frac{\text{Value of stock}}{\text{Total Cost per unit}} = \frac{\text{Rs.2,88,000}}{\text{Rs.64}} = 4,500 \text{ units}$$

Comparative Statement of Working Capital Requirement

| | Single Shift (24,000 units) | | | Double Shift (48,000 units) | | |
|----------------------------------|-----------------------------|-------------|-----------------|-----------------------------|-------------|------------------|
| | Units | Rate (₹) | Amount (₹) | Units | Rate (₹) | Amount (₹) |
| Current Assets | | | | | | |
| Inventories: | | | | | | |
| Raw Materials | 6,000 | 24 | 1,44,000 | 12,000 | 21.6 | 2,59,200 |
| Work-in-Progress | 2,000 | 44 | 88,000 | 2,000 | 37.6 | 75,200 |
| Finished Goods | 4,500 | 64 | 2,88,000 | 9,000 | 49.6 | 4,46,400 |
| Sundry Debtors | 6,000 | 64 | 3,84,000 | 12,000 | 49.6 | 5,95,200 |
| Total Current Assets (A) | | | 9,04,000 | | | 13,76,000 |
| Current Liabilities | | | | | | |
| Creditors for Materials | | | 96,000 | | | 1,72,800 |
| Creditors for Wages | 4,000 | 24 | 40,000 | 8,000 | 21.6 | 64,000 |
| Creditors for Overheads | 2,000 | 20 | 40,000 | 4,000 | 16 | 48,000 |
| | 2,000 | 20 | 40,000 | 4,000 | 12 | 48,000 |
| Total Current Liabilities (B) | | | 1,76,000 | | | 2,84,800 |
| Working Capital (A) – (B) | | | 7,28,000 | | | 10,91,200 |

Analysis: Additional Working Capital requirement = ₹ 10,91,200 – ₹ 7,28,000 = ₹ 3,63,200, if the policy

Question 13

While applying for financing of working capital requirements to a commercial bank, TN Industries Ltd. projected the following information for the next year:

| Cost Element | Per unit (₹) | Per unit (₹) |
|---|--------------|--------------|
| Raw materials | | |
| X | 30 | |
| Y | 7 | |
| Z | 6 | 43 |
| Direct Labour | | 25 |
| Manufacturing and administration overheads (excluding depreciation) | | 20 |
| Depreciation | | 10 |
| Selling overheads | | 15 |
| | | 113 |

Additional Information:

- Raw Materials are purchased from different suppliers leading to different credit period allowed as follows:
 X – 2 months; Y – 1 months; Z – ½ month
- Production cycle is of ½ month. Production process requires full unit of X and Y in the beginning of the production. Z is required only to the extent of half unit in the beginning and the remaining half unit is needed at a uniform rate during the production process.
- X is required to be stored for 2 months and other materials for 1 month.
- Finished goods are held for 1 month.
- 25% of the total sales is on cash basis and remaining on credit basis. The credit allowed by debtors is 2 months.
- Average time lag in payment of all overheads is 1 months and ½ months for direct labour.
- Minimum cash balance of ₹ 8,00,000 is to be maintained.

CALCULATE the estimated working capital required by the company on cash cost basis if the budgeted level of activity is 1,50,000 units for the next year. The company also intends to increase the estimated working capital requirement by 10% to meet the contingencies. (You may assume that production is carried on evenly throughout the year and direct labour and other overheads accrue similarly.) (RTP May '21)

Answer 13

Statement showing Working Capital Requirements of TN Industries Ltd. (on cash cost basis)

| | Amount in (₹) | Amount in (₹) |
|---|---------------|---------------|
| A. Current Assets | | |
| (i) Inventories: | | |
| Raw material | | |
| $X \left(\frac{1,50,000 \text{ units} \times \text{Rs. } 30}{12 \text{ Months}} \times 2 \text{ months} \right)$ | 7,50,000 | |



| | | |
|--|-----------|------------------|
| $Y \left(\frac{1,50,000 \text{ units} \times \text{Rs. } 7}{12 \text{ Months}} \times 1 \text{ month} \right)$ | 87,500 | |
| $Z \left(\frac{1,50,000 \text{ units} \times \text{Rs. } 6}{12 \text{ Months}} \times 1 \text{ month} \right)$ | 75,000 | |
| $WIP \left(\frac{1,50,000 \text{ units} \times \text{Rs. } 64}{12 \text{ Months}} \times 0.5 \text{ month} \right)$ | 4,00,000 | |
| $Finished \text{ goods} \left(\frac{1,50,000 \text{ units} \times \text{Rs. } 88}{12 \text{ Months}} \times 1 \text{ month} \right)$ | 11,00,000 | 24,12,500 |
| (ii) Receivables (Debtors) $\left(\frac{1,50,000 \text{ units} \times \text{Rs. } 103}{12 \text{ Months}} \times 2 \text{ months} \right) \times 0.75$ | | 19,31,250 |
| (iii) Cash and bank balance | | 8,00,000 |
| Total Current Assets | | 51,43,750 |
| B. Current Liabilities: | | |
| (i) Payables (Creditors) for Raw materials | | |
| $X \left(\frac{1,50,000 \text{ units} \times \text{Rs. } 30}{12 \text{ Months}} \times 2 \text{ months} \right)$ | 7,50,000 | |
| $Y \left(\frac{1,50,000 \text{ units} \times \text{Rs. } 7}{12 \text{ Months}} \times 1 \text{ month} \right)$ | 87,500 | |
| $Z \left(\frac{1,50,000 \text{ units} \times \text{Rs. } 6}{12 \text{ Months}} \times 0.5 \text{ month} \right)$ | 37,500 | 8,75,000 |
| (ii) Outstanding Direct Labour $\left(\frac{1,50,000 \text{ units} \times \text{Rs. } 25}{12 \text{ Months}} \times 0.5 \text{ month} \right)$ | | 1,56,250 |
| (iii) Outstanding Manufacturing and administration overheads $\left(\frac{1,50,000 \text{ units} \times \text{Rs. } 20}{12 \text{ Months}} \times 1 \text{ month} \right)$ | | 2,50,000 |
| (iv) Outstanding Selling Overheads $\left(\frac{1,50,000 \text{ units} \times \text{Rs. } 15}{12 \text{ Months}} \times 1 \text{ month} \right)$ | | 1,87,500 |
| Total Current Liabilities | | 14,68,750 |
| Net Working Capital Needs (A – B) | | 36,75,000 |
| Add: Provision for contingencies @ 10% | | 3,67,500 |
| Working capital requirement | | 40,42,500 |

Workings:

1.

| (i) Computation of Cash Cost of Production | Per unit (₹) |
|--|--------------|
| Raw Material consumed | 43 |
| Direct Labour | 25 |
| Manufacturing and administration overheads | 20 |
| Cash cost of production | 88 |
| (ii) Computation of Cash Cost of Sales | Per unit (₹) |
| Cash cost of production as in (i) above | 88 |
| Selling overheads | 15 |
| Cash cost of sales | 103 |

2. Calculation of cost of WIP

| Particulars | Per unit (₹) |
|---|--------------|
| Raw material (added at the beginning): | |
| X | 30 |
| Y | 7 |
| Z (₹ 6 x 50%) | 3 |
| Cost during the year: | |
| Z {(₹ 6 x 50%) x 50%} | 1.5 |
| Direct Labour (₹ 25 x 50%) | 12.5 |
| Manufacturing and administration overheads (₹ 20 x 50%) | 10 |
| | 64 |

Question 14

The management of Trux Company Ltd. is planning to expand its business and consults you to prepare an estimated working capital statement. The records of the company reveals the following annual information:

| | (₹) |
|--|-----------|
| Sales – Domestic at one month's credit | 18,00,000 |
| Export at three month's credit (sales price 10% below domestic price) | 8,10,000 |
| Materials used (suppliers extend two months credit) | 6,75,000 |
| Lag in payment of wages – ½ month | 5,40,000 |
| Lag in payment of manufacturing expenses (cash) – 1 month | 7,65,000 |
| Lag in payment of Administration Expenses – 1 month | 1,80,000 |
| Selling expenses payable quarterly in advance | 1,12,500 |
| Income tax payable in four installments, of which one falls in the next financial year | 1,68,000 |

Rate of gross profit is 20%. Ignore work-in-progress and depreciation.

The company keeps one month's stock of raw materials and finished goods (each) and believes in keeping ₹ 2,50,000 available to it including the overdraft limit of ₹ 75,000 not yet utilized by the company. The management is also of the opinion to make 10% margin for contingencies on computed figure. You are required to PREPARE the estimated working capital statement for the next year. (RTP Nov '21, Old & New SM)

Answer 14



Preparation of Statement of Working Capital Requirement for Trux Company Ltd.

| | (₹) | (₹) |
|---|----------|----------|
| A. Current Assets | | |
| (i) Inventories: | | |
| Material (1 month) $\left(\frac{\text{Rs. 6,75,000}}{12 \text{ Months}} \times 1 \text{ month}\right)$ | 56,250 | |
| Finished goods (1 month) $\left(\frac{\text{Rs. 21,60,000}}{12 \text{ Months}} \times 1 \text{ month}\right)$ | 1,80,000 | 2,36,250 |
| (ii) Receivables (Debtors) | | |
| For Domestic Sales $\left(\frac{\text{Rs. 15,17,586}}{12 \text{ Months}} \times 1 \text{ month}\right)$ | 1,26,466 | |
| For Export Sales $\left(\frac{\text{Rs. 7,54,914}}{12 \text{ Months}} \times 3 \text{ months}\right)$ | 1,88,729 | 3,15,195 |
| (iii) Prepayment of Selling expenses $\left(\frac{\text{Rs. 1,12,500}}{12 \text{ Months}} \times 3 \text{ months}\right)$ | | 28,125 |
| (iii) Cash in hand & at bank | | 1,75,000 |
| Total Current Assets | | 7,54,570 |
| B. Current Liabilities: | | |
| (i) Payables (Creditors) for materials (2 months) $\left(\frac{\text{Rs. 6,75,000}}{12 \text{ Months}} \times 2 \text{ months}\right)$ | | 1,12,500 |
| (ii) Outstanding wages (0.5 months) $\left(\frac{\text{Rs. 5,40,000}}{12 \text{ Months}} \times 0.5 \text{ month}\right)$ | | 22,500 |
| (iii) Outstanding manufacturing expenses $\left(\frac{\text{Rs. 7,65,000}}{12 \text{ Months}} \times 1 \text{ month}\right)$ | | 63,750 |
| (iv) Outstanding administrative expenses $\left(\frac{\text{Rs. 1,80,000}}{12 \text{ Months}} \times 1 \text{ month}\right)$ | | 15,000 |
| (v) Income tax payable | | 42,000 |
| Total Current Liabilities | | 2,55,750 |
| Net Working Capital (A – B) | | 4,98,820 |

| | | | |
|--------------------------------|------------------------|--|----------|
| Add: | 10% contingency margin | | 49,882 |
| Total Working Capital required | | | 5,48,702 |

Working Notes:
1. Calculation of Cost of Goods Sold and Cost of Sales

| | Domestic (₹) | Export (₹) | Total (₹) |
|--|--------------|------------|-----------|
| Domestic Sales | 18,00,000 | 8,10,000 | 26,10,000 |
| Less: Gross profit @ 20% on domestic sales and 11.11% on export sales (Working note-2) | 3,60,000 | 90,000 | 4,50,000 |
| Cost of Goods Sold | 14,40,000 | 7,20,000 | 21,60,000 |
| Add: Selling expenses (Working note-3) | 77,586 | 34,914 | 1,12,500 |
| Cash Cost of Sales | 15,17,586 | 7,54,914 | 22,72,500 |

2. Calculation of gross profit on Export Sales

Let domestic selling price is ₹100. Gross profit is ₹20, and then cost per unit is ₹80 Export price is 10% less than the domestic price i.e. ₹100 – (1-0.1) = ₹90

Now, gross profit will be = ₹90 - ₹80 = ₹10

So, Gross profit ratio at export price will be = Rs.10/ Rs. 90 X 100 = 11.11%

3. Apportionment of Selling expenses between Domestic and Exports sales:

Apportionment on the basis of sales value:

$$\text{Domestic Sales} = \frac{\text{Rs. } 1,12,500}{\text{Rs. } 26,10,000} \times \text{Rs. } 18,00,000 = \text{Rs. } 77,586$$

$$\text{Exports Sales} = \frac{\text{Rs. } 1,12,500}{\text{Rs. } 26,10,000} \times \text{Rs. } 8,10,000 = \text{Rs. } 34,914$$

4. Assumptions

- (i) It is assumed that administrative expenses is related to production activities.
- (ii) Value of opening and closing stocks are equal.

Question 15

PQR Ltd., a company newly commencing business in the year 2021-22, provides the following projected Profit and Loss Account:

| | (₹) | (₹) |
|--|----------|----------|
| Sales | | 5,04,000 |
| Cost of goods sold | | 3,67,200 |
| Gross Profit | | 1,36,800 |
| Administrative Expenses | 33,600 | |
| Selling Expenses | 31,200 | 64,800 |
| Profit before tax | | 72,000 |
| Provision for taxation | | 24,000 |
| Profit after tax | | 48,000 |
| The cost of goods sold has been arrived at as under: | | |
| Materials used | 2,01,600 | |
| Wages and manufacturing Expenses | 1,50,000 | |



| | | |
|---|--------------------|--|
| Depreciation | 56,400 4,08,000 | |
| Less: Stock of Finished goods (10% of goods produced not yet sold) | 40,800 | |
| | 3,67,200 | |

The figure given above relate only to finished goods and not to work-in-progress. Goods equal to 15% of the year's production (in terms of physical units) will be in process on the average requiring full materials but only 40% of the other expenses. The company believes in keeping materials equal to two months' consumption in stock.

All expenses will be paid one month in advance. Suppliers of materials will extend 1 -1/2 months credit. Sales will be 20% for cash and the rest at two months' credit. 70% of the Income tax will be paid in advance in quarterly instalments. The company wishes to keep ₹ 19,200 in cash. 10% must be added to the estimated figure for unforeseen contingencies. PREPARE an estimate of working capital. (RTP May 22)
(Same concepts different figures Old & New SM)

Answer 15

Statement showing the requirements of Working Capital

| Particulars | (₹) | (₹) |
|--|----------|----------|
| A. Current Assets: | | |
| Inventory: | | |
| Stock of Raw material ($₹ 2,31,840 \times 2/12$) | 38,640 | |
| Stock of Work-in-progress (As per Working Note) | 39,240 | |
| Stock of Finished goods ($₹ 3,51,600 \times 10/100$) | 35,160 | |
| Receivables (Debtors) ($₹ 3,04,992 \times 2/12$) | 50,832 | |
| Cash in Hand | 19,200 | |
| Prepaid Expenses: | | |
| Wages & Mfg. Expenses ($₹ 1,59,000 \times 1/12$) | 13,250 | |
| Administrative expenses ($₹ 33,600 \times 1/12$) | 2,800 | |
| Selling & Distribution Expenses ($₹ 31,200 \times 1/12$) | 2,600 | |
| Advance taxes paid $\{(70\% \text{ of } ₹ 24,000) \times 3/12\}$ | 4,200 | |
| Gross Working Capital | 2,05,922 | 2,05,922 |
| B. Current Liabilities: | | |
| Payables for Raw materials ($₹ 2,70,480 \times 1.5/12$) | 33,810 | |
| Provision for Taxation (Net of Advance Tax) ($₹ 24,000 \times 30/100$) | 7,200 | |
| Total Current Liabilities | 41,010 | 41,010 |
| C. Excess of CA over CL | | 1,64,912 |
| Add: 10% for unforeseen contingencies | | 16,491 |
| Net Working Capital requirements | | 1,81,403 |

Working Notes:

(i) **Calculation of Stock of Work-in-progress**

| Particulars | (₹) |
|--|--------|
| Raw Material ($₹ 2,01,600 \times 15\%$) | 30,240 |
| Wages & Mfg. Expenses ($₹ 1,50,000 \times 15\% \times 40\%$) | 9,000 |



| | |
|-------|--------|
| Total | 39,240 |
|-------|--------|

(ii) **Calculation of Stock of Finished Goods and Cost of Sales**

| Particulars | (₹) |
|--|----------|
| Direct material Cost [₹ 2,01,600 + ₹ 30,240] | 2,31,840 |
| Wages & Mfg. Expenses [₹ 1,50,000 + ₹ 9,000] | 1,59,000 |
| Depreciation | 0 |
| Gross Factory Cost | 3,90,840 |
| Less: Closing W.I.P. | (39,240) |
| Cost of goods produced | 3,51,600 |
| Add: Administrative Expenses | 33,600 |
| | 3,85,200 |
| Less: Closing stock | (35,160) |
| Cost of Goods Sold | 3,50,040 |
| Add: Selling and Distribution Expenses | 31,200 |
| Total Cash Cost of Sales | 3,81,240 |
| Debtors (80% of cash cost of sales) | 3,04,992 |

(iii) **Calculation of Credit Purchase**

| Particulars | (₹) |
|-----------------------|----------|
| Raw material consumed | 2,31,840 |
| Add: Closing Stock | 38,640 |
| Less: Opening Stock | - |
| Purchases | 2,70,480 |

Question 16

Trading and Profit and Loss Account of Beat Ltd. for the year ended 31st March, 2022 is given below:

| Particulars | Amount (₹) | Amount (₹) | Particulars | Amount (₹) | Amount (₹) |
|---------------------------|---------------|---------------|---------------------|---------------|---------------|
| To Opening Stock: | | | By Sales (Credit) | | 1,60,00,000 |
| - Raw Materials | 14,40,000 | | By Closing Stock: | | |
| - Work-in- progress | 4,80,000 | | - Raw Materials | 16,00,000 | |
| - Finished Goods | 20,80,000 | 40,00,000 | - Work-in-progress | 8,00,000 | |
| To Purchases (credit) | | 88,00,000 | - Finished Goods | 24,00,000 | 48,00,000 |
| To Wages | | 24,00,000 | | | |
| To Production Exp. | | 16,00,000 | | | |
| To Gross Profit c/d | | 40,00,000 | | | |
| | | 2,08,00,000 | | | 2,08,00,000 |
| To Administration Exp. | | 14,00,000 | By Gross Profit b/d | | 40,00,000 |
| To Selling Exp. | | 6,00,000 | | | |
| To Net Profit | | 20,00,000 | | | |
| | | 40,00,000 | | | 40,00,000 |



The opening and closing payables for raw materials were ₹ 16,00,000 and ₹ 19,20,000 respectively whereas the opening and closing balances of receivables were ₹ 12,00,000 and ₹ 16,00,000 respectively. You are required to ASCERTAIN the working capital requirement by operating cycle method. (RTP Nov'22)

Answer 16

Computation of Operating Cycle

1. Raw Material Storage Period (R)

$$\text{Raw Material Storage Period (R)} = \frac{\text{Average stock of Raw Material}}{\text{Daily Average Consumption of Raw Material}} = \frac{14,40,000 + 16,00,000}{2} \div \frac{86,40,000}{365} = 64.21 \text{ Days}$$

Raw Material Consumed = Opening Stock + Purchases – Closing Stock

$$= ₹ 14,40,000 + ₹ 88,00,000 - ₹ 16,00,000 = ₹ 86,40,000$$

2. Conversion/Work-in-Process Period (W)

$$\frac{\text{Average stock of WIP}}{\text{Daily Average Production Cost}} = \frac{(4,80,000 + 8,00,000)/2}{1,23,20,000 / 365} = 18.96 \text{ days}$$

| Production Cost: | |
|----------------------------|-------------|
| Opening Stock of WIP | 4,80,000 |
| Add: Raw Material Consumed | 86,40,000 |
| Add: Wages | 24,00,000 |
| Add: Production Expenses | 16,00,000 |
| | 1,31,20,000 |
| Less: Closing Stock of WIP | 8,00,000 |
| Production Cost | 1,23,20,000 |

3. Finished Goods Storage Period (F)

$$= \frac{\text{Average stock of Finished Goods}}{\text{Daily Average Cost of Good Sold}}$$

$$= \frac{(20,80,000 + 24,00,000) / 2}{1,20,00,000 / 365} = 68.13 \text{ Days}$$

| Cost of Goods Sold | |
|---------------------------------------|-------------|
| Opening Stock of Finished Goods | 20,80,000 |
| Add: Production Cost | 1,23,20,000 |
| | 1,44,00,000 |
| Less: Closing Stock of Finished Goods | (24,00,000) |
| | 1,20,00,000 |

4. Receivables Collection Period (D)

Receivables Collection Period

$$= \frac{\text{Average Receivables}}{\text{Daily average credit sales}}$$

$$= \frac{(12,00,000 + 16,00,000) / 2}{1,60,00,000 / 365} = 31.94 \text{ Days}$$



5. Payables Payment Period (C)

$$\begin{aligned} \text{Payables Payment Period} &= \frac{\text{Average Payables}}{\text{Daily average credit purchase}} \\ &= \frac{(16,00,000 + 19,20,000) / 2}{88,00,000 / 365} = 73 \text{ Days} \end{aligned}$$

Computation of Working Capital

(i) Number of Operating Cycles per Year
 $= 365 / \text{Duration Operating Cycle} = 365 / 110.24 = 3.311$

| | |
|-------------------------------|-------------|
| (ii) Total Operating Expenses | ₹ |
| Total Cost of Goods sold | 1,20,00,000 |
| Add: Administration Expenses | 14,00,000 |
| Add: Selling Expenses | 6,00,000 |
| | 1,40,00,000 |

(iii) Working Capital Required $\frac{\text{Total Operating Expenses}}{\text{Number of Operating Cycles per year}}$
 $= \frac{1,40,00,000}{3.311} = ₹ 42,28,329.81$

Question 17

The following information is provided by MNP Ltd. for the year ending 31st March, 2020:

| | |
|---|--------------|
| Raw Material Storage period | 45 days |
| Work-in-Progress conversion period | 20 days |
| Finished Goods storage period | 25 days |
| Debt Collection period | 30 days |
| Creditors payment period | 60 days |
| Annual Operating Cost | Rs.25,00,000 |
| (Including Depreciation of Rs.2,50,000) | |
| Assume 360 days in a year. | |
| You are required to calculate: | |

- Operating Cycle period
- Number of Operating Cycle in a year.
- Amount of working capital required for the company on a cost basis.
- The company is a market leader in its product and it has no competitor in the market. Based on a market survey it is planning to discontinue sales on credit and deliver products based on pre-payments in order to reduce its working capital requirement substantially. You are required to compute the reduction in working capital requirement in such a scenario. (PYP 5 Marks, Jan'21)

Answer 17

- (i) Calculation of Operating Cycle Period:
 $\text{Operating Cycle Period} = R + W + F + D - C$
 $= 45 + 20 + 25 + 30 - 60 = 60 \text{ days}$

(ii) Number of Operating Cycle in a Year

$$= \frac{360}{\text{Operating cycle period}} = \frac{360}{60} = 6$$

(iii) Amount of Working Capital Required

$$= \frac{\text{Annual operating cost}}{\text{Number of operating cyc}} = \frac{\text{Rs.25,00,000} - 2,50,000}{6}$$

$$\frac{\text{Rs.22,50,000}}{6} = ₹ 3,75,000$$

(iv) Reduction in Working Capital

$$\text{Operating Cycle Period} = R + W + F - C$$

$$= 45 + 20 + 25 - 60 = 30 \text{ days}$$

$$\text{Amount of Working Capital Required} = \frac{\text{Rs.22,50,000}}{360} \times 30 = \text{Rs.1,87,500}$$

$$\text{Reduction in Working Capital} = \text{Rs.3,75,000} - \text{Rs.1,87,500} = \text{Rs.1,87,500}$$

Note: If we use Total Cost basis, then amount of Working Capital required will be Rs.4,16,666.67 (approx.) and Reduction in Working Capital will be Rs.2,08,333.33 (approx.)

Question 18

PK Ltd., a manufacturing company, provides the following information:

| | (Rs.) |
|---|-------------|
| Sales | 1,08,00,000 |
| Raw Material Consumed | 27,00,000 |
| Labour Paid | 21,60,000 |
| Manufacturing Overhead (Including Depreciation for the year ₹ 3,60,000) | 32,40,000 |
| Administrative & Selling Overhead | 10,80,000 |

Additional Information:

- Receivables are allowed 3 months' credit.
- Raw Material Supplier extends 3 months' credit.
- Lag in payment of Labour is 1 month.
- Manufacturing Overhead are paid one month in arrears.
- Administrative & Selling Overhead is paid 1-month advance.
- Inventory holding period of Raw Material & Finished Goods are of 3 months.
- Work-in-Progress is Nil.
- PK Ltd. sells goods at Cost plus 33⅓%.
- Cash Balance ₹ 3,00,000.
- Safety Margin 10%.

You are required to compute the Working Capital Requirements of PK Ltd. on Cash Cost basis. (PYP 10 Marks, Nov'20)

Answer 18

Statement showing the requirements of Working Capital (Cash Cost basis)

| Particulars | (Rs.) | (Rs.) |
|-------------|-------|-------|
|-------------|-------|-------|



| | | |
|---|-----------|-----------|
| A. Current Assets: | | |
| Inventory: | | |
| Stock of Raw material (Rs.27,00,000 × 3/12) | 6,75,000 | |
| Stock of Finished goods (₹ 77,40,000 × 3/12) | 19,35,000 | |
| Receivables (₹ 88,20,000 × 3/12) | 22,05,000 | |
| Administrative and Selling Overhead (Rs.10,80,000 × 1/12) | 90,000 | |
| Cash in Hand | 3,00,000 | |
| Gross Working Capital | 52,05,000 | 52,05,000 |
| B. Current Liabilities: | | |
| Payables for Raw materials* (Rs.27,00,000 × 3/12) | 6,75,000 | |
| Outstanding Expenses: | | |
| Wages Expenses (Rs.21,60,000 × 1/12) | 1,80,000 | |
| Manufacturing Overhead (Rs.28,80,000 × 1/12) | 2,40,000 | |
| Total Current Liabilities | 10,95,000 | 10,95,000 |
| Net Working Capital (A-B) | | 41,10,000 |
| Add: Safety margin @ 10% | | 4,11,000 |
| Total Working Capital requirements | | 45,21,000 |

Working Notes:(i)

| (A) Computation of Annual Cash Cost of Production | (Rs.) |
|---|-----------|
| Raw Material consumed | 27,00,000 |
| Wages (Labour paid) | 21,60,000 |
| Manufacturing overhead (₹ 32,40,000 - ₹ 3,60,000) | 28,80,000 |
| Total cash cost of production | 77,40,000 |
| (B) Computation of Annual Cash Cost of Sales | (Rs.) |
| Cash cost of production as in (A) above | 77,40,000 |
| Administrative & Selling overhead | 10,80,000 |
| Total cash cost of sales | 88,20,000 |

*Purchase of Raw material can also be calculated by adjusting Closing Stock and Opening Stock (assumed nil). In that case Purchase will be Raw material consumed +Closing Stock-Opening Stock i.e. Rs.27,00,000 + ₹6,75,000 - Nil = Rs.33,75,000. Accordingly, Total Working Capital requirements (Rs.43,35,375) can be calculated.

Question 19

Bitu Limited manufactures used in the steel industry. The following information regarding the company is given for your consideration:

- Expected level of production 9000 units per annum.
- Raw materials are expected to remain in store for an average of two months before issue to production.
- Work-in-progress (50 percent complete as to conversion cost) will approximate to 1/2 month's production.
- Finished goods remain in warehouse on an average for one month.



- (v) Credit allowed by suppliers is one month.
- (vi) Two month's credit is normally allowed to debtors.
- (vii) A minimum cash balance of ₹ 67,500 is expected to be maintained.
- (viii) Cash sales are 75 percent less than the credit sales.
- (ix) Safety margin of 20 percent to cover unforeseen contingencies.
- (x) The production pattern is assumed to be even during the year.
- (xi) The cost structure for Bita Limited's product is as follows:

| | Rs. |
|--|--------------|
| Raw Materials | 80 per unit |
| Direct Labour | 20 per unit |
| Overheads (including depreciation Rs.20) | 80 per unit |
| Total Cost | 180 per unit |
| Profit | 20 per unit |
| Selling Price | 200 per unit |

You are required to estimate the working capital requirement of Bita limited. (PYP 10 Marks, May'19)

Answer 19

Statement showing Estimate of Working Capital Requirement

| | (Amount in ₹) | (Amount in ₹) |
|--|---------------|---------------|
| A. Current Assets | | |
| (i) Inventories: | | |
| - Raw material inventory $\left[\frac{9,000 \text{ Units} \times \text{Rs.} 80}{12 \text{ Month}} \times 2 \text{ Month} \right]$ | | 1,20,000 |
| - Work in Progress: | | |
| Raw material $\left[\frac{9,000 \text{ Units} \times \text{Rs.} 80}{12 \text{ Month}} \times 0.5 \text{ Month} \right]$ | 30,000 | |
| Wages $\left[\frac{9,000 \text{ Units} \times \text{Rs.} 60}{12 \text{ Month}} \times 0.5 \text{ Month} \right] \times 50\%$ | 3,750 | |
| Overheads $\left[\frac{9,000 \text{ Units} \times \text{Rs.} 160}{12 \text{ Month}} \times 0.5 \text{ Month} \right] \times 50\%$ | 11,250 | 45,000 |
| Finished goods (inventory held for 1 months) $\left[\frac{9,000 \text{ Units} \times \text{Rs.} 160}{12 \text{ Month}} \times 1 \text{ Month} \right]$ | | 1,20,000 |
| (ii) Debtors (for 2 months) $\left[\frac{9,000 \text{ Units} \times \text{Rs.} 160}{12 \text{ Month}} \times 2 \text{ Month} \right] \times 80\%$ Or $\left[\frac{11,52,000}{12 \text{ Month}} \times 2 \text{ Month} \right]$ | | 1,92,000 |
| (iii) Cash balance expected | | 67,500 |
| Total Current assets | | 5,44,500 |
| B. Current Liabilities | | |
| (i) Creditors for Raw material (1 month) $\left[\frac{9,000 \text{ Units} \times \text{Rs.} 80}{12 \text{ Month}} \times 1 \text{ Month} \right]$ | | 60,000 |

| | | |
|----------------------------------|--|----------|
| Total current liabilities | | 60,000 |
| Net working capital (A – B) | | 4,84,500 |
| Add: Safety margin of 20 percent | | 96,900 |
| Working capital Requirement | | 5,81,400 |

Working Notes:

1. If Credit sales is x, then cash sales are x-75% of x i.e. x/4. Or $x + 0.25x = \text{Rs. } 18,00,000$
 Or $x = \text{Rs. } 14,40,000$
 So, credit Sales is Rs.14,40,000
2. Hence, Cash cost of credit sales = $\left[\frac{\text{Rs. } 14,40,000}{5} \times 4 \right] = \text{Rs. } 11,52,000$
3. It is assumed that safety margin of 20% is on net working capital.
4. No information is given regarding lag in payment of wages, hence ignored assuming it is paid regularly.
5. Debtors/Receivables is calculated based on total cost.
6. [If Debtors/Receivables is calculated based on sales, then debtors will be

$$\left[\frac{9,000 \text{ Units} \times \text{Rs. } 200}{12 \text{ month}} \times 2 \text{ month} \right] \times 80\% \text{ or } \left[\frac{14,40,000}{12 \text{ month}} \times 2 \text{ month} \right] = \text{Rs. } 2,40,000$$

Then Total Current assets will be ₹ 5,92,500 and accordingly Net working capital and Working capital requirement will be ₹ 5,32,500 and ₹ 6,39,000 respectively].

Question 20

“Permanent working capital and fluctuating (temporary) working capital, both are necessary to facilitate production and sales through the operating cycle.” - Describe. (PYP 4 Marks May ‘23)

Answer 20

Both kinds of working capital i.e. permanent and fluctuating (temporary) are necessary to facilitate production and sales through the operating cycle:

Permanent working capital refers to the base working capital, which is the minimum level of investment in the current assets that is carried by the entity at all times to carry its day to day activities. It generally stays invested in the business unless the operations are scaled up or down permanently which would also result in increase or decrease in permanent working capital. It is generally financed by long term sources of finance.

Temporary working capital refers to that part of total working capital, which is required by an entity in addition to the permanent working capital. It is also called variable or fluctuating working capital which is used to finance the short-term working capital requirements which arises due to fluctuation in sales volume. For instance, an organization would maintain increased levels of inventory to meet increased seasonal demand.



Chapter 9.2 Treasury & Cash Management

Question 1

STATE Virtual Banking? DISCUSS its advantages (MTP 4 Marks, April'19).

Answer 1

Virtual Banking and its Advantages

Virtual banking refers to the provision of banking and related services through the use of information technology without direct recourse to the bank by the customer.

The advantages of virtual banking services are as follows:

- ✓ Lower cost of handling a transaction.
- ✓ The increased speed of response to customer requirements.
- ✓ The lower cost of operating branch network along with reduced staff costs leads to cost efficiency.

Virtual banking allows the possibility of improved and a range of services being made available to the customer rapidly, accurately and at his convenience.

Question 2

EXPLAIN Concentration Banking (MTP 2 Marks, April'19)

Answer 2

Concentration Banking: In concentration banking the company establishes a number of strategic collection centers in different regions instead of a single collection center at the head office. This system reduces the period between the time a customer mails in his remittances and the time when they become spendable funds with the company. Payments received by the different collection centers are deposited with their respective local banks which in turn transfer all surplus funds to the concentration bank of head office.

Question 3

A firm maintains a separate account for cash disbursement. Total disbursement are Rs.10,50,000 per month or Rs. 1,26,00,000 per year. Administrative and transaction cost of transferring cash to disbursement account is Rs.20 per transfer. Marketable securities yield is 8% per annum.

COMPUTE the optimum cash balance according to William J. Baumol model. [MTP 2 Marks, Oct'19, Old & New SM]

Answer 3

$$\text{The optimum cash balance } C = \sqrt{\frac{2 \times \text{Rs.} 1,26,00,000 \times \text{Rs.} 20}{0.08}} = \text{Rs.} 79,372.54$$

Question 4

EXPLAIN Billing float and Mail float with reference to management of cash. [MTP 2 Marks, Oct'20]

Answer 4

Billing Float: An invoice is the formal document that a seller prepares and sends to the purchaser as the payment request for goods sold or services provided. The time between the sale and the mailing of the invoice is the billing float.

Mail Float: This is the time when a cheque is being processed by post office, messenger service or other means of delivery.

Question 5

Write a short note on electronic fund transfer. [MTP 2 Marks, Oct'21]

Answer 5

Electronic Fund Transfer: With the developments which took place in the information technology, the present banking system has switched over to the computerization of banks branches to offer efficient banking services and cash management services to their customers. The network will be linked to the



different branches, banks. This helped the customers in the following ways:

- (i) Instant updating of accounts.
- (ii) Quick transfer of funds.
- (iii) Instant information about foreign exchange rates.

Question 6

You are given the following information:

- (i) Estimated monthly Sales are as follows:

| | ₹ | | ₹ |
|----------|----------|-----------|----------|
| January | 5,50,000 | June | 4,40,000 |
| February | 6,60,000 | July | 5,50,000 |
| March | 7,70,000 | August | 4,40,000 |
| April | 4,40,000 | September | 3,30,000 |
| May | 3,30,000 | October | 5,50,000 |

- (ii) Wages and Salaries are estimated to be payable as follows:

| | ₹ | | ₹ |
|-------|--------|-----------|--------|
| April | 49,500 | July | 55,000 |
| May | 44,000 | August | 49,500 |
| June | 55,000 | September | 49,500 |

- (iii) Of the sales, 75% is on credit and 25% for cash. 60% of the credit sales are collected within one month and the balance in two months. There are no bad debt losses.
- (iv) Purchases amount to 75% of sales and are made and paid for in the month preceding the sales.
- (v) The firm has taken a loan of ₹6,00,000. Interest @ 12% p.a. has to be paid quarterly in January, April and so on.
- (vi) The firm is to make payment of tax of ₹26,000 in July 2023.
- (vii) The firm had a cash balance of ₹35,000 on 1st April 2023 which is the minimum desired level of cash balance. Any cash surplus/deficit above/below this level is made up by temporary investments/liquidation of temporary investments or temporary borrowings at the end of each month (interest on these to be ignored).

Required:

PREPARE monthly cash budgets for six months beginning from April, 2023 on the basis of the above information. (MTP 10 Marks March '23) (Same concept different figures MTP 10 Marks Oct '19, MTP 10 Marks Mar'21)

Answer 6

Computation – Collections from Customers

| Particulars | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep |
|-------------|----------|----------|----------|----------|----------|----------|----------|----------|
| | (₹) | (₹) | (₹) | (₹) | (₹) | (₹) | (₹) | (₹) |
| Total Sales | 6,60,000 | 7,70,000 | 4,40,000 | 3,30,000 | 4,40,000 | 5,50,000 | 4,40,000 | 3,30,000 |



| | | | | | | | | |
|---|----------|----------|----------|----------|----------|----------|----------|----------|
| Credit Sales (75% of total Sales) | 4,95,000 | 5,77,500 | 3,30,000 | 2,47,500 | 3,30,000 | 4,12,500 | 3,30,000 | 2,47,500 |
| Collection (within one month) | | 2,97,000 | 3,46,500 | 1,98,000 | 1,48,500 | 1,98,000 | 2,47,500 | 1,98,000 |
| Collection (within two months) | | | 1,98,000 | 2,31,000 | 1,32,000 | 99,000 | 1,32,000 | 1,65,000 |
| Total Collections | | | 5,44,500 | 4,29,000 | 2,80,500 | 2,97,000 | 3,79,500 | 3,63,000 |

Monthly Cash Budget for Six Months: April to September 2023

| Particulars | April | May | June | July | August | Sept. |
|--|-----------|-----------|----------|----------|-----------|----------|
| | (₹) | (₹) | (₹) | (₹) | (₹) | (₹) |
| Receipts: | | | | | | |
| Opening Balance | 35,000 | 35,000 | 35,000 | 35,000 | 35,000 | 35,000 |
| Cash Sales | 1,10,000 | 82,500 | 1,10,000 | 1,37,500 | 1,10,000 | 82,500 |
| Collections from Debtors | 5,44,500 | 4,29,000 | 2,80,500 | 2,97,000 | 3,79,500 | 3,63,000 |
| Total Receipts (A) | 6,89,500 | 5,46,500 | 4,25,500 | 4,69,500 | 5,24,500 | 4,80,500 |
| Payments: | | | | | | |
| Purchases | 2,47,500 | 3,30,000 | 4,12,500 | 3,30,000 | 2,47,500 | 4,12,500 |
| Wages and Salaries | 49,500 | 44,000 | 55,000 | 55,000 | 49,500 | 49,500 |
| Interest on Loan | 18,000 | ----- | ----- | 18,000 | ----- | ----- |
| Tax Payment | ----- | ----- | ----- | 26,000 | ----- | ----- |
| Total Payment (B) | 3,15,000 | 3,74,000 | 4,67,500 | 4,29,000 | 2,97,000 | 4,62,000 |
| Minimum Cash Balance | 35,000 | 35,000 | 35,000 | 35,000 | 35,000 | 35,000 |
| Total Cash Required (C) | 3,50,000 | 4,09,000 | 5,02,500 | 4,64,000 | 3,32,000 | 4,97,000 |
| Surplus/ (Deficit) (A)-(C) | 3,39,500 | 1,37,500 | -77,000 | 5,500 | 1,92,500 | -16,500 |
| Investment/Financing: | | | | | | |
| Total effect of (Invest)/ Financing (D) | -3,39,500 | -1,37,500 | 77,000 | -5,500 | -1,92,500 | 16,500 |
| Closing Cash Balance (A) + (D) - (B) | 35,000 | 35,000 | 35,000 | 35,000 | 35,000 | 35,000 |

Question 7

Write short notes on the following:

STATE the functions of treasury department. (RTP Nov '19)

Answer 7

- Cash Management:** It involves efficient cash collection process and managing payment of cash both inside the organization and to third parties. There may be complete centralization within a group treasury or the treasury may simply advise subsidiaries and divisions on policy matter viz., collection/payment periods, discounts, etc.

Treasury will also manage surplus funds in an investment portfolio. Investment policy will consider future needs for liquid funds and acceptable levels of risk as determined by company policy.



2. **Currency Management:** The treasury department manages the foreign currency risk exposure of the company. In a large multinational company (MNC) the first step will usually be to set off intra-group indebtedness. The use of matching receipts and payments in the same currency will save transaction costs. Treasury might advise on the currency to be used when invoicing overseas sales.

The treasury will manage any net exchange exposures in accordance with company policy. If risks are to be minimized then forward contracts can be used either to buy or sell currency forward.

3. **Fund Management:** Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs. Treasury department will also participate in the decision on capital structure and forecast future interest and foreign currency rates.
4. **Banking:** It is important that a company maintains a good relationship with its bankers. Treasury department carry out negotiations with bankers and act as the initial point of contact with them. Short-term finance can come in the form of bank loans or through the sale of commercial paper in the money market.
5. **Corporate Finance:** Treasury department is involved with both acquisition and divestment activities within the group. In addition, it will often have responsibility for investor relations. The latter activity has assumed increased importance in markets where share-price performance is regarded as crucial and may affect the company's ability to undertake acquisition activity or, if the price falls drastically, render it vulnerable to a hostile bid.

Question 8

You are given below the Profit & Loss Accounts for two years for a company:

Profit and Loss Account

| | Year 1 | Year 2 | | Year 1 | Year 2 |
|---------------------------|-------------|-------------|------------------|-------------|-------------|
| | (₹) | (₹) | | (₹) | (₹) |
| To Opening stock | 32,00,000 | 40,00,000 | By Sales | 3,20,00,000 | 4,00,00,000 |
| To Raw materials | 1,20,00,000 | 1,60,00,000 | By Closing stock | 40,00,000 | 60,00,000 |
| To Stores | 38,40,000 | 48,00,000 | By Misc. Income | 4,00,000 | 4,00,000 |
| To Manufacturing Expenses | 51,20,000 | 64,00,000 | | | |
| To Other Expenses | 40,00,000 | 40,00,000 | | | |
| To Depreciation | 40,00,000 | 40,00,000 | | | |
| To Net Profit | 42,40,000 | 72,00,000 | | - | - |
| | 3,64,00,000 | 4,64,00,000 | | 3,64,00,000 | 4,64,00,000 |

Sales are expected to be ₹ 4,80,00,000 in year 3.

As a result, other expenses will increase by ₹ 20,00,000 besides other charges. Only raw materials are in stock. Assume sales and purchases are in cash terms and the closing stock is expected to go up by the same amount as between year 1 and 2. You may assume that no dividend is being paid. The Company can use 75% of the cash generated to service a loan. COMPUTE how much cash from operations will be available in year 3 for the purpose? Ignore income tax. (RTP May 22, Old & New SM)

Answer 8

Projected Profit and Loss Account for the year 3

| Particulars | Year 2 Actual (₹ in lakhs) | Year 3 Projected (₹ in lakhs) | Particulars | Year 2 Actual(₹ in lakhs) | Year 3 Projected (₹ in lakhs) |
|-------------|----------------------------------|-------------------------------------|-------------|---------------------------------|-------------------------------------|
|-------------|----------------------------------|-------------------------------------|-------------|---------------------------------|-------------------------------------|



| | | | | | |
|-----------------------|--------|--------|-----------------|--------|--------|
| To Materials consumed | 140.00 | 168.00 | By Sales | 400.00 | 480.00 |
| To Stores | 48.00 | 57.60 | By Misc. Income | 4.00 | 4.00 |
| To Mfg. Expenses | 64.00 | 76.80 | | | |
| To Other expenses | 40.00 | 60.00 | | | |
| To Depreciation | 40.00 | 40.00 | | | |
| To Net profit | 72.00 | 81.60 | | | |
| | 404.00 | 484.00 | | 484.00 | 484.00 |

Cash Flow:

| Particulars | (₹ in lakhs) |
|---|--------------|
| Profit | 81.60 |
| Add: Depreciation | 40.00 |
| | 121.60 |
| Less: Cash required for increase in stock | 20.00 |
| Net cash inflow | 101.60 |

Available for servicing the loan: 75% of ₹ 1,01,60,000 or ₹ 76,20,000

Working Notes:

- (i) Material consumed in year 1 = $(32 + 120 - 40)/320 = 35\%$ Material consumed in year 2 = $(40 + 160 - 60)/400 = 35\%$

Likely consumption in year 3 = $480 \times \frac{35}{100} = \text{Rs. } 168 \text{ (lakhs)}$

- (ii) Stores are 12% of sales & Manufacturing expenses are 16% of sales for both the years.

Question 9

A company was incorporated w.e.f. 1st April, 2021. Its authorised capital was ₹ 1,00,00,000 divided into 10 lakh equity shares of ₹ 10 each. It intends to raise capital by issuing equity shares of ₹ 50,00,000 (fully paid) on 1st April. Besides this, a loan of ₹ 6,50,000 @ 12% per annum will be obtained from a financial institution on 1st April and further borrowings will be made at same rate of interest on the first day of the month in which borrowing is required. All borrowings will be repaid along with interest on the expiry of one year. The company will make payment for the following assets in April.

| Particulars | (₹) |
|------------------------|-----------|
| Plant and Machinery | 10,00,000 |
| Land and Building | 20,00,000 |
| Furniture | 5,00,000 |
| Motor Vehicles | 5,00,000 |
| Stock of Raw Materials | 5,00,000 |

The following further details are available:

(1) Projected Sales (April-September):

| | (₹) |
|-------|-----------|
| April | 15,00,000 |
| May | 17,50,000 |
| June | 17,50,000 |
| July | 20,00,000 |



| | |
|-----------|-----------|
| August | 20,00,000 |
| September | 22,50,000 |

- (2) Gross profit margin will be 25% on sales.
- (3) The company will make credit sales only and these will be collected in the second month following sales.
- (4) Creditors will be paid in the first month following credit purchases. There will be credit purchases only.
- (5) The company will keep minimum stock of raw materials of ₹ 5,00,000.
- (6) Depreciation will be charged @ 10% per annum on cost on all fixed assets.
- (7) Payment of miscellaneous expenses of ₹ 50,000 will be made in April.
- (8) Wages and salaries will be ₹ 1,00,000 each month and will be paid on the first day of the next month.
- (9) Administrative expenses of ₹ 50,000 per month will be paid in the month of their incurrence.
- (10) No minimum cash balance is required.

You are required to PREPARE the monthly cash budget (April-September), the projected Income Statement for the 6 months period and the projected Balance Sheet as on 30th September, 2021.(RTP Nov'22)

Answer 9

| | April | May | June | July | August | September |
|---|-----------|-----------|-----------|-----------|-----------|-----------|
| Opening cash balance | - | 10,50,000 | - | 1,37,500 | 5,25,000 | 7,25,000 |
| A. Cash inflows | | | | | | |
| Equity shares | 50,00,000 | - | - | - | - | - |
| Loans (Refer to working note 1) | 6,50,000 | 1,25,000 | - | - | - | - |
| Receipt from debtors | - | - | 15,00,000 | 17,50,000 | 17,50,000 | 20,00,000 |
| Total (A) | 56,50,000 | 11,75,000 | 15,00,000 | 18,87,500 | 22,75,000 | 27,25,000 |
| B. Cash Outflows | | | | | | |
| Plant and Machinery | 10,00,000 | - | - | - | - | - |
| Land and Building | 20,00,000 | - | - | - | - | - |
| Furniture | 5,00,000 | - | - | - | - | - |
| Motor Vehicles | 5,00,000 | - | - | - | - | - |
| Stock of raw materials (Minimum stock) | 5,00,000 | - | - | - | - | - |
| Miscellaneous expenses | 50,000 | - | - | - | - | - |
| Payment to creditors for credit purchases (Refer to working note 2) | - | 10,25,000 | 12,12,500 | 12,12,500 | 14,00,000 | 14,00,000 |
| Wages and salaries | - | 1,00,000 | 1,00,000 | 1,00,000 | 1,00,000 | 1,00,000 |
| Admn. expenses | 50,000 | 50,000 | 50,000 | 50,000 | 50,000 | 50,000 |
| Total :(B) | 46,00,000 | 11,75,000 | 13,62,500 | 13,62,500 | 15,50,000 | 15,50,000 |
| Closing balance (A)-(B) | 10,50,000 | - | 1,37,500 | 5,25,000 | 7,25,000 | 11,75,000 |

Budgeted Income Statement for six-month period ending 30th September

| Particulars | (₹) | Particulars | (₹) |
|-----------------------|-----------|------------------|-------------|
| To Purchases | 83,37,500 | By Sales | 1,12,50,000 |
| To Wages and Salaries | 6,00,000 | By Closing stock | 5,00,000 |



| | | | |
|--|-------------|---------------------|-------------|
| To Gross profit c/d | 28,12,500 | | |
| | 1,17,50,000 | | 1,17,50,000 |
| To Admn. expenses | 3,00,000 | By Gross profit b/d | 28,12,500 |
| To Depreciation | 2,00,000 | | |
| (10% on ₹ 40 lakhs for six months) | | | |
| To Accrued interest on loan (Refer to working note 3) | 45,250 | | |
| To Miscellaneous expenses | 50,000 | | |
| To Net profit c/d | 22,17,250 | | |
| | 28,12,500 | | 28,12,500 |

Projected Balance Sheet as on 30th September 2021

| Liabilities | | | Assets | | | Amount(₹) |
|--|-----------|-------------|---------------------|-----------|-----------|-----------|
| Share Capital: | | | Fixed Assets: | | | |
| Authorized capital | | | Land and Building | 20,00,000 | | |
| Less: Depreciation | | 1,00,00,000 | Less: Depreciation | 1,00,000 | 19,00,000 | |
| Issued, subscribed and paid-up capital 5,00,000 equity shares of ₹ 10 each | | 50,000 | Plant and Machinery | 10,00,000 | | |
| Reserve and Surplus: | | | Less: Depreciation | 50,000 | 9,50,000 | |
| Profit and Loss | | 22,17,250 | Furniture | 5,00,000 | | |
| Long-term loans | | 7,75,000 | Less: Depreciation | 25,000 | 4,75,000 | |
| Current liabilities and provisions: | | | Motor Vehicles | 5,00,000 | | |
| Sundry creditors | 15,87,500 | | Less: Depreciation | 25,000 | 4,75,000 | 38,00,000 |
| Accrued interest | 45,250 | | Current Assets: | | | |
| Outstanding | 1,00,000 | 17,32,750 | Stock | | 5,00,000 | |
| | | | Sundry debtors | | 42,50,000 | |
| | | | Cash | | 11,75,000 | 59,25,000 |
| expenses | | 97,75,000 | | | | 97,75,000 |
| | | | | | | |

Working Notes:

Subsequent Borrowings Needed

(₹)

| | April | May | June | July | August | September |
|----------------|-----------|-----|------|------|--------|-----------|
| A. Cash Inflow | | | | | | |
| Equity shares | 50,00,000 | | | | | |



| | | | | | | |
|--------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Loans | 6,50,000 | | | | | |
| Receipt from debtors | - | - | 15,00,000 | 17,50,000 | 17,50,000 | 20,00,000 |
| Total (A) | 56,50,000 | - | 15,00,000 | 17,50,000 | 17,50,000 | 20,00,000 |
| B. Cash Outflow | | | | | | |
| Purchase of fixed assets | 40,00,000 | | | | | |
| Stock | 5,00,000 | | | | | |
| Miscellaneous expenses | 50,000 | | | | | |
| Payment to creditors | - | 10,25,000 | 12,12,500 | 12,12,500 | 14,00,000 | 14,00,000 |
| Wages and salaries | - | 1,00,000 | 1,00,000 | 1,00,000 | 1,00,000 | 1,00,000 |
| Administrative expenses | 50,000 | 50,000 | 50,000 | 50,000 | 50,000 | 50,000 |

(1) There is shortage of cash in May of ₹ 1,25,000 which will be met by borrowings in May.

(2) Payment to Creditors

Purchases = Cost of goods sold - Wages and salaries

Purchases for April = (75% of 15,00,000) - ₹ 1,00,000 = ₹ 10,25,000

(Note: Since gross margin is 25% of sales, cost of manufacture i.e. materials plus wages and salaries should be 75% of sales)

Hence, Purchases = Cost of manufacture minus wages and salaries of ₹ 1,00,000)

The creditors are paid in the first month following purchases.

Therefore, payment in May is ₹ 10,25,000

The same procedure will be followed for other months.

| | | | |
|-----------------|--------------------|--------------|---------------|
| April | (75% of 15,00,000) | - ₹ 1,00,000 | = ₹ 10,25,000 |
| May | (75% of 17,50,000) | - ₹ 1,00,000 | = ₹ 12,12,500 |
| June | (75% of 17,50,000) | - ₹ 1,00,000 | = ₹ 12,12,500 |
| July | (75% of 20,00,000) | - ₹ 1,00,000 | = ₹ 14,00,000 |
| August | (75% of 20,00,000) | - ₹ 1,00,000 | = ₹ 14,00,000 |
| September | (75% of 22,50,000) | - ₹ 1,00,000 | = ₹ 15,87,500 |
| Minimum Stock | | | ₹ 5,00,000 |
| Total Purchases | | | ₹ 83,37,500 |

(3) Accrued Interest on Loan

| | |
|--|--------|
| 12% interest on ₹ 6,50,000 for 6 months | 39,000 |
| Add: 12% interest on ₹ 1,25,000 for 5 months | 6,250 |
| | 45,250 |



Explain Electronic Cash Management System. (PYP 4 Marks, Jan'21)

Answer 10

Electronic Cash Management System: Most of the cash management systems now-a-days are electronically based, since 'speed' is the essence of any cash management system. Electronically, transfer of data as well as funds play a key role in any cash management system. Various elements in the process of cash management are linked through a satellite. Various places that are interlinked may be the place where the instrument is collected, the place where cash is to be transferred in company's account, the place where the payment is to be transferred etc.

Question 11

Slide Ltd. is preparing a cash flow forecast for the three months' period from January to the end of March. The following sales volumes have been forecasted:

| Months | December | January | February | March | April |
|---------------|----------|---------|----------|-------|-------|
| Sales (units) | 1,800 | 1,875 | 1,950 | 2,100 | 2,250 |

Selling price per unit is Rs.600. Sales are all on one-month credit. Production of goods for sale takes place one month before sales. Each unit produced requires two units of raw materials costing Rs.150 per unit. No raw material inventory is held. Raw materials purchases are on one-month credit. Variable overheads and wages equal to Rs.100 per unit are incurred during production and paid in the month of production. The opening cash balance on 1st January is expected to be ₹ 35,000. A long term loan of ₹ 2,00,000 is expected to be received in the month of March. A machine costing ₹ 3,00,000 will be purchased in March.

- Prepare a cash budget for the months of January, February and March and calculate the cash balance at the end of each month in the three months' period.
- Calculate the forecast current ratio at the end of the three months' period. (PYP 10 Marks, Nov'19)

Answer 11

Working

1. Calculation of Collection from Trade Receivables:

| Particulars | December | January | February | March |
|---|-----------|-----------|-----------|-----------|
| Sales (units) | 1,800 | 1,875 | 1,950 | 2,100 |
| Sales (@ Rs.600 per unit) / Trade Receivables (Debtors) (Rs.) | 10,80,000 | 11,25,000 | 11,70,000 | 12,60,000 |
| Collection from Trade Receivables (Debtors) (Rs.) | | 10,80,000 | 11,25,000 | 11,70,000 |

2. Calculation of Payment to Trade Payables:

| Particulars | December | January | February | March |
|---|----------|----------|----------|----------|
| Output (units) | 1,875 | 1,950 | 2,100 | 2,250 |
| Raw Material (2 units per output) (units) | 3,750 | 3,900 | 4,200 | 4,500 |
| Raw Material (@ Rs.150 per unit) / Trade Payables (Creditors) (Rs.) | 5,62,500 | 5,85,000 | 6,30,000 | 6,75,000 |
| Payment to Trade Payables (Creditors) (Rs.) | | 5,62,500 | 5,85,000 | 6,30,000 |

3. Calculation of Variable Overheads and Wages:

| Particulars | January | February | March |
|---|----------|----------|----------|
| Output (units) | 1,950 | 2,100 | 2,250 |
| Payment in the same month @ Rs.100 per unit (Rs.) | 1,95,000 | 2,10,000 | 2,25,000 |



a) Preparation of Cash Budget

| Particulars | January (Rs.) | February (Rs.) | March (Rs.) |
|---|------------------|-------------------|----------------|
| Opening Balance | 35,000 | 3,57,500 | 6,87,500 |
| Receipts: | | | |
| Collection from Trade Receivables (Debtors) | 10,80,000 | 11,25,000 | 11,70,000 |
| Receipt of Long-Term Loan | | | 2,00,000 |
| Total (A) | 11,15,000 | 14,82,500 | 20,57,500 |
| Payments: | | | |
| Trade Payables (Creditors) for Materials | 5,62,500 | 5,85,000 | 6,30,000 |
| Variable Overheads and Wages | 1,95,000 | 2,10,000 | 2,25,000 |
| Purchase of Machinery | | | 3,00,000 |
| Total (B) | 7,57,500 | 7,95,000 | 11,55,000 |
| Closing Balance (A – B) | 3,57,500 | 6,87,500 | 9,02,500 |

b) Calculation of Current Ratio

| Particulars | March (Rs.) |
|---|--------------------|
| Output Inventory (i.e. units produced in March) [(2,250 unit's x 2 units of raw material per unit of output x Rs.150 per unit of raw material) + 2,250 unit's x Rs.100 for variable overheads and wages] or, [6,75,000 + 2,25,000] from Working Notes 2 and 3 | 9,00,000 |
| Trade Receivables (Debtors) | 12,60,000 |
| Cash Balance | 9,02,500 |
| Current Assets | 30,62,500 |
| Trade Payables (Creditors) | 6,75,000 |
| Current Liabilities | 6,75,000 |
| Current Ratio (Current Assets / Current Liabilities) | 4.537 prox. |

Question 12

A garment trader is preparing cash forecast for first three months of calendar year 2021. His estimated sales for the forecasted periods are as below:

| | January (₹ '000) | February (₹ '000) | March (₹ '000) |
|--------------------|------------------|-------------------|----------------|
| Total sales | 600 | 600 | 800 |

- The trader sells directly to public against cash payments and to other entities on credit. Credit sales are expected to be four times the value of direct sales to public. He expects 15% customers to pay in the month in which credit sales are made, 25% to pay in the next month and 58% to pay in the next to next month. The outstanding balance is expected to be written off.
- Purchases of goods are made in the month prior to sales and it amounts to 90% of sales and are made on credit. Payments of these occur in the month after the purchase. No inventories of goods are held.
- Cash balance as on 1st January, 2021 is ₹ 50,000.



(iv) Actual sales for the last two months of calendar year 2020 are as below:

| | November (₹ '000) | December (₹ '000) |
|-------------|-------------------|-------------------|
| Total sales | 640 | 880 |

You are required to prepare a monthly cash, budget for the three months from January to March, 2021. (PYP 5 Marks Dec '21)

Answer 12

Working Notes:

(1) Calculation of cash and credit sales (₹ in thousands)

| | Nov. | Dec. | Jan. | Feb. | Mar. |
|-------------------------------------|------|------|------|------|------|
| Total Sales | 640 | 880 | 600 | 600 | 800 |
| Cash Sales (1/5th of total sales) | 128 | 176 | 120 | 120 | 160 |
| Credit Sales (4/5th of total sales) | 512 | 704 | 480 | 480 | 640 |

(2) Calculation of Credit Sales Receipts (₹ in thousands)

| Month | Nov. | Dec. | Jan. | Feb. | Mar. |
|--|--------|--------|--------|--------|--------|
| Forecast Credit sales (Working note 1) | 512.00 | 704.00 | 480.00 | 480.00 | 640.00 |
| Receipts: | | | | | |
| 15% in the month of sales | | | 72.00 | 72.00 | 96.00 |
| 25% in next month | | | 176.00 | 120.00 | 120.00 |
| 58% in next to next month | | | 296.96 | 408.32 | 278.40 |
| Total | | | 544.96 | 600.32 | 494.40 |

Cash Budget (₹ in thousands)

| | Nov. | Dec. | Jan. | Feb. | Mar. |
|--|--------|--------|--------|--------|--------|
| Opening Balance (A) | | | 50.00 | 174.96 | 355.28 |
| Sales | 640.00 | 880.00 | 600.00 | 600.00 | 800.00 |
| Receipts: | | | | | |
| Cash Collection (Working note 1) | | | 120.00 | 120.00 | 160.00 |
| Credit Collections (Working note 2) | | | 544.96 | 600.32 | 494.40 |
| Total (B) | | | 664.96 | 720.32 | 654.40 |
| Purchases (90% of sales in the month prior to sales) | | 540 | 540 | 720 | |
| Payments: | | | | | |
| Payment for purchases (next month) | | | 540 | 540 | 720 |
| Total (C) | | | 540 | 540 | 720 |
| Closing balance(D) = (A + B – C) | | | 174.96 | 355.28 | 289.68 |

Question 13

K Ltd. has a Quarterly cash outflow of ₹ 9,00,000 arising uniformly during the Quarter. The company has an Investment portfolio of Marketable Securities. It plans to meet the demands for cash by periodically selling marketable securities. The marketable securities are generating a return of 12% p.a. Transaction cost of converting investments to cash is ₹ 60. The company uses Baumol model to find out the optimal transaction size for converting marketable securities into cash.

Consider 360 days in a year.

You are required to calculate

- (i) Company's average cash balance,
- (ii) Number of conversions each year and
- (iii) Time interval between two conversions. (PYP 5 Marks Nov '22)

Answer 13

- (i) **Computation of Average Cash balance:**

$$\text{Annual cash outflow (U)} = 9,00,000 \times 4 = ₹36,00,000$$

$$\text{Fixed cost per transaction (P)} = ₹60$$

$$\text{Opportunity cost of one rupee p.a. (S)} = \frac{12}{100} = 0.12$$

$$\text{Optimum cash balance (C)} = \sqrt{\frac{2UP}{S}} = \sqrt{\frac{2 \times 36,00,000 \times 60}{0.12}} = ₹60,000$$

$$\therefore \text{Average Cash balance} = \frac{(0+60,000)}{2} = 30,000$$

- (ii) **Number of conversions p.a.**

$$\text{Annual cash outflow} = ₹36,00,000$$

$$\text{Optimum cash balance} = ₹60,000$$

$$\therefore \text{No. of conversions p.a.} = \frac{36,00,000}{60,000} = 60$$

- (iii) **Time interval between two conversions**

$$\text{No. of days in a year} = 360$$

$$\text{No. of conversions p.a.} = 60$$

$$\therefore \text{Time interval} = \frac{360}{60} = 6 \text{ days}$$

Question 14

Elucidate the fundamental tasks of treasury department of a firm.

(PYP 4 Marks Nov '22)

Answer 14

Fundamental tasks of treasury department of a firm:

- (i) **Cash management:** It involves efficient cash collection process and managing payment of cash both inside the organization and to third parties. Treasury will also manage surplus funds in an investment portfolio.
- (ii) **Currency management:** The treasury department manages the foreign currency risk exposure of the company. In a large multi-national company, the first step will usually be to set off intra-group

indebtedness. The use of matching receipts and payments in the same currency will save transaction costs and will save the organization from any unfavorable exchange movement.

- (iii) **Fund management:** Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs. It also facilitates temporary investment of surplus funds by mapping the time gap between funds inflow and outflow.
- (iv) **Banking:** It is important that a company maintains a good relationship with its bankers. Treasury department carry out negotiations with bankers with respect to interest rates, foreign exchange rates etc. and act as the initial point of contact with them.
- (v) **Corporate finance:** Treasury department is involved with both acquisition and divestment activities within the group. In addition, it will often have responsibility for investors' relations.





Chapter 9.3 Management of Inventory

Question 1

A company requires 36,000 units of a product per year at cost of ₹ 100 per unit. Ordering cost per order is ₹ 250 and the carrying cost is 4.5% per year of the inventory cost. Normal lead time is 25 days and safety stock is NIL.

Assume 360 working days in a year.

- Calculate the Reorder Inventory Level.
- Calculate the Economic Order Quantity (EOQ).
- If the supplier offers 1% quantity discount for purchase in lots of 9,000 units or more, should the company accept the proposal? (PYP 5 Marks May'22)

Answer 1

Annual Consumption = 36,000 (A) Ordering Cost = ₹ 250 per order (O)

Carrying Cost = $\frac{4.5}{100} \times 100 = ₹ 4.5$ (C)

Lead Time = 25 days

- Reorder Level = Lead Time × Daily Consumption**

$$25 \times \frac{36000}{360}$$

= 2,500 units

$$\text{Economic Order Quantity (EOQ)} = \sqrt{\frac{2AO}{C}}$$

$$= \sqrt{\frac{2 \times 36,000 \times 250}{4.5}} = 2,000 \text{ units}$$

- Evaluation of Profitability of Quantity Discount Offer:**

- When EOQ is ordered**

| | | (₹) |
|---------------|--|-----------|
| Purchase Cost | (36,000 units × ₹ 100) | 36,00,000 |
| Ordering Cost | [(36,000 units / 2,000 units) × ₹ 250] | 4,500 |
| Carrying Cost | (2,000 units × ½ × ₹ 4.5) | 4,500 |
| Total Cost | | 36,09,000 |

- When Quantity Discount is accepted**

| | | (₹) |
|---------------|--|-----------|
| Purchase Cost | (36,000 units × ₹ 99*) | 35,64,000 |
| Ordering Cost | [(36,000 units / 9,000 units) × ₹ 250] | 1,000 |
| Carrying Cost | (9,000 units × ½ × ₹ 99 × 4.5%) | 20,048 |
| Total Cost | | 35,85,048 |

*Unit Cost = ₹100

Less: Quantity Discount @ 1% $\frac{= ₹1}{= ₹99}$

Advise – The total cost of inventory is lower if Quantity Discount is accepted. Hence, the company is advised to accept the proposal.



Chapter 9.4 Management of Receivables

Question 1 illustration

A company is presently having credit sales of Rs. 12 lakh. The existing credit terms are 1/10, net 45 days and average collection period is 30 days. The current bad debts loss is 1.5%. In order to accelerate the collection process further as also to increase sales, the company is contemplating liberalization of its existing credit terms to 2/10, net 45 days. It is expected that sales are likely to increase by 1/3 of existing sales, bad debts increase to 2% of sales and average collection period to decline to 20 days. The contribution to sales ratio of the company is 22% and opportunity cost of investment in receivables is 15 percent (pre-tax). 50 per cent and 80 percent of customers in terms of sales revenue are expected to avail cash discount under existing and liberalization scheme respectively. The tax rate is 30%. ADVISE, should the company change its credit terms? (Assume 360 days in a year). (Old & New SM) (PYP 5 Marks May '23)

Answer 1

Working Notes:

(i) Calculation of Cash Discount

Cash Discount = Total credit sales × % of customers who take up discount × Rate

$$\text{Present Policy} = \frac{12,00,000 \times 50 \times 0.01}{100} = \text{Rs. 6,000}$$

$$\text{Proposed Policy} = 16,00,000 \times 0.80 \times 0.02 = \text{Rs. 25,600}$$

(ii) Opportunity Cost of Investment in Receivables

$$\text{Present Policy} = 9,36,000 \times (30/360) \times (70\% \text{ of } 15)/100 = 78,000 \times 10.5/100 = \text{Rs. 8,190}$$

$$\text{Proposed Policy} = 12,48,000 \times (20/360) \times 10.5/100 = \text{Rs. 7,280}$$

Statement showing Evaluation of Credit Policies

| Particulars | Present Policy | Proposed Policy |
|---|----------------|-----------------|
| Credit Sales | 12,00,000 | 16,00,000 |
| Variable Cost @ 78%* of sales | 9,36,000 | 12,48,000 |
| Bad Debts @ 1.5% and 2% | 18,000 | 32,000 |
| Cash Discount | 6,000 | 25,600 |
| Profit before tax | 2,40,000 | 2,94,400 |
| Tax @ 30% | 72,000 | 88,320 |
| Profit after Tax | 1,68,000 | 2,06,080 |
| Opportunity Cost of Investment in Receivables | 8,190 | 7,280 |
| Net Profit | 1,59,810 | 1,98,800 |

*Only relevant or variable costs are considered for calculating the opportunity costs on the funds blocked in receivables. Since 22% is contribution, hence the relevant costs are taken to be 78% of the respective sales.

Advise: Proposed policy should be adopted since the net benefit is increased by (Rs. 1,98,800 - 1,59,810) Rs. 38,990.



Question 2

RST Limited is considering relaxing its present credit policy and is in the process of evaluating two proposed policies. Currently, the firm has annual credit sales of Rs 225 lakhs and accounts receivable turnover ratio of 5 times a year. The current level of loss due to bad debts is Rs.7,50,000. The firm is required to give a return of 20% on the investment in new accounts receivables. The company's variable costs are 60% of the selling price. Given the following information, DETERMINE which is a better option?

Amount in lakhs)

| | Present Policy | Policy Option I | Policy Option II |
|------------------------------------|----------------|-----------------|------------------|
| Annual credit sales (Rs) | 225 | 275 | 350 |
| Accounts receivable turnover ratio | 5 | 4 | 3 |
| Bad debt losses (Rs) | 7.5 | 22.5 | 47.5 |

(MTP 10 Marks, Oct'18) (Same concept different figures MTP 5 Marks Oct'20, MTP 5 Marks Oct'22, Old & New SM)

Answer 2

Statement showing Evaluation of Credit Policies (Amount in lakhs)

| | Particulars | Present Policy (Rs.) | Proposed Policy I (Rs.) | Proposed Policy II (Rs.) |
|---|--|----------------------|-------------------------|--------------------------|
| A | Expected Profit : | | | |
| | (a) Credit Sales | 225.00 | 275.00 | 350.00 |
| | (b) Total Cost other than Bad Debts: | | | |
| | Variable Costs | 135.00 | 165.00 | 210.00 |
| | (c) Bad Debts | 7.50 | 22.50 | 47.50 |
| | (d) Expected Profit [(a)-(b)-(c)] | 82.50 | 87.50 | 92.50 |
| B | Opportunity Cost of Investment in Receivables* | 5.40 | 8.25 | 14.00 |
| | Net Benefits [A-B] | 77.10 | 79.25 | 78.50 |

Recommendation: The Proposed Policy I should be adopted since the net benefits under this policy is higher than those under other policies.

Working Note:

***Calculation of Opportunity Cost of Average Investments**

| | | | |
|--------------------|-----------------|--|--|
| Opportunity Cost | = Total Cost | $\times \frac{\text{Collection Period}}{12}$ | $\times \frac{\text{Rate of Return}}{100}$ |
| Present Policy | = Rs.135 lakhs | $\times 2.4/12 \times 20\%$ | = Rs. 5.40 lakhs |
| Proposed Policy I | = Rs. 165 lakhs | $\times 3/12 \times 20\%$ | = Rs. 8.25 lakhs |
| Proposed Policy II | = Rs. 210 lakhs | $\times 4/12 \times 20\%$ | = Rs. 14.00 lakhs |

Question 3

A bank is analyzing the receivables of J Ltd. in order to identify acceptable collateral for a short- term loan. The company's credit policy is 2/10 net 30. The bank lends 80 percent on accounts where customers are not currently overdue and where the average payment period does not exceed 10 days past the net period. A schedule of J Ltd.'s receivables has been prepared. ANALYSE, how much will the bank lend on pledge of receivables, if the bank uses a 10 per cent allowance for cash discount and returns?

| Account | Amount Rs. | Days Outstanding in days | Average Payment Period historically |
|---------|------------|--------------------------|-------------------------------------|
| 74 | 25,000 | 15 | 20 |
| 91 | 9,000 | 45 | 60 |
| 107 | 11,500 | 22 | 24 |



| | | | |
|-----|----------|----|----|
| 108 | 2,300 | 9 | 10 |
| 114 | 18,000 | 50 | 45 |
| 116 | 29,000 | 16 | 10 |
| 123 | 14,000 | 27 | 48 |
| | 1,08,800 | | |

(MTP 7 Marks, March'19)

Answer 3

Analysis of the receivables of J Ltd. by the bank in order to identify acceptable collateral for a short- term loan:

- (i) The J Ltd.'s credit policy is 2/10 net 30.

The bank lends 80 per cent on accounts where customers are not currently overdue and where the average payment period does not exceed 10 days past the net period i.e. thirty days. From the schedule of receivables of J Ltd. Account No. 91 and Account No. 114 are currently overdue and for Account No. 123 the average payment period exceeds 40 days. Hence Account Nos. 91, 114 and 123 are eliminated. Therefore, the selected Accounts Are Account Nos. 74, 107, 108 and 116.

- (ii) Statement showing the calculation of the amount which the bank will lend on a pledge of receivables if the bank uses a 10 per cent allowances for cash discount and returns

| Account No. | Amount (Rs.) | per cent of amount (Rs.) | 80% of amount (Rs.) |
|-------------------|--------------|--------------------------|---------------------|
| | (a) | (b) = 90% of (a) | (c) = 80% of (b) |
| 74 | 25,000 | 22,500 | 18,000 |
| 107 | 11,500 | 10,350 | 8280 |
| 108 | 2,300 | 2,070 | 1,656 |
| 116 | 29,000 | 26,100 | 20,880 |
| Total loan amount | | | 48,816 |

Question 4

Navy Ltd has annual credit sales of Rs. 45 lakhs. Credit terms are 30 days, but its management of receivables has been poor and the average collection period is 50 days, Bad debt is 0.4 per cent of sales. A factor has offered to take over the task of debt administration and credit checking, at an annual fee of 1 per cent of credit sales. Navy Ltd. estimates that it would save Rs. 35,000 per year in administration costs as a result. Due to the efficiency of the factor, the average collection period would reduce to 30 days and bad debts would be zero. The factor would advance 80 per cent of invoiced debts at an annual interest rate of 11 per cent. Navy Ltd. is currently financing receivables from an overdraft costing 10 per cent per year.

If occurrence of credit sales is throughout the year, COMPUTE whether the factor's services should be accepted or rejected. Assume 365 days in a year. (MTP 6 Marks, April'19)

Answer 4

| | Rs. |
|---|----------|
| Present level of receivables is $45 \text{ lakh} \times 50/365$ | 6,16,438 |
| In case of factor, receivables would reduce to $45 \text{ lakhs} \times 30/365$ | 3,69,863 |
| The costs of the existing policy are as follows: | |
| Cost of financing existing receivables: $6,16,438 \times 10\%$ | 61,644 |
| Cost of bad debts: $45 \text{ lakhs} \times 0.4\%$ | 18,000 |
| Cost of current policy | 79,644 |
| The cost under the factor are as follows: | |
| Cost of financing new receivable through factor: | |
| $(\text{Rs. } 3,69,863 \times 0.8 \times 0.11) + (\text{Rs. } 3,69,863 \times 0.2 \times 0.10)$ | 39,945 |
| $= (32,548 + 7,397)$ | |
| Factor's annual fee: $45 \text{ Lakhs} \times 0.01$ | 45,000 |
| Administration costs saved: | (35,000) |



Net cost under factor:

49,945

From the above analysis it is clear that the factor's services are cheaper than Existing policy by Rs. 29,699 (Rs. 79,644 - Rs. 49,945) per year. Hence, the services of the factor should be accepted.

Question 5

GT Ltd. is taking into account the revision of its credit policy with a view to increasing its sales and profit. Currently, all its sales are on one month credit. Other information is as follows:

Contribution

2/5th of Sales Revenue

Additional funds raising cost

20% per annum

The marketing manager of the company has given the following options along with estimates for considerations:

| Particulars | Current Position | Option I | Option II | Option III |
|-----------------------------------|------------------|-----------|-----------|------------|
| Sales Revenue (₹) | 40,00,000 | 42,00,000 | 44,00,000 | 50,00,000 |
| Credit period (in months) | 1 | 1½ | 2 | 3 |
| Bad debts (% of sales) | 2 | 2½ | 3 | 5 |
| Cost of Credit administration (₹) | 24,000 | 26,000 | 30,000 | 60,000 |

You are required to ADVISE the company for the best option.

(MTP 10 Marks Sep'22)

Answer 5

Statement Showing Evaluation of Credit Policies

(₹ in lakhs)

| Particulars | Current position (1 month) | Option I (1.5 months) | Option II (2 months) | Option III (3 months) |
|---|--------------------------------------|-------------------------------------|--------------------------------------|------------------------------------|
| Sales Revenue | 40,00,000 | 42,00,000 | 44,00,000 | 50,00,000 |
| Contribution @ 40% | 16,00,000 | 16,80,000 | 17,60,000 | 20,00,000 |
| Increase in contribution over current level (A) | - | 80,000 | 1,60,000 | 4,00,000 |
| Debtors = (Average Collection period x Credit Sale 12) | 1 × 40,00,000 12 = 3,33,333.33 | 1.5 × 42,00,000 12 = 5,25,000 | 2 × 44,00,000 12 = 7,33,333.33 | 3 × 50,00,000 12 = 12,50,000 |
| Increase in debtors over current level | 2 | 1,91,666.67 | 4,00,000.00 | 9,16,666.67 |
| Cost of funds for additional amount of debtors @ 20% (B) | - | 38,333.33 | 80,000.00 | 1,83,333.33 |
| Credit administrative cost | 24,000 | 26,000 | 30,000 | 60,000 |
| Increase in credit administration cost over present level (C) | ₹ | 2,000 | 6,000 | 36,000 |
| Bad debts | 80,000 | 1,05,000 | 1,32,000 | 2,50,000 |
| Increase in bad debts over current levels (D) | - | 25,000 | 52,000 | 1,70,000 |
| Net gain/loss A – (B + C + D) | - | 14,666.67 | 22,000.00 | 10,666.67 |

Advise: It is suggested that the company GT Ltd. should implement Option II with a net gain of ₹ 22,000 which has a credit period of 2 months.

Question 6

Tony Limited, manufacturer of Colour TV sets is considering the liberalization of existing credit terms to three of their large customers A, B and C. The credit period and likely quantity of TV sets that will be sold to the customers in addition to other sales are as follows:

Quantity sold (No. of TV Sets)



| Credit Period (Days) | A | B | C |
|----------------------|-------|-------|-------|
| 0 | 1,000 | 1,000 | - |
| 30 | 1,000 | 1,500 | - |
| 60 | 1,000 | 2,000 | 1,000 |
| 90 | 1,000 | 2,500 | 1,500 |

The selling price per TV set is ₹ 9,000. The expected contribution is 20% of the selling price. The cost of carrying receivable averages 20% per annum.

You are required:

- COMPUTE the credit period to be allowed to each customer.
(Assume 360 days in a year for calculation purposes).
- DEMONSTRATE the other problems the company might face in allowing the credit period as determined in (a) above? (RTP Nov '18) (Same concept different figures RTP May'20)

Answer 6

In case of customer A, there is no increase in sales even if the credit is given. Hence comparative statement for B & C is given below:

| Particulars | Customer B | | | | Customer C | | | |
|--|------------|-------|-------|-------|------------|----|-------|-------|
| 1. Credit period (days) | 0 | 30 | 60 | 90 | 0 | 30 | 60 | 90 |
| 2. Sales Units | 1,000 | 1,500 | 2,000 | 2,500 | - | - | 1,000 | 1,500 |
| | ₹ in lakhs | | | | ₹ in lakhs | | | |
| 3. Sales Value | 90 | 135 | 180 | 225 | - | - | 90 | 135 |
| 4. Contribution at 20% (A) | 18 | 27 | 36 | 45 | - | - | 18 | 27 |
| 5. Receivables: Credit Period × Sales 360 | - | 11.25 | 30 | 56.25 | - | - | 15 | 33.75 |
| 6. Debtors at cost i.e. 80% of 11.25 | - | 9 | 24 | 45 | - | - | 12 | 27 |
| 7. Cost of carrying debtors at 20% (B) | - | 1.8 | 4.8 | 9 | - | - | 2.4 | 5.4 |
| 8. Excess of contributions over cost of carrying debtors (A – B) | 18 | 25.2 | 31.2 | 36 | - | - | 15.6 | 21.6 |

The excess of contribution over cost of carrying Debtors is highest in case of credit period of 90 days in respect of both the customers B and C. Hence, credit period of 90 days should be allowed to B and C.

Question 7

River limited currently uses the credit terms of 1.5/15 net 45 days and average collection period was 30 days. The company presently having sales of ₹ 50,00,000 and 30% customers availing the discount. The chances of default are currently 5%. Variable cost constitutes 65% and total cost constitute 85% of sales. The company is planning liberalization of credit terms to 2/20 net 50 days. It is expected that sales are likely to increase by ₹ 5,00,000, the default chances are 10% and average collection period will decline to 25 days. There won't be any change in the fixed cost and 50% customers are expected to avail the discount. Tax rate is 35%.

EVALUATE this policy in comparison with the current policy and recommend whether the new policy should be implemented. Assume cost of capital to be 10% (post tax) and 360 days in a year. (RTP May



23)

Answer 7

Evaluation of Credit Policies

| Particulars | | 1.5/15 net 45 | 2/20 net 50 |
|-------------|--------------------------------------|---------------|-------------|
| A | Sales | ₹50,00,000 | ₹55,00,000 |
| B | Variable Cost (65%) | ₹32,50,000 | ₹35,75,000 |
| C | Fixed Cost (20% in 1st Case) | ₹10,00,000 | ₹10,00,000 |
| D | Bad Debts (5% and 10%) | ₹2,50,000 | ₹5,50,000 |
| E | Discounts | | |
| | (₹5000000x30%x1.5%) | ₹22,500 | - |
| | (₹5500000x50%x2%) | - | ₹55,000 |
| F | PBT (A-B-C-D-E) | ₹4,77,500 | ₹3,20,000 |
| G | Tax @ 35% | ₹1,67,125 | ₹1,12,000 |
| H | PAT | ₹3,10,375 | ₹2,08,000 |
| I | Opportunity Cost | | |
| | (₹3250000 + ₹1000000) x 30/360x10% | ₹35,417 | - |
| | (₹3575000 + ₹1000000) x 25/360 x 10% | - | ₹31,771 |
| J | Net Benefit | ₹2,74,958 | ₹1,76,229 |

The new policy leads to lower net benefit for the company. Hence it should not be implemented.

Question 8

A regular customer of your company has approached to you for extension of credit facility for purchasing of goods. On analysis of past performance and on the basis of information supplied, the following pattern of payment schedule emerges:

| Pattern of Payment Schedule | |
|-----------------------------|------------------|
| At the end of 30 days | 20% of the bill |
| At the end of 60 days | 30% of the bill. |
| At the end of 90 days | 30% of the bill |
| At the end of 100 days | 18% of the bill |
| Non-recovery | 2% of the bill |

The customer wants to enter into a firm commitment for purchase of goods of ₹ 40 lakhs in 2022, deliveries to be made in equal quantities on the first day of each quarter in the calendar year. The price per unit of commodity is ₹ 400 on which a profit of ₹ 20 per unit is expected to be made. It is anticipated that taking up of this contract would mean an extra recurring expenditure of ₹ 20,000 per annum. If the opportunity cost is 18% per annum, would you as the finance manager of the company RECOMMEND the grant of credit to the customer? Assume 1 year = 360 days. (RTP Nov'23) (Same concept different figures RTP Nov'19, Old & New SM)

Answer 8

Statement showing the Evaluation of credit Policies

| Particulars | Proposed Policy ₹ |
|---------------------|-------------------|
| A. Expected Profit: | |
| (a) Credit Sales | 40,00,000 |
| (b) Total Cost | |



| | |
|---|-----------|
| (i) Variable Costs (₹ 380 x 10000 units) | 38,00,000 |
| (ii) Recurring Costs | 20,000 |
| | 38,20,000 |
| (c) Bad Debts | 80,000 |
| (d) Expected Profit [(a) – (b) – (c)] | 1,00,000 |
| B. Opportunity Cost of Investments in Receivables | 1,31,790 |
| C. Net Benefits (A – B) | (31,790) |

Recommendation: The Proposed Policy should not be adopted since the net benefits under this policy are negative.

Working Note: Calculation of Opportunity Cost of Average Investments

$$\text{Opportunity Cost} = \text{Total Cost} \times \frac{\text{Collection period}}{360} \times \frac{\text{Rate of Return}}{100}$$

| Particulars | 20% | 30% | 30% | 18% | Total |
|---------------------------------|----------|-----------|-----------|----------|-----------|
| A. Total Cost | 7,64,000 | 11,46,000 | 11,46,000 | 6,87,600 | 37,43,600 |
| B. Collection period | 30/360 | 60/360 | 90/360 | 100/360 | |
| C. Required Rate of Return | 18% | 18% | 18% | 18% | |
| D. Opportunity Cost (A × B × C) | 11,460 | 34,380 | 51,570 | 34,380 | 1,31,790 |

Question 9

TM Limited, a manufacturer of colour TV sets is considering the liberalization of existing credit terms to three of their large customers A, B and C. The credit period and likely quantity of TV sets that will be sold to the customers in addition to other sales are as follows:

Quantity sold (No. of TV Sets)

| Credit Period (Days) | A | B | C |
|----------------------|--------|--------|--------|
| 0 | 10,000 | 10,000 | - |
| 30 | 10,000 | 15,000 | - |
| 60 | 10,000 | 20,000 | 10,000 |
| 90 | 10,000 | 25,000 | 15,000 |

The selling price per TV set is ₹15,000. The expected contribution is 50% of the selling price. The cost of carrying receivable averages 20% per annum. You are required to COMPUTE the credit period to be allowed to each customer. (Assume 360 days in a year for calculation purposes). (May '20)

Answer 9

In case of customer A, there is no increase in sales even if the credit is given. Hence comparative statement for B & C is given below:

| Particulars | Customer B | | | | Customer C | | | |
|----------------------------|------------|--------|--------|--------|------------|----|--------|--------|
| 1. Credit period (days) | 0 | 30 | 60 | 90 | 0 | 30 | 60 | 90 |
| 2. Sales Units | 10,000 | 15,000 | 20,000 | 25,000 | - | - | 10,000 | 15,000 |
| | ₹ in lakh | | | | ₹ in lakh | | | |
| 3. Sales Value | 1,500 | 2,250 | 3,000 | 3,750 | - | - | 1,500 | 2,250 |
| 4. Contribution at 50% (A) | 750 | 1,125 | 1,500 | 1,875 | - | - | 750 | 1,125 |



| | | | | | | | | |
|--|-----|----------|----------|----------|---|---|-----|----------|
| 5. Receivables:- <u>Credit Period × Sales</u> 360 | - | 187.5 | 500 | 937.5 | - | - | 250 | 562.5 |
| 6. Debtors at cost | - | 93.75 | 250 | 468.75 | - | - | 125 | 281.25 |
| 7. Cost of carrying debtors at 20% (B) | - | 18.75 | 50 | 93.75 | - | - | 25 | 56.25 |
| 8. Excess of contributions over cost of carrying debtors (A – B) | 750 | 1,106.25 | 1,406.25 | 1,781.25 | - | - | 725 | 1,068.75 |

The excess of contribution over cost of carrying Debtors is highest in case of credit period of 90 days in respect of both the customers B and C. Hence, credit period of 90 days should be allowed to B and C.

Question 10

A company wants to follow a more prudent policy to improve its sales for the region which is ₹ 9 lakhs per annum at present, having an average collection period of 45 days. After certain researches, the management consultant of the company reveals the following information:

| Credit Policy | Increase in collection period | Increase in sales | Present default anticipated |
|---------------|-------------------------------|-------------------|-----------------------------|
| W | 15 days | ₹ 60,000 | 1.5% |
| X | 30 days | ₹ 90,000 | 2% |
| Y | 45 days | ₹ 1,50,000 | 3% |
| Z | 70 days | ₹ 2,10,000 | 4% |

The selling price per unit is ₹ 3. Average cost per unit is ₹ 2.25 and variable costs per unit are ₹ 2. The current bad debt loss is 1%. Required return on additional investment is 20%. (Assume 360 days year) ANALYSE which of the above policies would you recommend for adoption? (RTP Nov '20) (Same concept different figures Old & New SM)

Answer 10

A) Statement showing the Evaluation of Debtors Policies (Total Approach)

(Amount in ₹)

| Particulars | Present Policy 45 days | Proposed Policy W 60 days | Proposed Policy X 75 days | Proposed Policy Y 90 days | Proposed Policy Z 115 days |
|-------------------------------------|------------------------|---------------------------|---------------------------|---------------------------|----------------------------|
| I. Expected Profit: | | | | | |
| (a) Credit Sales | 9,00,000 | 9,60,000 | 9,90,000 | 10,50,000 | 11,10,000 |
| (b) Total Cost other than Bad Debts | | | | | |
| (i) Variable Costs [Sales × 2/ 3] | 6,00,000 | 6,40,000 | 6,60,000 | 7,00,000 | 7,40,000 |
| (ii) Fixed Costs | 75,000 | 75,000 | 75,000 | 75,000 | 75,000 |
| | 6,75,000 | 7,15,000 | 7,35,000 | 7,75,000 | 8,15,000 |
| (c) Bad Debts | 9,000 | 14,400 | 19,800 | 31,500 | 44,400 |



| | | | | | | |
|------|---|----------|----------|----------|----------|----------|
| | (d) Expected Profit [(a) – (b) – (c)] | 2,16,000 | 2,30,600 | 2,35,200 | 2,43,500 | 2,50,600 |
| II. | Opportunity Cost of Investments Receivables | 16,875 | 23,833 | 30,625 | 38,750 | 52,069 |
| III. | Net Benefits (I – II) | 1,99,125 | 2,06,767 | 2,04,575 | 2,04,750 | 1,98,531 |

Recommendation: The Proposed Policy W (i.e. increase in collection period by 15 days or total 60 days) should be adopted since the net benefits under this policy are higher as compared to other policies.

Working Notes:

- (i) **Calculation of Fixed Cost** = [Average Cost per unit – Variable Cost per unit] × No. of Units sold
 $= [₹ 2.25 - ₹ 2.00] \times (₹ 9,00,000/3)$
 $= ₹ 0.25 \times 3,00,000 = ₹ 75,000$

- (ii) **Calculation of Opportunity Cost of Average Investments**

$$\text{Opportunity Cost} = \text{Total Cost} \times \frac{\text{Collection Period}}{360} \times \frac{\text{Rate of Return}}{100}$$

$$\text{Present Policy} = 6,75,000 \times \frac{45}{360} \times \frac{20}{100} = 16,875$$

$$\text{Policy W} = 7,15,000 \times \frac{60}{360} \times \frac{20}{100} = 23,833$$

$$\text{Policy X} = 7,35,000 \times \frac{75}{360} \times \frac{20}{100} = 30,625$$

$$\text{Policy Y} = 7,75,000 \times \frac{90}{360} \times \frac{20}{100} = 38,750$$

$$\text{Policy Z} = 8,15,000 \times \frac{115}{360} \times \frac{20}{100} = 52,069$$

- B) Another method of solving the problem is Incremental Approach. Here we assume that sales are all credit sales. (Amount in ₹)

| Particulars | | Present Policy 45 days | Proposed Policy W 60 days | Proposed Policy X 75 days | Proposed Policy Y 90 days | Proposed Policy Z 115 days |
|-------------|--|------------------------|---------------------------|---------------------------|---------------------------|----------------------------|
| I. | Incremental Expected Profit: | | | | | |
| | (a) Incremental Credit Sales | 0 | 60,000 | 90,000 | 1,50,000 | 2,10,000 |
| | (b) Incremental Costs | | | | | |
| | (i) Variable Costs | 6,00,000 | 40,000 | 60,000 | 1,00,000 | 1,40,000 |
| | (ii) Fixed Costs | 75,000 | - | - | - | - |
| | (c) Incremental Bad Debt Losses | 9,000 | 5,400 | 10,800 | 22,500 | 35,400 |
| | (d) Incremental Expected Profit (a – b – c)] | | 14,600 | 19,200 | 27,500 | 34,600 |
| II. | Required Return on Incremental Investments: | | | | | |
| | (a) Cost of Credit Sales | 6,75,000 | 7,15,000 | 7,35,000 | 7,75,000 | 8,15,000 |
| | (b) Collection period | 45 | 60 | 75 | 90 | 115 |



| | | | | | | |
|-----|--|--------|----------|----------|----------|----------|
| | (c) Investment in Receivable (a × b/360) | 84,375 | 1,19,167 | 1,53,125 | 1,93,750 | 2,60,347 |
| | (d) Incremental Investment in Receivables | - | 34,792 | 68,750 | 1,09,375 | 1,75,972 |
| | (e) Required Rate of Return (in %) | | 20 | 20 | 20 | 20 |
| | (f) Required Return on Incremental Investments (d × e) | - | 6,958 | 13,750 | 21,875 | 35,194 |
| II. | Net Benefits (I – II) | - | 7,642 | 5,450 | 5,625 | (594) |

Recommendation: The Proposed Policy W should be adopted since the net benefits under this policy are higher than those under other policies.

C) Another method of solving the problem is by computing the **Expected Rate of Return**.

$$\text{Expected Rate of Return} = \frac{\text{Incremental Expected Profit}}{\text{Incremental Investment in Receivables}} \times 100$$

$$\text{For Policy W} = \frac{\text{Rs.14,600}}{\text{Rs.34,792}} \times 100 = 41.96\%$$

$$\text{For Policy X} = \frac{\text{Rs.19,200}}{\text{Rs.68,750}} \times 100 = 27.93\%$$

$$\text{For Policy Y} = \frac{\text{Rs.27,500}}{\text{Rs.1,09,375}} \times 100 = 25.14\%$$

$$\text{For Policy Z} = \frac{\text{Rs.34,600}}{\text{Rs.1,75,972}} \times 100 = 19.66\%$$

Recommendation: The Proposed Policy W should be adopted since the Expected Rate of Return (41.96%) is more than the Required Rate of Return (20%) and is highest among the given policies compared.

Question 11

Current annual sale of SKD Ltd. is Rs.360 lakhs. Its directors are of the opinion that company's current expenditure on receivables management is too high and with a view to reduce the expenditure they are considering following two new alternate credit policies:

Policy X Policy Y

Average collection period 1.5 months 1 month

% of default 2% 1%

Annual collection expenditure Rs.12 lakh Rs.20 lakh Selling price per unit of product is Rs.150. Total cost per unit is Rs.120.

Current credit terms are 2 months and percentage of default is 3%.

Current annual collection expenditure is ₹ 8 lakh. Required rate of return on investment of SKD Ltd. is 20%. Determine which credit policy SKD Ltd. should follow. (PYP 5 Marks, July'21)

Answer 11

Statement showing the Evaluation of Credit policies (Total Approach)

| Particulars | | Present Policy (2 Months) | Proposed Policy X (1.5 Months) | Proposed Policy Y (1 Month) |
|-------------|-------------------|------------------------------|-----------------------------------|--------------------------------|
| | | Rs.in lakhs | Rs.in lakhs | Rs.in lakhs |
| A. | Expected Profit: | | | |
| | (a) Credit Sales* | 360 | 360 | 360 |



| | | | | |
|-----------|--|----------------------|---------------------|---------------------|
| | (b) Total Cost other than Bad Debts and collection expenditure (360/150 x 120) | 288 | 288 | 288 |
| | (c) Bad Debts | 10.8 (360 x 0.03) | 7.2 (360 x 0.02) | 3.6 (360 x 0.01) |
| | (d) Collection expenditure | 8 | 12 | 20 |
| | (e) Expected Profit [(a) – (b) – (c) - (d)] | 53.2 | 52.8 | 48.4 |
| B. | Opportunity Cost of Investments in Receivables (Working Note) | 9.6 | 7.2 | 4.8 |
| C. | Net Benefits (A – B) | 43.6 | 45.6 | 43.6 |

Recommendation: The Proposed Policy X should be followed since the net benefits under this policy are higher as compared to other policies.

***Note:** It is assumed that all sales are on credit.

Working Note:

Calculation of Opportunity Cost of Average Investments

$$= \text{Total Cost} \times \frac{\text{Collection period}}{12} \times \frac{\text{Rate of Return}}{100}$$

$$\text{Present Policy} = \text{Rs. 288 lakhs} \times \frac{2}{12} \times \frac{20}{100} = \text{Rs. 9.6 Lakhs}$$

$$\text{Policy X} = \text{Rs. 288 lakhs} \times \frac{1.5}{12} \times \frac{20}{100} = \text{Rs. 7.2 Lakhs}$$

$$\text{Policy Y} = \text{Rs. 288 lakhs} \times \frac{1}{12} \times \frac{20}{100} = \text{Rs. 4.8 Lakhs}$$

Alternatively

Statement showing the Evaluation of Credit policies (Incremental Approach)

| Particulars | | Present Policy (2 Months) | Proposed Policy X (1.5 Months) | Proposed Policy Y (1 Month) |
|-------------|---|------------------------------|-----------------------------------|--------------------------------|
| | | Rs.in lakhs | Rs.in lakhs | Rs.in lakhs |
| | (a) Credit Sales* | 360 | 360 | 360 |
| | (b) Cost of sales (360/150 x 120) | 288 | 288 | 288 |
| | (c) Receivables (Refer Working Note) | 48 | 36 | 24 |
| | (d) Reduction in receivables from present policy | - | 12 | 24 |
| (A) | Savings in Opportunity Cost of Investment in Receivables (@ 20%) | - | 2.4 | 4.8 |
| | (e) Bad Debts | 10.8 (360 x 0.03) | 7.2 (360 x 0.02) | 3.6 (360 x 0.01) |



| | | | | |
|-----|--|---|-----|-----|
| (B) | Reduction in bad debts from present policy | - | 3.6 | 7.2 |
| | (f) Collection expenditure | 8 | 12 | 20 |
| (C) | Increase in Collection expenditure from Present policy | - | 4 | 12 |
| (D) | Net Benefits (A +B-C) | | 2 | 0 |

Recommendation: The Proposed Policy X should be followed since the net benefits under this policy are higher as compared to other policies.

*Note: It is assumed that all sales are on credit.

Working Note:

Calculation of Investment in Receivables

$$= \text{Total Cost} \times \frac{\text{Collection period}}{12}$$

$$\text{Present Policy} = \text{Rs. 288 lakhs} \times \frac{2}{12} = \text{Rs. 48 Lakhs}$$

$$\text{Policy X} = \text{Rs. 288 lakhs} \times \frac{1.5}{12} = \text{Rs. 36 Lakhs}$$

$$\text{Policy Y} = \text{Rs. 288 lakhs} \times \frac{1}{12} = \text{Rs. 24 Lakhs}$$

Question 12

Describe the salient features of FORFAITING. (PYP 4 Marks, July'21)

Answer 12

E.C.G.C. Guarantee: Post-shipment finance, given to an exporter by a bank through purchase, negotiation or discount of an export bill against an order, qualifies for post-shipment export credit guarantee. It is necessary, however, that exporters should obtain a shipment or contracts risk policy of E.C.G.C. Banks insist on the exporters to take a contracts shipment (comprehensive risks) policy covering both political and commercial risks. The Corporation, on acceptance of the policy, will fix credit limits for individual exporters and the Corporation's liability will be limited to the extent of the limit so fixed for the exporter concerned irrespective of the amount of the policy.

Question 13

MN Ltd. has a current turnover of Rs.30,00,000 p.a. Cost of Sale is 80% of turnover and Bad Debts are 2% of turnover, Cost of Sales includes 70% variable cost and 30% Fixed Cost, while company's required rate of return is 15%. MN Ltd. currently allows 15 days' credit to its customer, but it is considering increase this to 45 days' credit in order to increase turnover.

It has been estimated that this change in policy will increase turnover by 20 %, while Bad Debts will increase by 1%. It is not expected that the policy change will result in an increase in fixed cost and creditors and stock will be unchanged.

Should MN Ltd. introduce the proposed policy? (Assume 360 days' year) (PYP 10 Marks, Nov'18) (Same concept different figures Old & New SM)

Answer 13

Statement Showing Evaluation of Credit Policies

| | Particulars | Present Policy | Proposed Policy |
|----|-----------------------|----------------|-----------------|
| A. | Expected Contribution | | |



| | | | |
|----|---|-----------|-----------|
| | (a) Credit Sales | 30,00,000 | 36,00,000 |
| | Less: Variable Cost | 16,80,000 | 20,16,000 |
| | Contribution | 13,20,000 | 15,84,000 |
| | (d) Less: Bad Debts | 60,000 | 1,08,000 |
| | (e) Contribution after Bad debt [(c)-(d)] | 12,60,000 | 14,76,000 |
| B. | Opportunity Cost of investment in Receivables | 15,000 | 54,000 |
| C. | Net Benefits [A-B] | 12,45,000 | 14,22,000 |
| D. | Increase in Benefit | | 1,77,000 |

Recommendation: Proposed Policy i.e credit from 15 days to 45 days should be implemented by NM Ltd since the net benefit under this policy are higher than those under present policy

Working Note: (1)

| | Present Policy (Rs.) | Propose Policy (Rs.) |
|--------------------------------------|----------------------|----------------------|
| Sales | 30,00,000 | 36,00,000 |
| Cost of Sales (80% of sales) | 24,00,000 | 28,80,000 |
| Variable cost (70% of cost of sales) | 16,80,000 | 20,16,000 |

2. Opportunity Costs of Average Investments

$$= \text{Variable Cost} \times \frac{\text{Collection period}}{12} \times \text{Rate of Return}$$

$$\text{Present Policy} = \text{Rs. } 24,00,000 \times \frac{45}{360} \times 15\% = \text{₹ } 54,000$$

$$\text{Proposed Policy} = \text{Rs. } 28,80,000 \times \frac{15}{360} \times 15\% = \text{Rs. } 18,000$$

Question 14

A factoring firm has offered a company to buy its accounts receivables. The relevant information is given below:

- The current average collection period for the company's debt is 80 days and ½% of debtors default. The factor has agreed to pay over money due to the company after 60 days and it will suffer all the losses of bad debts also.
- Factor will charge commission @2%.
- The company spends ₹ 1,00,000 p.a. on administration of debtor. These are avoidable cost.
- Annual credit sales are ₹ 90 lakhs. Total variable costs is 80% of sales. The company's cost of borrowing is 15% per annum. Assume 365 days in a year.

Should the company enter into agreement with factoring firm? (PYP 5 Marks Dec '21)

Answer 14

| | Particulars | (₹) |
|----|---|----------|
| A. | Annual Savings (Benefit) on taking Factoring Service | |
| | Cost of credit administration saved | 1,00,000 |
| | Bad debts avoided (₹ 90 lakh x ½%) | 45,000 |
| | Interest saved due to reduction in average collection period [₹ 90 lakh x 0.80 x 0.15 x (80 days – 60 days)/365 days] | 59,178 |
| | Total | 2,04,178 |
| B. | Annual Cost of Factoring to the Firm: | |
| | Factoring Commission [₹ 90 lakh x 2%] | 1,80,000 |



| | | |
|----|---|----------|
| | Total | 1,80,000 |
| C. | Net Annual Benefit of Factoring to the Firm (A – B) | 24,178 |

Advice: Since savings to the firm exceeds the cost to the firm on account of factoring, therefore, the company should enter into agreement with the factoring firm.





Chapter 9.5 Management of Payables

Question 1

A Ltd. is in the manufacturing business and it acquires raw material from X Ltd. on a regular basis. As per the terms of agreement the payment must be made within 40 days of purchase. However, A Ltd. has a choice of paying ₹ 98.50 per ₹ 100 it owes to X Ltd. on or before 10th day of purchase.

Required:

EXAMINE whether A Ltd. should accept the offer of discount assuming average billing of A Ltd. with X Ltd. is ₹ 10,00,000 and an alternative investment yield a return of 15% and company pays the invoice. (RTP May '18)

Answer 1

Annual Benefit of accepting the Discount

$$\frac{Rs.1.5}{Rs.100 - Rs.1.50} \times \frac{365 \text{ days}}{40 - 10 \text{ days}} = 18.53\%$$

Annual Cost = Opportunity Cost of foregoing interest on investment = 15%

If average invoice amount is ₹ 10,00,000

| | If discount is | |
|--|-----------------|---------------------|
| | Accepted (₹) | Not Accepted (₹) |
| Payment to Supplier (₹) | 9,85,000 | 10,00,000 |
| Return on investment of ₹9,85,000 for 30 days {₹ 9,85,000 × (30/365) × 15%} | | (12,144) |
| | 9,85,000 | 9,87,856 |

Thus, from above table it can be seen that it is cheaper to accept the discount.



Chapter 9.6 Financing of Working Capital

Question 1

Sundaram limited a plastic manufacturing company had invested enormous amount of money in a new expansion project. Due to such a great amount of capital investment, Company needs an additional ₹ 2,00,00,000 in working capital immediately. The CFO has determined the following three feasible sources of working capital funds:

Bank Loan: The company's bank will lend ₹2,30,00,000 at 12% per annum. However, the bank will require 15% of the loan granted to be kept in a current account as the minimum average balance which otherwise would have been just ₹ 50,000.

Trade Credit: A major supplier with 2/20 net 80 credit terms has approached for supply of raw material worth ₹1,90,00,000 p.m.

Factoring: factoring firm will buy the companies receivables of ₹ 2,50,00,000 per month, which have a collection period of 60 days. factor will advance up to 75% of the face value of the receivables at 14 percent per annum. Factor Commission will amount to 2% on all receivables purchased. Factoring will save credit department expense and bad debts of ₹ 1,75,000 p.m. and ₹ 2,25,000 p.m.

Based on annual percentage cost, ADVISE which alternative should the company select. Assume 360 days a year (MTP 5 Marks April '23, RTP Nov '21)

Answer 1

- (i) **Bank Loan:** As the minimum average balance more than ₹ 50,000 need not be kept if loan is not undertaken, the incremental money made available by bank through bank loan is ₹ 2,30,00,000- (15% x ₹ 2,30,00,000- ₹ 50,000) = ₹ 1,96,00,000. Real annual cost of bank loan = (₹ 2.3 crores x 12%) / ₹ 1.96 crores = 14.08%.
- (ii) **Trade Credit:** The real annual cost of trade credit will be $2/98 \times 360/60 \times 100 = 12.24\%$.
- (iii) **Factoring:**

Commission charges per year = 2% x 2.5 crores x 12 = ₹ 60,00,000 Savings per year =

(1,75,000+2,25,000) x 12 = ₹ 48,00,000

Net Factoring cost per year = ₹ 60,00,000 – ₹ 48,00,000 = ₹12,00,000 Annual cost of borrowing ₹ 2.5

crores x 75% i.e. ₹ 1,87,50,000 will be

$$\frac{1,87,50,000 \times 14\% + \text{Rs.} 12,00,000}{1,87,50,000} = 20.4\%$$

Conclusion: The company should select trade credit as a preferred mode of financing the working capital requirement as it results in lowest cost on an annual basis.

Question 2

Kalyan limited has provided you the following information for the year 2021-22:

By working at 60% of its capacity the company was able to generate sales of ₹ 72,00,000. Direct labour cost per unit amounted to ₹ 20 per unit. Direct material cost per unit was 40% of the selling price per unit. Selling price was 3 times the direct labour cost per unit. Profit margin was 25% on the total cost.

For the year 2022-23, the company makes the following estimates:

Production and sales will increase to 90% of its capacity. Raw material per unit price will remain unchanged. Direct expense per unit will increase by 50%. Direct labour per unit will increase by 10%. Despite the fluctuations in the cost structure, the company wants to maintain the same profit margin on sales.

Raw materials will be in stock for one month whereas finished goods will remain in stock for two months.

Production cycle is for 2 months. Credit period allowed by suppliers is 2 months. Sales are made to three



zones:

| Zone | Percentage of sale | Mode of Credit |
|------|--------------------|---------------------------|
| A | 50% | Credit period of 2 months |
| B | 30% | Credit period of 3 months |
| C | 20% | Cash Sales |

There are no cash purchases and cash balance will be ₹ 1,11,000

The company plans to apply for a working capital financing from bank for the year 2022 - 23. ESTIMATE Net Working Capital of the Company receivables to be taken on sales and also COMPUTE the maximum permissible bank finance for the company using 3 criteria of Tandon Committee Norms. (Assume stock of finished goods to be a core current asset) (RTP May 23)

Answer 2

Cost Structure

| Particulars | Calculations | 2021-22 | | Calculations | 2022-23 | |
|-----------------|------------------------|----------------------------|-----------------------|--------------|---------------------------|-----------------------|
| | | P.U. | Amount (p.u. X units) | | P.U. | Amount (p.u. X units) |
| Direct Material | 40% of SP | ₹24 | ₹28,80,000 | Same as PY | ₹24 | ₹43,20,000 |
| Direct labour | Given | ₹20 | ₹24,00,000 | 20*1.1 | ₹22 | ₹39,60,000 |
| Direct Expenses | bal. fig. | ₹4 | ₹4,80,000 | 4*1.5 | ₹6 | ₹10,80,000 |
| Total Cost | SP - Profit | ₹48 | ₹57,60,000 | | ₹52 | ₹93,60,000 |
| Profit | (SP/125x25) | ₹12 | ₹14,40,000 | 52*25% | ₹13 | ₹23,40,000 |
| Sales | 3 x Direct Labour p.u. | ₹60 | ₹72,00,000 | | ₹65 | ₹1,17,00,000 |
| *units= | | ₹72,00,000 / ₹60 =1,20,000 | | | 1,20,000/60 x 90=1,80,000 | |

Operating Cycle

| | |
|-------------------------------|------------|
| Raw material holding period | 1 month |
| Finished Goods holding period | 2 months |
| WIP conversion period | 2 months |
| Creditor Payment Period | 2 months |
| Receivables Collection Period | 2/3 months |

| Estimation of Working Capital | | |
|-------------------------------|------------------|-----------|
| Particulars | Calculation | Amount |
| Current Assets | | |
| Stock of Raw Material | 43,20,000 x 1/12 | ₹3,60,000 |
| Stock of WIP | | |
| RM cost | ₹43,20,000 | |
| Labour cost | ₹19,80,000 | |
| Direct Exp cost | ₹5,40,000 | |
| Total WIP Cost | ₹68,40,000 | |



| | | |
|-------------------------|---------------------------------------|-------------|
| Stock of WIP | $68,40,000 \times 2/12$ | ₹11,40,000 |
| Stock of Finished Goods | $93,60,000 \times 2/12$ | ₹15,60,000 |
| Receivables (on sales) | | |
| A | $1,17,00,000 \times 50\% \times 2/12$ | ₹9,75,000 |
| B | $1,17,00,000 \times 30\% \times 3/12$ | ₹8,77,500 |
| C | NIL | - |
| Cash Balance | Given | ₹1,11,000 |
| Total Current Assets | | ₹ 50,23,500 |
| Current Liabilities | | |
| Payables | $*₹44,40,000 \times 2/12$ | ₹7,40,000 |
| Net Working Capital | | ₹ 42,83,500 |

Opening RM stock = $28,80,000 \times 1/12 = ₹2,40,000$

* RM purchased = RM consumed – Opening Stock + Closing Stock

= $₹43,20,000 - ₹2,40,000 + ₹3,60,000$

= ₹44,40,000

| Computation of Maximum Permissible Bank Finance | | | |
|---|--|---|------------|
| Method | Formula | Calculation | ₹ |
| I | 75% x (Current Assets- Current Liabilities) | $75\% \times (₹50,23,500 - ₹7,40,000)$ | ₹32,12,625 |
| II | 75% x Current Assets- Current Liabilities | $75\% \times ₹50,23,500 - ₹7,40,000$ | ₹30,27,625 |
| III | 75% x (Current Assets- Core CA)- Current Liabilities | $75\% \times (₹50,23,500 - ₹15,60,000) - ₹7,40,000$ | ₹18,57,625 |



Chapter 1

Introduction of Strategic Management

Question 1

Mr. Raj has been hired as a CEO by XYZ Ltd a FMCG company that has diversified into affordable cosmetics. The company intends to launch Feelgood brand of cosmetics. XYZ wishes to enrich the lives of people with its products that are good for skin and are produced in ecologically beneficial manner using herbal ingredients. Draft vision and mission statement that may be formulated by Raj.(RTP Nov'20, Nov'19, New SM)

Answer 1

Feelgood brand of cosmetics may have following vision and mission:

Vision: Vision implies the blueprint of the company's future position. It describes where the organisation wants to land. Mr. Raj should aim to position "Feelgood cosmetics" as India's beauty care company. It may have vision to be India's largest beauty care company that improves looks, give extraordinary feeling and bring happiness to people.

Mission: Mission delineates the firm's business, its goals and ways to reach the goals. It explains the reason for the existence of the firm in the society. It is designed to help potential shareholders and investors understand the purpose of the company:

Mr. Raj may identify mission in the following lines:

- ◆ To be in the business of cosmetics to enhance the lives of people, give them confidence to lead.
- ◆ To protect skin from harmful elements in environment and sun rays.
- ◆ To produce herbal cosmetics using natural ingredients.

Question 2

Define the role of corporate level managers. (Nov'18)

Answer 2

Corporate-level managers participate in strategic decision making within the organization. The role of corporate-level managers is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources among the different businesses, formulating and implementing strategies that span individual businesses, and providing leadership for the organization.

Question 3

"Strategy is partly proactive and partly reactive." Discuss. (MTP Oct '19, Mar'21 5 Marks, PYP 5 Marks Nov '18, RTP May 18 & Nov '20, Old & New SM)

Answer 3

Strategy is partly proactive and partly reactive. In proactive strategy, organizations will analyze possible environmental scenarios and create strategic framework after proper planning and set procedures and work on these strategies in a predetermined manner. However, in reality no company can forecast both internal and external environment exactly. Everything cannot be planned in advance. It is not possible to anticipate moves of rival firms, consumer behaviour, evolving technologies and so on.

There can be significant deviations between what was visualized and what actually happens.

Strategies need to be attuned or modified in the light of possible environmental changes. There can be significant or major strategic changes when the environment demands. Reactive strategy is triggered by the changes in the environment and provides ways and means to cope with the negative factors or

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Candidates had sufficient knowledge of strategy as being partly proactive and partly reactive. The overall performance was good.

take advantage of emerging opportunities.

Question 4

Which of the following statements are 'correct' and which are 'incorrect'? Give reasons, in brief, for your answer: Every strategic move is the result of proactive planning. (MTP March '18, 2 Marks]

Answer 4

Incorrect: In business, things happen that cannot be fully anticipated or planned for. When market and competitive conditions take an unexpected turn or some aspect of a company's strategy hits a stone wall, some kind of strategic reaction or adjustment is required.

Question 5

Briefly explain the importance of strategic management. (MTP-March '18, Oct'18 5 Marks, RTP-Nov '18 & Nov '22, PYP 5 Marks Dec '21)

Answer 5

Importance of Strategic Management: Strategic Management is very important for the survival and growth of business organizations in dynamic business environment. Other major benefits of strategic management are as follows:

- It helps organizations to be more proactive rather than reactive in dealing with its future. It facilitates the organisations to work within vagaries of environment and remains adaptable with the turbulence or uncertain future. Therefore, they are able to control their own destiny in a better way.
- It provides better guidance to entire organization on the crucial point – what it is trying to do. Also provides framework for all major business decisions of an enterprise such a decision on businesses, products, markets, organization structures, etc.
- It facilitates to prepare the organization to face the future and act as path finder to various business opportunities. Organizations are able to identify the available opportunities and identify ways and means as how to reach them.
- It serves as a corporate defense mechanism against mistakes and pitfalls. It helps organizations to avoid costly mistakes in product market choices or investments.
- Over a period of time, strategic management helps organizations to evolve certain core competencies and competitive advantages that assist in the fight for survival and growth.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Most of the examinees were explained well the benefits of strategic management. Hence, the performance was above average.

Question 6

What benefits accrue by following a strategic approach to managing? (MTP 5 Marks Oct 20, RTP May 23 & Nov '18)

Answer 6

The following are the benefits of strategic approach to managing:

- ◆ Strategic management helps organisations to be more proactive instead of reactive in shaping its future. Organisations are able to analyse and take actions instead of being mere spectators. Thereby they are able to control their own destiny in a better manner. It helps them in working within vagaries of environment and shaping it, instead of getting carried away by its turbulence or uncertainties.
- ◆ Strategic management provides framework for all the major decisions of an enterprise such as decisions on businesses, products, markets, manufacturing facilities, investments and organisational structure. It provides better guidance to entire organisation on the crucial point - what it is trying to do.
- ◆ Strategic management is concerned with ensuring a good future for the firm. It seeks to prepare the corporation to face the future and act as pathfinder to various business opportunities. Organisations are able to identify the available opportunities and identify ways and means as

how to reach them.

- ♦ Strategic management serves as a corporate defence mechanism against mistakes and pitfalls. It helps organisations to avoid costly mistakes in product market choices or investments. Over a period of time strategic management helps organisation to evolve certain core competencies and competitive advantages that assist in its fight for survival and growth.

Question 7

Kamal Sweets Corner, a very popular sweets shop in Ranchi, was facing tough competition from branded stores of packaged sweets and imported goods. The owners realised that their business reduced by 50% in the last six months, and this created a stressful business environment for them. To find a solution, they consulted a business consultant to help them develop a strategy to fight competition and sustain their century old family business. The business consultant advised them to innovate a new snack for the public and market it as a traditional snack of the region. The owners liked the idea and developed a new snack called Dahi Samosa, which very quickly became popular amongst the public and it helped regain the lost business of Kamal Sweets Corner.

One of the very crucial importance of strategic management was used by the business consultant to help the owners of Kamal Sweets Corner. Which one could it be? Also, was this strategy Reactive or Proactive? According to you who are more beneficial in general parlance? (MTP 5 Marks April 21, Old SM)

Answer 7

The strategy used here was of developing a competitive advantage via product which helped Kamal Sweets Corner regain their lost business. This is also one of the major importance cum advantage of strategic management, that is helps to develop core competencies and competitive advantages to overcome competition.

This strategy was a Reactive strategy. Wherein, the owners saw their business fall to 50% of revenue and then seeking a strategic advisory. They did not plan proactively as to when the new shops were already opening. They reacted only when the business started to lose up.

Generally, it is always beneficial to develop strategies proactively, so that the dip in businesses is small and manageable, and even if they are huge, the management has ample time to fix it.

Question 8

Yummy Foods and Tasty Foods are successfully competing in the business of ready to eat snacks in Patna. Yummy has been pioneer in introducing innovative products. These products will give them good sale. However, Tasty Foods will introduce similar products in reaction to the products introduced by the Yummy Foods taking away the advantage gained by the former (MTP 5 Marks Oct 21 & April '23, Old & New SM, RTP Nov '18)

Answer 8

Yummy foods are proactive in its approach. On the other hand, Tasty Food is reactive. Proactive strategy is planned strategy whereas reactive strategy is adaptive reaction to changing circumstances. A company's strategy is typically a blend of proactive actions on the part of managers to improve the company's market position and financial performance and reactions to unanticipated developments and fresh market conditions.

If organisational resources permit, it is better to be proactive rather than reactive. Being proactive in aspects such as introducing new products will give you advantage in the mind of customers.

At the same time, crafting a strategy involves stitching together a proactive/intended strategy and then adapting first one piece and then another as circumstances surrounding the company's situation change or better options emerge-a reactive/adaptive strategy. This aspect can be accomplished by Yummy Foods.

Question 9

What is strategic decision making? What tasks are performed by a strategic Manager? (MTP- Oct '19 & Sep '23, 5 Marks, RTP Nov'20, RTP Nov'23, Old SM]

Answer 9

Decision making is a managerial process of selecting the best course of action out of several alternative

courses for the purpose of accomplishment of the organizational goals. Decisions may be operational i.e., which relate to general day-to-day operations. They may also be strategic in nature. According to Jauch and Glueck **"Strategic decisions encompass the definition of the business, products to be handled, markets to be served, functions to be performed and major policies needed for the organisation to execute these decisions to achieve the strategic objectives."**

The primary task of the strategic manager is conceptualizing, designing and executing company strategies. For this purpose, his tasks include:

- Defining the mission and goals of the organization.
- Determining what businesses it should be in.
- Allocating resources among the different businesses.
- Formulating and implementing strategies that span individual businesses.
- Providing leadership for the organization

Question 10

"A business organization cannot always plan all their strategies in advance and often need to blend planned strategies with reactive strategies." Do you agree with the statement? Give reasons. (MTP 5 Marks April 22, RTP May 23)

Answer 10

Yes, a business organization cannot always plan all their strategies in advance and often need to blend planned strategies with reactive strategies. In planned strategy, organisations will analyse possible environmental scenarios and create strategic framework after proper planning and set procedures and work on these strategies in a pre-determined manner. However, in reality no company can forecast both internal and external environment exactly. Everything cannot be planned in advance. It is not possible to anticipate moves of rival firms, consumer behaviour, evolving technologies and so on. There can be significant deviations between what was visualised and what actually happens. There can be significant or major strategic changes when the environment demands. Reactive strategy is triggered by the changes in the environment and provides ways and means to cope with the negative factors or take advantage of emerging opportunities.

Question 11

Define Strategic Management. Also discuss the limitations of Strategic Management. (MTP 5 Marks Sep'22, March '19, May'20, Apr'21, Mar'22, Oct'22 & Oct '23 5 Marks, PYP May 18 & May '19, RTP May'19, May'21, May '18, Nov '21, Nov'23 Old SM)

OR

The strategic management cannot counter all hindrances and always achieve success for an organization." Do you agree with this statement? Give arguments in support of your answer. (RTP Nov '23) (PYP 5 Marks Nov 22)

Answer 11

The term 'strategic management' refers to the managerial process of developing a strategic vision, setting objectives, crafting a strategy, implementing and evaluating the strategy, and initiating corrective adjustments where deemed appropriate.

The presence of strategic management cannot counter all hindrances and always achieve success as there are limitations attached to strategic management. These can be explained in the following lines:

- ◆ Environment is highly complex and turbulent. It is difficult to understand the complex environment and exactly pinpoint how it will shape-up in future. The organisational estimate about its future shape may awfully go wrong and jeopardise all strategic plans. The environment affects as the organisation has to deal with suppliers, customers, governments and other external factors.
- ◆ Strategic Management is a time-consuming process. Organisations spend a lot of time in preparing, communicating the strategies that may impede daily operations and negatively impact the routine business.
- ◆ Strategic Management is a costly process. Strategic management adds a lot of expenses to an organization. Expert strategic planners need to be engaged, efforts are made for analysis of external and internal environments devise strategies and properly implement. These can be really costly for

organisations with limited resources particularly when small and medium organisation create strategies to compete.

- ◆ Competition is unpredictable. In a competitive scenario, where all organisations are trying to move strategically, it is difficult to clearly estimate the competitive responses to the strategies.

Question 12

ABC Limited is in a wide range of businesses which include apparels, lifestyle products, furniture, real estate and electrical products. The company is looking to hire a suitable Chief Executive Officer. Consider yourself as the HR consultant for ABC limited. You have been assigned the task to enlist the activities involved with the role of the Chief Executive Officer. Name the strategic level that this role belongs to and enlist the activities associated with it. (MTP 5 Marks Oct'22 & Sep '23, PYP Jan '21 5 Marks, Old & New SM)

Answer 12

The role of Chief Executive Officer pertains to Corporate level.

The corporate level of management consists of the Chief Executive Officer (CEO) and other top-level executives. These individuals occupy the apex of decision making within the organization.

The role of Chief Executive Officer is to:

1. oversee the development of strategies for the whole organization;
2. defining the mission and goals of the organization;
3. determining what businesses, it should be in;
4. allocating resources among the different businesses;
5. formulating, and implementing strategies that span individual businesses;
6. providing leadership for the organization;
7. ensuring that the corporate and business level strategies which company pursues are consistent with maximizing shareholders wealth; and
8. managing the divestment and acquisition process.

Question 13

Explain the difference between three levels of strategy formulation. (MTP 5 Marks March '23, MTP Aug'18 5 Marks, Old & New SM, RTP May'20)

Answer 13

A typical large organization is a multidivisional organisation that competes in several different businesses. It has separate self-contained divisions to manage each of these. There are three levels of strategy in management of business - corporate, business, and functional.

The corporate level of management consists of the chief executive officer and other top level executives. These individuals occupy the apex of decision making within the organization. The role of corporate-level managers is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources among the different businesses and so on rests at the Corporate Level.

The development of strategies for individual business areas is the responsibility of the general managers in these different businesses or business level managers. A business unit is a self - contained division with its own functions - for example, finance, production, and marketing. The strategic role of business-level manager, head of the division, is to translate the general statements of direction and intent that come from the corporate level into concrete strategies for individual businesses.

Functional-level managers are responsible for the specific business functions or operations such as human resources, purchasing, product development, customer service, and so on. Thus, a functional manager's sphere of responsibility is generally confined to one organizational activity, whereas general managers oversee the operation of a whole company or division.

Question 14

Distinguish between vision and mission statement. (MTP-Aug. '18, April'22 5 Marks, RTP May'18, RTP

May'19, Old SM)

Answer 14

A Mission statement tells you the fundamental purpose of the organization. It concentrates on the present. It defines the customer and the critical processes. It informs you of the desired level of performance. On the other hand, a vision statement outlines what the organization wants to be. It concentrates on the future. It is a source of inspiration. It provides clear decision-making criteria.

A mission statement can resemble a vision statement in a few companies, but that can be a grave mistake. It can confuse people. Following are the major differences between vision and mission:

1. The vision states the future direction while the mission states the ongoing activities of the organisation.
2. The vision statement can galvanize the people to achieve defined objectives, even if they are stretch objectives, provided the vision is specific, measurable, achievable, relevant and time bound. A mission statement provides a path to realize the vision in line with its values. These statements have a direct bearing on the bottom line and success of the organization.
3. A vision statement defines the purpose or broader goal for being in existence or in the business and can remain the same for decades if crafted well while a mission statement is more specific in terms of both the future state and the time frame. Mission describes what will be achieved if the organization is successful.

Question 15

**Enumerate the task to be performed as a strategic manager of a company.
(MTP-April '19, 5 Marks)**

Answer 15

The primary tasks of the strategic manager is conceptualizing, designing and executing company strategies.

For this purpose, his tasks will include:

- Defining the mission and goals of the organization.
- Determining what businesses it should be in.
- Allocating resources among the different businesses.
- Formulating strategies.
- Implementing strategies.
- Providing leadership for the organization.

Question 16

What is strategic vision? (MTP-March '18, 2 Marks, RTP Nov'18, PYP 2 Marks May'18)

Answer 16

A strategic vision delineates organisation's aspirations for the business, providing a panoramic view of the position where the organisation is going. A strategic vision points an organization in a particular direction, charts a strategic path for it to follow in preparing for the future, and moulds organizational identity. A Strategic vision is a road map of a company's future – providing specifics about technology and customer focus, the geographic and product markets to be pursued, the capabilities it plans to develop, and the kind of company that management is trying to create

Question 17

**Mission statement of a company focuses on the question: 'who we are' and 'what we do'. Explain briefly.
(MTP 5 Marks Oct 20, Apr'21, RTP May'23)**

Answer 17

A company's mission statement is typically focused on its present business scope — "who we are and what we do"; mission statements broadly describe an organizations present capability, customer focus activities and business makeup. An organisation's mission states what customers it serves, what need it satisfies, and what type of product it offers. It is an expression of the growth ambition of the

organisation. It helps organisation to set its own special identity, business emphasis and path for development. Mission amplifies what brings the organization to this business or why it is there, what existence it seeks and what purpose it seeks to achieve as a business organisation.

In other words, the mission serves as a justification for the firm's very presence and existence; it legitimizes the firm's presence.

Question 18

Explain briefly the. key areas in which the strategic planner should concentrate his mind to achieve desired results. (5 Marks March '22)(RTP Nov '22 & May '21)

Answer 18

A strategic manager defines the strategic intent of the organisation and take it on the path of achieving the organisational objectives. There can be a number of areas that a strategic manager should concentrate on to achieve desired results. They commonly establish long-term objectives in seven areas as follows.

- Profitability.
- Productivity.
- Competitive Position.
- Employee Development.
- Employee Relations.
- Technological Leadership.
- Public Responsibility.

Question 19

What are 'objectives'? What characteristics it must possess to be meaningful? (MTP 5 Marks April '23, RTP May'22, May'21, PYP 5 Marks May'19)

Answer 19

Objectives are organizations performance targets — the results and outcomes it wants to achieve. They function as yardstick for tracking an organization's performance and progress.

Objectives with strategic focus relate to outcomes that strengthen an organization's overall business position and competitive vitality. Objectives, to be meaningful to serve the intended role, must possess the following characteristics:

- Objectives should define the organization's relationship with its environment.
 - Objectives should be facilitative towards achievement of mission and purpose.
 - Objectives should provide the basis for strategic decision-making.
 - Objectives should provide standards for performance appraisal.
 - Objectives should be understandable.
- Objectives should be concrete and specific.
- Objectives should be related to a time frame.
- Objectives should be measurable and controllable.
- Objectives should be challenging.
- Different objectives should correlate with each other.
- Objectives should be set within constraints.

Question 20

Define strategic management. (RTP May'18)

Answer 20

The term 'strategic management' refers to the managerial process of developing a strategic vision, setting objectives, crafting a strategy, implementing and evaluating the strategy, and initiating corrective adjustments where deemed appropriate.

Question 21

**State with reasons which of the following statements are correct/incorrect:
Strategic management involves huge cost(RTP May'18).**

Answer 21

Correct: Strategic management is a costly process. Strategic management adds a lot of expenses to an organization. Expert strategic planners need to be engaged. Efforts are made for analysis of external and internal environments, devise strategies and properly implement them. These can be really costly for organizations with limited resources particularly when small and medium organization create strategies to compete.

Question 22

Dharma Singh, the procurement department head of Cyclic, a mountain biking equipment company, was recently promoted to look after sales department along with procurement department. His seniors at the corporate level have always liked his way of leadership and are assures that he would ensure the implementation of policies and strategies to the best of his capacity but have never involved him in decision making for the company.

Do you think this is the right approach? Validate your answer with logical reasoning around management levels and decision making. (RTP May'21, Old & New SM)

Answer 22

Functional managers provide most of the information that makes it possible for business and corporate level managers to formulate realistic and attainable strategies.

This is so because functional managers like Dharma Singh are closer to the customer than the typical general manager is. A functional manager may generate important ideas that subsequently may become major strategies for the company. Thus, it is important for general managers to listen closely to the ideas of their functional managers and involve them in decision making.

An equally great responsibility for managers at the operational level is strategy implementation: the execution of corporate and business level plans, and if they are involved in formulation, the clarity of thoughts while implementation can benefit too.

Thus, the approach of Cyclic Corporate management is not right. They should involve Dharma Singh, as well as other functional managers too in strategic management.

Question 23

Ramesh Sharma has fifteen stores selling consumer durables in Delhi Region. Four of these stores were opened in last three years. He believes in managing strategically and enjoyed significant sales of refrigerator, televisions, washing machines, air conditioners and like till four years back. With shift to the purchases to online stores, the sales of his stores came down to about seventy per cent in last four years.

Analyze the position of Ramesh Sharma in light of limitations of strategic management. (RTP Nov'19 & Nov '20, Old & New SM)

Answer 23

Ramesh Sharma is facing declining sales on account of large scale shift of customers to online stores. While he is using the tools of strategic management, they cannot counter all hindrances and always achieve success. There are limitations attached to strategic management as follows:

- ◆ Environment under which strategies are made is highly complex and turbulent. Entry of online stores, a new kind of competitor brought a different dimension to selling consumer durables. Online stores with their size power could control the market and offer stiff competition to traditional stores.
- ◆ Another limitation of strategic management is that it is difficult to predict how things will shape-up in future. Ramesh Sharma, although managing strategically failed to see how online stores will impact the sales.
- ◆ Although, strategic management is a time-consuming process, he should continue to manage

strategically. The challenging times require more efforts on his part.

- ◆ Strategic management is costly. Ramesh Sharma may consider engaging experts to find out preferences of the customers and attune his strategies to better serve them in a customized manner. Such customized offerings may be difficult to match by the online stores.
- ◆ The stores owned by Ramesh Sharma are much smaller than online stores. It is very difficult for him to visualize how online stores will be moving strategically.

Question 24

Strategic management helps an organization to work through changes in environment to gain competitive advantage. In light of statement discuss its benefits. (RTP Nov'19)

Answer 24

Strategic management involves developing the company's vision, environmental scanning, strategy formulation, implementation, evaluation and control. It emphasizes the monitoring and evaluation of external opportunities and threats in the light of a company's strengths and weaknesses and designing strategies for the survival and growth. It helps in creation of competitive advantage to outperform the competitors and also guide the company successfully through all changes in the environment.

The major benefits of strategic management are:

- (a) Strategic management gives a direction to the company to move ahead. It defines the goals and mission.
- (b) It helps organizations to be proactive instead of reactive in shaping its future.
- (c) It provides framework for all major decisions of an enterprise such as decisions on businesses, products, markets, manufacturing facilities, investments and organizational structure. It provides better guidance to entire organization on the crucial point - what it is trying to do.
- (d) It helps organizations to identify the available opportunities and identify ways and means to achieve them.
- (e) It serves as a corporate defense mechanism against mistakes and pitfalls.
- (f) It helps to enhance the longevity of the business.
- (g) It helps the organization to develop certain core competencies and competitive advantages that would facilitate survival and growth.

Question 25

Mr. Mehta sharing with his friend in an informal discussion that he has to move very cautiously in his organization as the decisions taken by him has organization wide impact and involves large commitments of resources. He also said that his decisions decide the future of his organization. Where will you place Mr. Mehta in the organizational hierarchy and explain his role in the organization. (RTP Nov'21)

Answer 25

Mr. Mehta works in an organization at top level. He participates in strategic decision making within the organization. The role of corporate-level managers is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources among the different businesses, formulating and implementing strategies that span individual businesses, and providing leadership for the organization.

Question 26

Distinguish between the following: Corporate and business level. (RTP May 19)

Answer 26

A typical large organization is a multi-divisional organization that competes in several different businesses. There are three main levels of management: corporate, business, and functional. Corporate level occupies the highest level of strategic decision making and cover actions dealing with the objective of the firm, acquisition and allocation of resources and coordination of strategies of various businesses for optimal performance. The corporate level of management consists of the Chief Executive Officer (CEO), other senior executives. The role of corporate level managers is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources and so on.

Business level comes below corporate level. Business level strategies are the courses of action adopted by an organization for each of its businesses separately, to serve identified customer groups and provide value to the customers by satisfaction of their needs.

Question 27

ABC Ltd. currently sells its product in two major markets – Europe and Asia. While it is a market leader in Europe, ABC Ltd. has struggled to penetrate the more competitive Asian market. ABC Ltd. hired a strategic consultant to analyze the situation and submit his report to them. After the report received from the strategic consultant, it has therefore decided to pull out of Asia entirely and focus on its European markets only. This decision relates to which level in ABC Ltd. and explain the role of managers at this level in the organization. (RTP May '22)

Answer 27

Corporate level strategy relates to the markets and industries that the organization chooses to operate in, as well as other decisions that affect the organization as a whole. The role of corporate-level managers is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources among the different businesses, formulating and implementing strategies that span individual businesses, and providing leadership for the organization.

Question 28

Falguni, CFO of Warships Advertisement Agency, stated that strategic management helps the organisation to develop certain core competencies and competitive advantages that facilitate management in the turbulent environment. Do you agree, if yes, then what and how does it facilitate in? (RTP Nov '23)

Answer 28

Yes, strategic management plays a crucial role in an organization's survival and growth, particularly in a turbulent environment. It provides the framework for developing and leveraging core competencies and competitive advantages that enable the organization to not only withstand challenges but also seize opportunities for expansion and success.

- **Survival:** In a turbulent environment characterized by rapid changes, uncertainties, and challenges, strategic management helps an organization adapt and respond effectively. By developing core competencies and competitive advantages, an organization becomes better equipped to navigate unexpected disruptions and stay relevant in the market.
- **Growth:** Strategic management goes beyond survival. It enables an organization to identify opportunities, innovate, and create value for its customers. By leveraging core competencies and competitive advantages, the organization can capture market share, expand its offerings, and achieve sustained growth.

Question 29

Define strategic intent. Briefly explain the elements of strategic intent. (RTP May'18, May'19, May'20)
OR

"Strategic intent provides the framework within which the firm would adopt a predetermined direction and would operate to achieve strategic objectives." In the light of this statement, discuss the elements of strategic intent. (PYP 5 Marks Nov 22)

Answer 29

Strategic Management is defined as a dynamic process of formulation, implementation, evaluation, and control of strategies to realize the organization's strategic intent. Strategic intent refers to purposes for what organization strives for. Top management must define "what they want to do" and "why they want to do". "Why they want to do" represents strategic intent of the firm. Clarity in strategic intent is extremely important for the future success and growth of the enterprise, irrespective of its nature and size.

Strategic intent can be understood as the philosophical base of strategic management. It implies the purposes which an organization endeavors to achieve. It is a statement that provides a perspective of the



means, which will lead the organization, reach its vision in the long run. Strategic intent gives an idea of what the organization desires to attain in future.

Strategic intent provides the framework within which the firm would adopt a predetermined direction and would operate to achieve strategic objectives. Strategic intent could be in the form of vision and mission statements for the organization at the corporate level. It could be expressed as the business definition and business model at the business level of the organization.

Strategic intent is generally stated in broad terms but when stated in precise terms it is an expression of aims to be achieved operationally i.e., goals and objectives.

Elements of Strategic Intent

- (i) **Vision:** Vision implies the blueprint of the company's future position. It describes where the organization wants to land. It depicts the organization's aspirations and provides a glimpse of what the organization would like to become in future. Every sub system of the organization is required to follow its vision.
- (ii) **Mission:** Mission delineates the firm's business, its goals and ways to reach the goals. It explains the reason for the existence of the firm in the society. It is designed to help potential shareholders and investors understand the purpose of the company. A mission statement helps to identify, 'what business the company undertakes.' It defines the present capabilities, activities, customer focus and business makeup.
- (iii) **Business definition:** It seeks to explain the business undertaken by the firm, with respect to the customer needs, target markets, and alternative technologies. With the help of business definition, one can ascertain the strategic business choices. Organizational restructuring also depends upon the business definition.
- (iv) **Business model:** Business model, as the name implies is a strategy for the effective operation of the business, ascertaining sources of income, desired customer base, and financial details. Rival firms, operating in the same industry rely on the different business model due to their strategic choice.
- (v) **Goals and objectives:** These are the base of measurement. Goals are the end results, that the organization attempts to achieve. On the other hand, objectives are time-based measurable targets, which help in the accomplishment of goals. These are the end results which are to be attained with the help of an overall plan, over the particular period. However, in practice no distinction is made between goals and objectives and both terms are used interchangeably.

The vision, mission, business definition, and business model explain the philosophy of the organization but the goals and objectives represent the results to be achieved in multiple areas of business.

Question 30

**State with reasons which of the following statements are correct/incorrect:
For a small entrepreneur vision and mission are irrelevant. (RTP Nov'18)**

Answer 30

Incorrect: Entrepreneur, big or small has to function within several influences from external forces. Competition in different form and different degree is present in all kind and sizes of business. Even entrepreneur with small businesses can have complicated environment. To grow and prosper they need to have clear vision and mission.

Question 31

Essentials of a strategic vision. (RTP Nov'18)

Answer 31

Essentials of a strategic vision:

- ◆ The entrepreneurial challenge in developing a strategic vision is to think creatively about how to prepare a company for the future.
- ◆ Forming a strategic vision is an exercise in intelligent entrepreneurship.
- ◆ A well-articulated strategic vision creates enthusiasm among the members of the organization.
- ◆ The best-worded vision statement clearly illuminates the direction in which organization is headed.

Question 32

'Objectives' and 'Goals' provide meaning and sense of direction to organizational endeavor. Explain. (RTP Nov'18)

Answer 32

Business organizations translate their vision and mission into objectives. Objectives are open-ended attributes that denote the future states or outcomes. Goals are close-ended attributes which are precise and expressed in specific terms. Thus, the goals are more specific and translate to objectives to short term perspective.

All organizations have objectives. The pursuit of objectives is an unending process such that organizations sustain themselves. They provide meaning and sense of direction to organizational endeavor. Organizational structure and activities are designed and resources are allocated around the objectives to facilitate their achievement. They also act as benchmarks for guiding organizational activity and for evaluating how the organization is performing.

Question 33

What should be the major components of a good mission statement? (RTP Nov'22)

Answer 33

Mission statements broadly describe an organizations' present capabilities, customer focus, activities, and business makeup. Following points are useful while writing a good mission statement of a company:

- Good mission statement is highly personalized – unique to the organization for which it is developed.
- *Mission statement should emphasize on giving an organization its own special identity, business emphasis and path for development.
- *Mission statement should clearly specify that, what needs it is trying to satisfy, customer groups it is targeting, technologies and competencies it uses and the activities it performs.
- Technology, competencies and activities are important in defining a company's business because they indicate the boundaries on its operation.
- The mission should not be to make profit.

Question 34

ABC Pharmaceuticals, a leading pharmaceutical company, is in the process of formulating its strategic intent. The top management of ABC Pharmaceuticals wants to define the company's future direction, objectives, and goals. They aim is to create a vision that sets the organization apart and provides a roadmap for future growth. ABC Pharmaceuticals aspires to enrich the lives of people by producing high-quality pharmaceutical products at competitive prices and wants to become the world's leading pharmaceutical company by 2030." Based on this context, draft a vision and mission statement that could be formulated by the top management of ABC Pharmaceuticals. (RTP Nov '23)

Answer 34

ABC Pharmaceuticals may have following vision and mission:

Vision: Vision implies the blueprint of the company's future position. It describes where the organisation wants to land. ABC Pharmaceuticals may have vision "To be the globally recognized leader in pharmaceutical innovation and enriching the lives of people worldwide by providing high-quality, affordable, and accessible pharmaceutical products."

Mission: Mission delineates the firm's business, its goals and ways to reach the goals. It explains the reason for the existence of the firm in the society. It is designed to help potential shareholders and investors understand the purpose of the company.

ABC Pharmaceuticals may identify mission in the following lines:

- To improve the well-being of individuals and communities by relentlessly pursuing excellence in pharmaceutical research, development, and manufacturing.
- Committed to producing safe, effective, and sustainable medicines that address unmet medical needs and enhance the quality of life for patients.
- Through innovation, collaboration, and ethical practices, we aim to make a positive impact on global healthcare and become the trusted partner of healthcare providers and patients alike.

**Question 35**

How strategic decisions differ in nature from other routine decisions taken in day-to-day working of an organization? Explain. (Nov'21)

Answer 35

Strategic decisions are different in nature than all other decisions which are taken at various levels of the organization during day-to-day working of the organizations. The major dimensions of strategic decisions are given below:

- ◆ Strategic issues require top management decisions.
- ◆ Strategic issues involve the allocation of large amounts of company resources.
- ◆ Strategic issues are likely to have a significant impact on the long term prosperity of the organization.
- ◆ Strategic issues are future oriented.
- ◆ Strategic issues usually have major multifunctional or multi-business consequences.
- ◆ Strategic issues necessitate consideration of factors in the organization's external environment.

Question 35

List the different strategic levels in an organization. (PYP 2 Marks, Nov'18)

Answer 35

There are three main strategic levels in an organization:

- Corporate level – consisting of CEO, Board of Directors and other senior executives.
- Business level – Divisional Managers and staff.
- Functional level – Functional Managers – Marketing, Finance, Production, Human Resource.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Answers, in general, were correct as most of the students were aware of three main Strategic levels in an organization as corporate, business and functional.

Question 36

'ALBELA' Foods and 'Just BE' Foods are successfully competing chain of restaurants in India. ALBELA' s are known for their innovative approach, which has resulted in good revenues. On the other hand, Just BE is slow in responding to environmental change. The initial stages of Covid-19 pandemic and the ensuring strict lockdown had an adverse impact on both the companies. Realizing its severity and future consequences. ALBELA, foods immediately chalked out its post lockdown strategies, which include initiatives like:

- (a) Contactless dining
- (b) New category of foods in the menu for boosting immunity
- (c) Improving safety measures and hygiene standards
- (d) Introducing online food delivery app

Seeing the positive buzz around these measures taken by ALBELA Food, Just BE Foods also thinks to introduce these measures.

- (i) **Identify the strategic approach taken by 'ALBELA' Foods and 'Just BE' Foods.**
- (ii) **Discuss these strategic approach.**
- (iii) **Which strategic approach is better and why? (PYP 5 Marks, July'21)**

Answer 36

- i. ALBELA' foods are proactive in its approach. On the other hand, 'Just BE' foods are reactive in its approach.
 - Proactive strategy is planned strategy. While continuing with the previously initiated business approaches that are working well, the newly launched managerial initiatives aim to strengthen the company's overall position and performance. These are outcomes of management's analysis and strategic thinking about the company's situation and its conclusions about the positioning of the company in the marketplace. If done well, it helps the company to effectively compete for buyer patronage.
 - Reactive strategy is an adaptive reaction to changing circumstances. It is not always possible for a company to fully anticipate or plan for changes in the market. There is also a need to adapt strategy as new learnings emerge about which pieces of strategy are working well and which



- aren't. By itself also, the management may hit upon new ideas for improving the current strategy.
- ii. In reference to the given case, proactive strategy seems to be better because ALBELA foods had been able to utilize available opportunities, reduce adverse impact, enhance the demand for product and is also able to avail the first mover advantage.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Majority of the examinees were not able to correctly identify the correct strategic approaches. Better strategic approach was identified correctly but arguments advanced in support of the strategy were not correct. Hence, the performance was average.

Question 37

Which of the following statements are correct and which are incorrect? Give reasons in brief for your answer.

Vision is one of the key elements of Strategic Intent. (PYP 2 Marks, Nov'18)

Answer 37

Correct: Vision implies the blueprint of the company's future position. It describes where the organization wants to land. It depicts the organization's aspirations and provides a glimpse of what the organization would like to become in future. Every sub system of the organization is required to follow its vision.

Question 38

Why an organization should have a mission? What considerations are to be kept in mind while writing a good mission statement of a company? (PYP 5 Marks, Nov'19, Old SM)

Answer 38

Organization should have a mission on account of the following reasons:

- ◆ To ensure unanimity of purpose within the organization.
- ◆ To develop a basis, or standard, for allocating organizational resources.
- ◆ To provide a basis for motivating the use of the organization's resources.
- ◆ To establish a general tone or organizational climate.
- ◆ To serve as a focal point for those who can identify with the organization's purpose and direction.
- ◆ To facilitate the translation of objective and goals into a work structure involving the assignment of tasks to responsible elements within the organization.
- ◆ To specify organizational purposes and the translation of these purposes into goals in such a way that cost, time, and performance parameters can be assessed and controlled.

The following points must be considered while writing a good mission statement of a company:

- (i) To establish the special identity of the business - one that typically distinct it from other similarly positioned companies.
- (ii) Good mission statements should be unique to the organization for which they are developed. Needs which business tries to satisfy, customer groups it wishes to target and the technologies and competencies it uses and the activities it performs

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

The performance was below average as many examinees answered the question in vaguely. They were not able to understand properly and most of the answers were deviated from the required answer.

Question 39

What is strategic vision? Describe the essentials of strategic vision. (PYP 5 Marks, Nov'20)

Answer 39**Strategic Vision**

A strategic vision is a **roadmap of a company's future** – providing specifics about technology and customer focus, the geographic and product markets to be pursued, the capabilities it plans to develop, and the kind of company that management is trying to create. It helps the company to answer the

question **“where we are to go”** and **provides a convincing** rationale for why this makes good business sense for the company.

A strategic vision delineates organization's aspirations for the business, providing a panoramic view of the position where the organization is going. A strategic vision points an organization in a particular direction, charts a strategic path for it to follow in preparing for the future, and molds organizational identity.

Essentials of a strategic vision

- ◆ The entrepreneurial challenge in developing a strategic vision is **to think creatively about how to prepare a company for the future.**
- ◆ Forming a strategic vision is **an exercise in intelligent entrepreneurship.**
- ◆ A well-articulated strategic vision **creates enthusiasm among the members of the organization.**
- ◆ The best-worded vision statement **clearly illuminates the direction** in which organization is headed.

Question 40

Strategic planning is an important constituent of strategic management. In the light of the same explain the meaning of strategic planning. Also outline the characteristics of strategic planning. (PYP 5 Marks May '23)

Answer 40

Yes, strategic planning is an important constituent of strategic management. It is a process of determining organizational strategy. It gives directions to the organization and involves making decisions and allocating resources to pursue the strategy. It is the formal blueprint of future course of an organization.

Strategic plans are made by the senior management for the entire organization after taking into account the organization strength and weaknesses in the light of opportunities and threats in the external environment. They involve acquisition and allocation of resources for the attainment of organizational objectives.

Strategic planning deals with one or more of three key questions:

- What are we doing?
- For whom do we do it?
- How to improve and excel?

Following are the characteristics of strategic planning:

- Strategic planning shapes the organisation and its resources.
- Strategic planning assesses the impact of environmental variables.
- Strategic planning takes a holistic view of the organisation.
- Strategic planning develops overall objectives and strategies.
- Strategic planning is concerned with the long-term success of the organisation.
- Strategic planning is a senior management responsibility.

Question 41

“Management at all levels develop strategies”. Explain the different strategies formulated at different levels of management. (PYP 5 Marks May '23)

Answer 41

At different levels of management, various strategies are formulated to align with organizational goals and objectives which are as follows:

Corporate-Level Strategies: At the highest level of management, corporate-level strategies are developed. These strategies focus on the overall direction and scope of the entire organization. Major corporate-level strategies include Stability strategies, Growth strategies, Retrenchment strategies and Combination strategies.

Business-Level Strategies: Business-level strategies are developed by middle-level management and focus on individual business units or divisions within the organization. These strategies aim to achieve competitive advantage within specific markets. Common business-level strategies include Cost Leadership, Differentiation and Focus strategies.

Functional-Level Strategies: Functional-level strategies are formulated by lower-level management or department heads responsible for specific functional areas, such as marketing, finance, operations, or human resources. These strategies align with business-level strategies and focus on achieving functional objectives. These strategies include Marketing strategies, Financial strategies, Operations strategies, Research & Development strategy and Human Resource strategies.

In conclusion, management at all levels develops strategies that align with the organization's goals. Corporate-level strategies determine the overall direction, business-level strategies focus on competitive advantage within specific markets, and functional-level strategies aim to achieve functional objectives in support of the broader strategies.

MULTIPLE CHOICE QUESTIONS

1. **Which of the following are responsible for formulating and developing realistic and attainable strategies?**
 - (a) Corporate level and business level managers
 - (b) Corporate level and functional level managers
 - (c) Functional level managers and business level managers
 - (d) Corporate level managers, business level managers and functional level managers **(MTP- Oct '19, 1 Mark)**

Ans: (d)

2. **What can be defined as the art and science of formulating, implementing and evaluating cross functional decisions that enable an organization to achieve its objectives?**
 - (a) Strategy formulation
 - (b) Strategy evaluation
 - (c) Strategy implementation
 - (d) Strategic management **(MTP- March '19, 1 Mark)**

Ans: (d)

3. **An important activity in is taking corrective action.**
 - (a) Strategy evaluation
 - (b) Strategy implementation
 - (c) Strategy formulation
 - (d) Strategy leadership **(March -19, 1 Mark)**

Ans: (a)

4. **Strategy helps in:**
 - (a) Unravelling complexity
 - (b) Reduce uncertainty
 - (c) Relate the goals with the resources.



- (d) All of Above. **(MTP-April '19, 1 Mark)**

Ans: (d)

5. Which of the following statement is not true:

- (a) Strategic environment is complex
- (b) Strategic environment is turbulent.
- (c) High cost of strategy makes them useless for charitable organization.
- (d) Public sector units should implement business strategy **(MTP-April '19, 1 Mark)**

Ans: (c)

6. Strategic management allows an organization to be more:

- (a) Authoritative
- (b) Participative
- (c) Commanding
- (d) Proactive **(1 Mark May 20)**

Ans: (d)

7. Which of the following is correct?

- (a) Strategy is always pragmatic and not flexible
- (b) Strategy is not always perfect, flawless and optimal
- (c) Strategy is always perfect, flawless and optimal
- (d) Strategy is always flexible but not pragmatic **(1 Mark May 20, Mar'21)**

Ans: (b)

8. Which of the following is correct?

- a) Strategy is always pragmatic and not flexible
- b) Strategy is not always perfect, flawless and optimal
- c) Strategy is always perfect, flawless and optimal
- d) Strategy is always flexible but not pragmatic **(1 Mark March '21)**

Ans: (b)

9. Greg was heading the Global Biscuits SBU for Jonky's Ltd. and he got an email congratulating him for being promoted as the head of entire business of Jonky's in India. Which of the following statements is true about Greg's position?

- (a) Greg was a business level manager but now he is a corporate level manager
- (b) Greg was a functional level manager but now he is a corporate level manager
- (c) Greg was a business level manager and now also he is a business level manager
- (d) Greg was a corporate level manager and now also he is a corporate level manager **(2 Marks March '22)**

Ans: (a)

10. Bank had strategically decided to setup a separate office in Mumbai back in 2016, specifically to invest in crypto currencies and in development of robust block chain facilities. Which importance of strategic management did BBL Bank made use of?

- (a) Gives direction to the management of the company
- (b) Helps to be proactive instead of being reactive
- (c) Provides a framework for all major future decisions
- (d) Supports development of new SBUs like in this case separate office for Blockchain **(2 Marks April 22)**

Ans: (b)

11. The strategic landscape of healthcare sector around the world is changing rapidly because of-

- (a) Doctors Educational Interests
- (b) Indian Nurses going to abroad
- (c) Internet and Technological advancement
- (d) Patients being more aware **(MTP 1 Mark Nov 21)**

Ans: (c)

12. Shreya, the owner of Kalakaari boutiques, delegated tasks as per competencies of her team. What is she covering here?

- (a) Risk
- (b) Work Culture
- (c) Employee friendly vision
- (d) Proper use of mission statement **(MTP 1 Mark Sep'22)**

Ans:(d)

13. Imagine you are part of a strategic planning team for a company. As you work on defining the company's identity and its current business scope, which of the following elements primarily concentrates on answering the question, "Who we are and what we do?"

- (a) Mission statement
- (b) Vision statement
- (c) Goals and Objectives
- (d) Purpose **(MTP 2 Marks Sep '23)**

Ans: (a)

14. Mr. Prakash and Mr. Pal are partners in a thriving business venture. Recently, they have become aware of their employees' dissatisfaction with their working conditions. Mr. Prakash believes that the situation should be dealt with before the employees explode. Mr. Pal, on the other hand, believes that if the employees have an outburst, then they will handle it. Mr. Prakash and Mr. Pal business philosophy is:

- (a) Reactive, Proactive
- (b) Reactive, Reactive
- (c) Proactive, Proactive
- (d) Proactive, Reactive **(MTP 2 Marks Oct '23)**

Ans: (d)

15. What is one of the key purposes of having an organizational mission?

- (a) Ensuring unanimity of purpose within the organization.
- (b) Setting short-term operational goals.
- (c) Providing a basis for marketing strategies.
- (d) Specifying financial forecasts. **(MTP 1 Mark Oct '23)**

Ans: (a)

16. In the questions given below select the best answer out of options (a), (b), (c), or (d): Which of the following statement is not true with regards to strategy?

- (a) Strategy reduces uncertainty.
- (b) Strategy is long range blueprint of desired position.
- (c) Strategy relates organizations to the external environment.
- (d) Strategy is perfect and flawless. **(RTP May'19)**

Ans: (d)

17. Which of the following statement is not true about strategic decisions?

- (a) They need top-management involvement.
- (b) Involve commitment of organizational resources.
- (c) They are based on external environment
- (d) They have insignificant impact on the long-term prosperity **(RTP May'19)**

Ans: (d)

18. In the questions given below select the best answer out of options (a), (b), (c), or (d): (i) Strategy is-

- (a) Proactive in action
- (b) Reactive in action
- (c) A blend of proactive and reactive actions
- (d) None of the above **(RTP May'20)**

Ans: (i) (c)

19. In the questions given below select the best answer out of options (a), (b), (c), or (d):

(ii) Which of the following are responsible for formulating and developing realistic and attainable strategies?

- (a) Corporate level and business level managers
- (b) Corporate level and functional level managers
- (c) Functional managers and business level managers
- (d) Corporate level managers, business level managers and functional level managers **(RTP May'20)**

Ans: (d)

20. In the questions given below select the best answer out of options (A), (B), (C), or (D): Which of the following statements correctly explain strategic management?

- (i) Strategic management provides framework for major decisions.
- (ii) Strategic management helps to enhance the longevity of the business.
- (iii) Strategic management is an inexpensive process.

(iv) Strategic management helps organization to be more reactive than proactive.

- (a) (i) and (ii)
- (b) (i), (ii) and (iii)
- (c) (i), (ii) and (iv)
- (d) (i), (iii) and (iv) (RTP Nov'19)**

Ans: (a)

Question 21

21. A person who searched for business opportunity and starts a new enterprise to make use of that opportunity called

- (a) Employee
- (b) Entrepreneur
- (c) Entrepreneur
- (d) Investor (RTP Nov'20)**

Ans: (d)

22. An organization during its strategy planning envisaged entire scenarios and created a strategy framework. But in mean time after implementation, it realized that its framework is not effective in certain unique scenarios. What is the reason for the same?

- (a) Strategy is "partly proactive and Partly reactive"
- (b) Lack of analysis and proper planning.
- (c) Strategy is highly reactive and highly proactive.
- (d) Improper creation of strategic framework. (RTP Nov'21)**

Ans: (a)

23. What involves formulating, implementing, and evaluating cross-functional decisions that enable an organization to achieve its objectives?

- (a) Strategy formulation
- (b) Strategy evaluation
- (c) Strategy implementation
- (d) Strategic management**

Ans: (d)

24. Strategic management allows an organization to be more

- (a) Authoritative
- (b) Participative
- (c) Commanding
- (d) Proactive**

Ans: (d)

25. Which one is not the element of strategic intent?

- (a) Business model
- (b) Vision
- (c) Business definition**



(d) Business standard (MTP-Oct '19, 1 Mark)

Ans: (d)

26. Objectives should be:

- (i) Concrete and specific.
- (ii) Related to time frame.
- (iii) Standards for performance appraisal. Which of the above statements are true:
 - (a) (i) & (ii).
 - (b) (ii) & (iii).
 - (c) (i) & (iii).
 - (d) (i), (ii) and (iii) **(MTP-April '19, 1 Mark)**

Ans: (d)

27. Financial objectives involve all of the following except:

- (a) Growth in revenues
- (b) Larger market share
- (c) Higher dividends
- (d) Greater return on investment **(MTP 1 Mark March 19)**

Ans: (b)

28. Which of these basic questions should a vision statement answer?

- (a) What is our business?
- (b) Who are our competitors?
- (c) Where we are to go?
- (d) Why do we exist? **(MTP 1 Mark March 19)**

Ans: (c)

29. The philosophical base of strategic management falls within the concept of-

- (a) Strategic Intent
- (b) Portfolio Analysis
- (c) Globalisation
- (d) Vision Statement **(MTP 1 Mark Oct 21, Apr'22)**

Ans: (a)

30. Meba Ltd. had a huge capacity of 40,000 Kilo Litres production of Kerosene Oil, and they were able to achieve 90% of it almost always, while the teams were also aware that they can achieve 100% capacity with very less efforts, but always kept margins. Further, the business team was planning to setup two more plants of 20,000 Kilo Litre capacity each in the next five years. This was a welcomed move from state governments as well. From the above, which of the following aspects of objectives is missing by production team?

- (a) They should be clear and quantifiable.
- (b) They should be concise.
- (c) They should be challenging.
- (d) They should provide standard for comparative appraisal. **(MTP 2 Marks Nov 21)**

Ans: (c)

31. Members of Infinite Care, an NGO, have met and determined that they need to formulate a

philosophical basis for their activities. Thereby they have come up with a statement:- “Provide children till age 12, living in homeless or low-income situations, with the essential items they need to thrive – at home, at school and at play” Identify the area of strategic intent, which the members have stated?

- (a) Vision
- (b) Business Definition
- (c) Goal and Objective
- (d) Mission **(MTP 2 Marks Oct 20)**

Ans: (d)

32. The statement “where we want to go “denotes company

- (a) Objective
- (b) Policy
- (c) Strategy
- (d) Vision **(MTP 1 Mark Mar '22)**

Ans: (c)

33. Mission

- (a) is an internally-focused definition of the organization's societal goals
- (b) is a statement of a firm's unique purpose and scope of operations
- (c) does not limit the firm by specifying the industry in which the firm intends to compete
- (d) is developed by a firm before the firm develops its strategic intent. **(MTP 1 Mark April 19, RTP May'19)**

Ans: (a)

34. Which one of the following, focuses on present business scope- ‘who we are and what we do’?

- (a) Mission Statement
- (b) Vision Statement
- (c) Goals and objectives
- (d) Purpose **(MTP 1 Mark April '23)**

Ans: (a)

35. Strategic decision making can take place at three common levels of an organization as follows:

- (a) Divisional, group and individual.
- (b) Executive, leader and manager.
- (c) Corporate, business and functional.
- (d) Strategic, tactical and operational. **(RTP May'19)**

Ans: (c) Corporate, business and functional.

36. Which one is not the element of strategic intent?

- (a) Business model
- (b) Vision
- (c) Business definition
- (d) Business standard **(May'20)**

Ans: (d)

**37. In the questions given below select the best answer out of options (A), (B), (C), or (D):
Statement that is typically focused on present business scope and broadly describes an organizations present capabilities, customer focus, activities, and business makeup is:**

- (a) Vision
- (b) Mission
- (c) Strategy
- (d) Goals **(Nov'19)**

Ans:(b)

38. Drishti Care is a not-for profit eye hospital and research Centre. Which one of the following statements is likely to relate to Drishti Care's vision, rather than its mission statement?

- (a) Drishti Care places patient care before all else.
- (b) Drishti Care will be the global leader in cutting edge eye surgery.
- (c) Drishti Care offers the highest level of patient care throughout country.
- (d) Drishti Care consultants strive to continually improve surgical techniques. **(Nov'21)**

Ans: (b) Drishti Care will be the global leader in cutting edge eye surgery.

39. Jaipur Mart an online marketplace where people from all over Rajasthan come and sell their goods is charging zero commission for listing goods but they take 1% of the sales per month from the seller. It is defined as?

- (a) Business Intent
- (b) Business Idea
- (c) Business Definition
- (d) Business Model **(Nov'22)**

Ans :(d)

40. Which one of the following cannot be considered as a part of proactive approach in strategy? (RTP Nov'23)

- (a) Planned strategy
- (b) Deliberate management design
- (c) Forecast about future market condition
- (d) Adaptive reactions to changing circumstances

Ans: (d)

Chapter 2

Strategic Analysis: External Environment

Question 1

Eco-carry bags Ltd., a recyclable plastic bags manufacturing, and trading company has seen a potential in the ever-growing awareness around hazards of plastics and the positive outlook of the society towards recycling and reusing plastics.

A major concern for Eco-carry bags Ltd. are paper bags and old cloth bags. Even though they are costlier than recyclable plastic bags, irrespective, they are being welcomed positively by the consumers.

Identify and explain that competition from paper bags and old cloth bags fall under which category of Porter's Five Forces Model for Competitive Analysis? (RTP May'20, Old & New SM)

Answer 1

Eco-carry bags Ltd. faces competition from paper bags and old cloth bags and falls under Threat of Substitutes force categories in Porter's Five Forces Model for Competitive Analysis. Paper and cloth bags are substitutes of recyclable plastic bags as they perform the same function as plastic bags. Substitute products are a latent source of competition in an industry. In many cases, they become a major constituent of competition. Substitute products offering a price advantage and/or performance improvement to the consumer can drastically alter the competitive character of an industry.

Question 2

Dinesh Yadav is the owner of a beverage-based private company in Sonapat, Haryana. His unit is producing fruit juices, cold drinks, soda and lime. While its products have significant market share in the northern part of country, the sales are on decline in last couple of years. He seeks help of a management expert who advises him to first understand the competitive landscape. Explain the steps to be followed by Dinesh Yadav to understand competitive landscape. [MTP-March '19 & Sep '22, 5 Marks, Old & New SM, PYP May '19 & July 21 5 Marks, RTP May '18]

Answer 2

Steps to understand the competitive landscape:

- (i) **Identify the competitor:** The first step to understand the competitive landscape is to identify the competitors in the firm's industry and have actual data about their respective market share.
- (ii) **Understand the competitors:** Once the competitors have been identified, the strategist can use market research report, internet, newspapers, social media, industry reports, and various other sources to understand the products and services offered by them in different markets.
- (iii) **Determine the strengths of the competitors:** What are the strength of the competitors? What do they do well? Do they offer great products? Do they utilize marketing in a way that comparatively reaches out to more consumers. Why do customers give them their business?
- (iv) **Determine the weaknesses of the competitors:** Weaknesses (and strengths) can be identified by going through consumer reports and reviews appearing in various media. After all, consumers are often willing to give their opinions, especially when the products or services are either great or very poor.
- (v) **Put all of the information together:** At this stage, the strategist should put together all information about competitors and draw inference about what they are not offering and what the firm can do to fill in the gaps. The strategist can also know the areas which need to be strengthened by the firm.



EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Majority of the examinees were able to present good answers in this simple and straightforward question. Overall the performance was good.

Performance was below average. Examinees explained the meaning and importance of the competitive advantage instead of competitive landscape. The explanation of steps to understand competitive landscape was not up to the mark.

Question 3

Which of the following statements are 'correct' and which are 'incorrect'? Give reasons, in brief, for your answer:

Economies of scale discourages new entrants.

[MTP-March '18, 2 Marks, PYP May'18 2

Marks]

Answer 3

Correct: Economies of scale refer to the decline in the per-unit cost of production (or other activity) as volume grows. A large firm that enjoys economies of scale can produce high volumes of goods at successively lower costs. This tends to discourage new entrants.

Question 4

Examine the significance of KSFs (Key Success Factors) for competitive success. (MTP 5 Marks March '21, PYP 3 Marks, Nov'18)

Answer 4

As industry's Key Success Factors (KSFs) are those things that most affect industry members' ability to prosper in the market place – the particular strategy elements, product attributes, resources, competencies, competitive capabilities and business outcomes that spell the difference between profit & loss and ultimately, between competitive success or failure. KSFs by their very nature are so important that all firms in the industry must pay close attention to them. They are the prerequisites for industry success, or, to put it in another way, KSFs are the rules that shape whether a company will be financially and competitively successful.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Overall performance of the examinees was below average in both the alternatives related to impact of IT systems on business process reengineering and key success factors.

Question 5

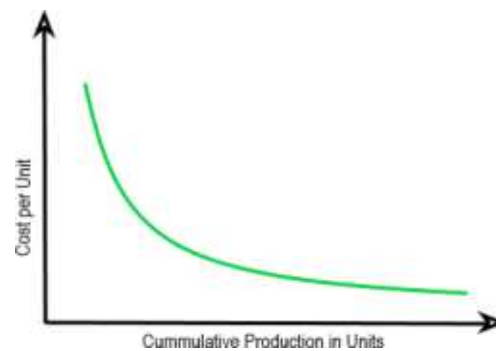
Explain the concept of Experience Curve and highlight its relevance in strategic management. (MTP 5 Marks Oct 20, Oct'18, Old & New SM, RTP May 18)

Answer 5

Experience curve is similar to learning curve which explains the efficiency gained by workers through repetitive productive work. Experience curve is based on the commonly observed phenomenon that unit costs decline as a firm accumulates experience in terms of a cumulative volume of production. It is represented diagrammatically as follows:

The implication is that larger firms in an industry would tend to have lower unit costs as compared to those of smaller organizations, thereby gaining a competitive cost advantage. Experience curve results from a variety of factors such as learning effects, economies of scale, product redesign and technological improvements in production.

The concept of experience curve is relevant for a number of areas in strategic management. For instance, experience curve is considered a barrier for new firms contemplating entry in an industry. It is also used to build market share and discourage competition.



Question 6

Write short note on "Phases and significance of Product Life Cycle". (MTP 5 Marks April 22, Old & New SM)

Answer 6

Product Life Cycle (PLC) is a useful concept for guiding strategic choice. Essentially, PLC is S-shaped curve which exhibits the relationship of sales with respect of time for a product that passes through the four successive stages of introduction (slow sales growth), growth (rapid market acceptance) maturity (slowdown in growth rate) and decline (sharp downward drift). If businesses are substituted for product, the concept of PLC could work just as well.

The first stage of PLC is the introduction stage in which competition is almost negligible, prices are relatively high, and markets are limited. The growth in sales is at a lower rate because of lack of knowledge on the part of customers.

The second stage of PLC is growth stage. In the growth stage, the demand expands rapidly, prices fall, competition increases, and market expands. The customer has knowledge about the product and shows interest in purchasing it.

The third stage of PLC is maturity stage. In this stage, the competition gets tough, and market gets stabilised. Profit comes down because of stiff competition. At this stage organisations may work for maintaining stability.

The fourth stage of PLC is declining stage in which the sales and profits fall down sharply due to some new product replaces the existing product. So, a combination of strategies can be implemented to stay in the market either by diversification or retrenchment.

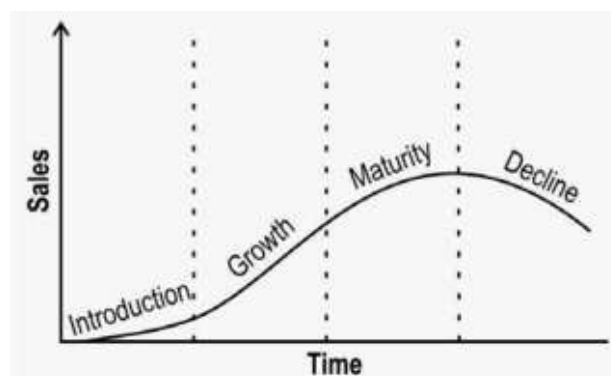


Figure: Product Life Cycle

Significance of PLC

The main advantage of PLC is that it can be used to diagnose a portfolio of products (or businesses) in order to establish the stage at which each of them exists. Particular attention is to be paid on the businesses that are in the declining stage. Depending on the diagnosis, appropriate strategic choice can be made. For instance, expansion may be a feasible alternative for businesses in the introductory and growth stages. Mature businesses may be used as sources of cash for investment in other businesses which need resources. A combination of strategies like selective harvesting, retrenchment, etc. may be adopted for declining businesses. In this way, a balanced portfolio of businesses may be built up by

exercising a strategic choice based on the PLC concept.

Question 7

Atrix Ltd. is a company engaged in the designing, manufacturing, and marketing of mechanical instruments like speed meters, oil pressure gauges, and so on. Their products are fitted into two and four wheelers. During the last couple of years, the company has been observing a fall in the market share. This is on account of shift to the new range of electronic instruments. The customers are switching away mechanical instruments that have been the backbone of Atrix Ltd. As a CEO of Atrix Ltd., what can be the strategic options available with you. (MTP 5 Marks Aug '18, Old SM)

Answer 7

Atrix is having a product portfolio that is evidently in the decline stage. The product is being replaced with the technologically superior product. Strategically the company should minimize their dependence on the existing products and identify other avenues for the survival and growth. As a CEO of Atrix Ltd., following can be the strategic options available with the CEO:

- Invest in new product development and switchover to the new technology. Atrix Ltd. also need time to invest in emerging new technology.
- They can acquire or takeover a competitor, provided they have or are able to generate enough financial resources.
- They may also consider unrelated growth and identify other areas for expansion. This will enable Atrix Ltd. to spread their risks.
- In longer run, they should divest the existing products. However, they may continue with the existing products in a limited manner for such time there is demand for the product.

Question 8

The CEO of ABC Enterprises, Mr. Rasik Mehta, had the idea of creating a fitness shake called Robust, which prompted the company to conduct research and development. The company conducted a market survey and feasibility study, which indicated that the idea was feasible and had potential for profitability. Consequently, the product was manufactured, marketed, and launched, which led to its success. As a result, the production of Robust grew, and it became widely available. However, with time, the demand for the product decreased, leading to its obsolescence. Identify and explain the concept highlighted in the above case? (MTP 5 Marks April '23)

Answer 8

The case highlights the concept of Product Life Cycle (PLC), which outlines the various stages a product goes through, including introduction, growth, maturity and decline. Successful businesses must adapt their strategies to each stage to remain profitable.

Product Life Cycle (PLC) is a useful concept for guiding strategic choice. Essentially, PLC is S-shaped curve which exhibits the relationship of sales with respect of time for a product that passes through the four successive stages of introduction (slow sales growth), growth (rapid market acceptance) maturity (slowdown in growth rate) and decline (sharp downward drift). If businesses are substituted for product, the concept of PLC could work just as well.

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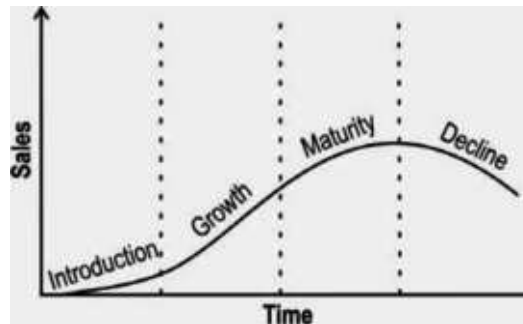


Figure: Product Life Cycle

Question 9

Explain briefly the primary activities that are grouped into five main activities under Value chain analysis. (MTP 5 Marks April '23)

Answer 9

The primary activities of the organization are grouped into five main areas: inbound logistics, operations, outbound logistics, marketing and sales, and service.

- **Inbound logistics** are the activities concerned with receiving, storing and distributing the inputs to the product/service. This includes materials handling, stock control, transport etc.
- **Operations transform these inputs into the final product or service:** machining, packaging, assembly, testing, etc.
- Outbound logistics collect, store and distribute the product to customers. For tangible products this would be warehousing, materials handling, transport, etc. In the case of services, it may be more concerned with arrangements for bringing customers to the service, if it is a fixed location (e.g., sports events).
- Marketing and sales provide the means whereby consumers/users are made aware of the product/service and are able to purchase it. This would include sales administration, advertising, selling and so on. In public services, communication networks which help users' access a particular service are often important.
- Service are all those activities, which enhance or maintain the value of a product/service, such as installation, repair, training and spares.

Question 10

Explain Porter's five forces model as to how businesses can deal with the competition. [MTP-March '19, 5 Marks, MTP-Oct '18, 6 Marks, RTP Nov '18]

Answer 10

To gain a deep understanding of a company's industry and competitive environment, managers do not need to gather all the information they can find and waste a lot of time digesting it. Rather, the task is much more focused. A powerful and widely used tool for systematically diagnosing the significant competitive pressures in a market and assessing the strength and importance of each is the Porter's five-forces model of competition. This model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market:

- Competitive pressures associated with the market maneuvering and jockeying for buyer patronage that goes on among rival sellers in the industry.
- Competitive pressures associated with the threat of new entrants into the market.
- Competitive pressures coming from the attempts of companies in other industries to win buyers

over to their own substitute products.

- Competitive pressures stemming from supplier bargaining power and supplier-seller collaboration.
- Competitive pressures stemming from buyer bargaining power and seller-buyer Collaboration.

Question 11

Pulkit was very confident about cloud kitchen business model, and he bought three real estate spaces in very hideous localities. Later due to government and court orders the cloud kitchens had to be only operated in a well-ventilated space, which made his investment redundant. What aspect of industry competition is Pulkit currently faced as a result of this situation? (5 Marks April '23)

Answer 11

Pulkit may be facing exit barriers due to his investment in the real estate spaces. Exit barriers are factors that make it difficult for a company to exit a particular market or industry. In this case, Pulkit's investment in the real estate spaces may make it difficult for him to exit the cloud kitchen industry or switch to a different business model. If Pulkit is unable to find new spaces or make the necessary renovations, he may be forced to continue operating in the hideous localities, which may impact his brand image and customer experience. This can create an exit barrier for Pulkit as it may be difficult for him to turn to a different business model or exit the industry entirely.

Additionally, Pulkit may have incurred significant sunk costs in the purchase and renovation of the real estate spaces, which can create a further exit barrier. Sunk costs refer to costs that have already been incurred and cannot be recovered. If Pulkit has invested a significant amount of money in the real estate spaces, he may be hesitant to exit the industry or switch to a different business model as it may mean that he has to write off the sunk costs.

Therefore, Pulkit may be facing exit barriers due to his investment in the real estate spaces, which may make it difficult for him to adapt to the new requirements or exit the industry entirely.

Question 12

State with reasons which of the following statements are correct/incorrect:

Key success factors determine competitive success. (RTP May'18)

Answer 12

Correct: The purpose of identifying Key Success Factors is to make judgments about things that are more important to competitive success and the things that are less important. To compile a list of every factor that matters even a little bit defeats the purpose of concentrating management attention on the factors truly critical to long-term competitive success.

Question 13

ABC Ltd. manufactures and sells air purifier 'Fresh Breath'. The 'Fresh Breath' has seen sales growth of around 1% for the last two years, after strong growth in the previous five years. This is due to new products entering the market in competition with the 'Fresh Breath'. ABC Ltd. is therefore considering cutting its prices to be in line with its major rivals with a hope to maintain the market share. Market research indicates that this will now cause a significant increase in the level of sales, even though in previous years' price cuts have had little effect on demand. ABC Ltd. is also planning to launch a promotional campaign to highlight the benefits of the 'Fresh Breath' against its rival products. Identify and explain the stage of the product life cycle in which 'Fresh Breath' falls. (RTP May'21)

Answer 13

Product Life Cycle is a useful concept for guiding strategic choice. PLC is an S-shaped curve which exhibits the relationship of sales with respect of time for a product that passes through the four successive stages of introduction (slow sales growth), growth (rapid market acceptance) maturity (slowdown in growth rate) and decline (sharp downward drift).

The product 'Fresh Breath' of ABC Ltd. falls under Maturity stage of product life cycle. In this stage, the competition gets tough and market gets stabilized. Profit comes down because of stiff competition. At this stage, ABC Ltd. have to work for maintaining stability by cutting the prices to be in line with its major

rivals with a hope to maintain the market share and by launching a promotional campaign to highlight the benefits of the 'Fresh Breath' against its rival products.

Question 14

Define key success factors (KSFs). (RTP Nov'18)

Answer 14

An industry's key success factors (KSFs) are those things or strategic elements that affect industry members' ability to prosper in a market place. For a business organization within an industry, it may include, cost structure, technology, distribution system and so on. It is correct to state that the KSFs help to shape whether a company will be financially and competitively successful.

Question 15

State with reasons which of the following statements are correct/incorrect:

Competitive strategy is designed to help firms achieve competitive advantage. (RTP Nov'18).

Answer 15

Correct: Competitive strategy is designed to help firms achieve competitive advantage. Having a competitive advantage is necessary for a firm to compete in the market. Competitive advantage comes from a firm's ability to perform activities more effectively than its rivals.

Question 16

A company has recently launched a new product in the market. Initially, it faced slow sales growth, limited markets, and high prices. However, over time, the demand for the product expanded rapidly, prices fell, and competition increased. Identify the stages of the product life cycle (PLC) that the company went through. (RTP Nov '23)

Answer 16

The company went through the following stages of the product life cycle (PLC):

Introduction stage: Initially, the company faced slow sales growth, limited markets, and high prices, which are characteristic of the introduction stage. During this stage, competition is almost negligible, and customers have limited knowledge about the product.

Growth stage: Over time, the demand for the product expanded rapidly, prices fell, and competition increased. These are typical features of the growth stage in the PLC. In this stage, the product gains market acceptance, and customers become more aware of the product's benefits and show interest in purchasing it.

Question 17

State with reasons the following statement is correct/incorrect:

Substitutes can also exert significant competitive pressures. (RTP May'18)

Answer 17

Correct: According to porter's five forces model, a final force that can influence industry profitability is the availability of substitutes for an industry's product. To predict profit pressure from this source, firms must search for products that perform the same, or nearly the same, function as their existing products.

Question 18

What are the common barriers that are faced by new entrants when an existing firm earns higher profits? (RTP May'18, RTP May '23)

OR

Rahul Sharma is Managing Director of a company which is manufacturing trucks. He is worried about the entry of new businesses. What kind of barriers will help Rahul against such a threat? (RTP May'19 ,Old SM)

Answer 18

A firm's profitability tends to be higher when other firms are blocked from entering the industry. New entrants can reduce industry profitability because they add new production capacity leading to increase

supply of the product even at a lower price and can substantially erode existing firm's market share. Barriers to entry represent economic forces (or 'hurdles') that slow down or impede entry by other firms. Common barriers to entry include:

- (i) **Capital requirements:** When a large amount of capital is required to enter an industry, firms lacking funds are effectively barred from the industry, thus enhancing the profitability of existing firms in the industry.
- (ii) **Economies of scale:** Many industries are characterized by economic activities driven by economies of scale. Economies of scale refer to the decline in the per-unit cost of production (or other activity) as volume grows. A large firm that enjoys economies of scale can produce high volumes of goods at successively lower costs. This tends to discourage new entrants.
- (iii) **Product differentiation:** Production differentiation refers to the physical or perceptual differences, or enhancements, that make a product special or unique in the eyes of customers. Firms in the personal care products and cosmetics industries actively engage in product differentiation to enhance their products' features. Differentiation works to reinforce entry barriers because the cost of creating genuine product differences may be too high for the new entrants.
- (iv) **Switching costs:** To succeed in an industry, new entrant must be able to persuade existing customers of other companies to switch to its products. To make a switch, buyers may need to test a new firm's product, negotiate new purchase contracts, and train personnel to use the equipment, or modify facilities for product use. Buyers often incur substantial financial (and psychological) costs in switching between firms. When such switching costs are high, buyers are often reluctant to change.
- (v) **Brand identity:** The brand identity of products or services offered by existing firms can serve as another entry barrier. Brand identity is particularly important for infrequently purchased products that carry a high unit cost to the buyer. New entrants often encounter significant difficulties in building up the brand identity, because to do so they must commit substantial resources over a long period.
- (vi) **Access to distribution channels:** The unavailability of distribution channels for new entrants poses another significant entry barrier. Despite the growing power of the internet, many firms may continue to rely on their control of physical distribution channels to sustain a barrier to entry to rivals. Often, existing firms have significant influence over the distribution channels and can retard or impede their use by new firms.
- (vii) **Possibility of aggressive retaliation:** Sometimes the mere threat of aggressive retaliation by incumbents can deter entry by other firms into an existing industry. For example, introduction of products by a new firm may lead existing firms to reduce their product prices and increase their advertising budgets.

Question 19

Competitive pressures operate as a composite in five areas of the overall market. Elaborate. (RTP May'21)

Answer 19

Competition makes organizations work harder, however, it is neither a coincidence nor bad luck. All organizations have competition and its benefit are enjoyed by the markets. The customers are able to get better products at lower costs. They get better value for their money because of competition. A powerful and widely used tool for systematically

diagnosing the significant competitive pressures in a market and assessing the strength and importance of each is the Porter's five-forces model of competition. This model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market as follows:

- (i) **Rivalry among current players:** Competitive pressures associated with the market maneuvering and jockeying for buyer patronage that goes on among rival sellers in the industry.
- (ii) **Threat of new entrants:** Competitive pressures associated with the threat of new entrants into the market.
- (iii) **Threats from substitutes:** Competitive pressures coming from the attempts of companies in other industries to win buyers over to their own substitute products.
- (iv) **Bargaining power of suppliers:** Competitive pressures stemming from supplier bargaining power and supplier-seller collaboration.
- (v) **Bargaining power of customers:** Competitive pressures stemming from buyer bargaining power and seller-buyer collaboration.

Question 20

State with reasons the following statement is correct/incorrect:

Porter's five forces model considers new entrants as a significant source of competition. (RTP Nov'18)

Answer 20

Correct: Direct marketing is done through various advertising media that interact directly with customer. Teleshopping is a form of direct marketing which operates without conventional intermediaries and employs television and other IT devices for reaching the customer. The communication between the marketer and the customer is direct through third party interfaces such as telecom or postal systems.

Question 21

Buyers can exert considerable pressure on business. Do you agree? Discuss. (RTP Nov'19)

Answer 21

Buyers of an industry's products or services can exert considerable pressure on existing firms to secure lower prices or better services. This is evident in situations where buyers enjoy superior position than the seller of product. This leverage is particularly evident when:

- (i) Buyers have full knowledge of the sources of products and their substitutes.
- (ii) They spend a lot of money on the industry's products, i.e., they are big buyers.
- (iii) The industry's product is not perceived as critical to the buyer's needs and buyers are more concentrated than firms supplying the product. They can easily switch to the substitutes available.

Question 22

Easy Access is a marketing services company providing consultancy to a range of business clients. Easy Access and its rivals have managed to persuade the Government to require all marketing services companies to complete a time-consuming and bureaucratic registration process and to comply with an industry code of conduct. Do you think that by doing this Easy Access and its rivals has an advantage in some way to fight off competitors? Explain. (RTP Nov'21, RTP Nov '23)

Answer 22

Yes, Easy Access and its rivals get advantage by this move. The new bureaucratic process is making it more complicated for organizations to start up and enter in Easy Access market, increasing barriers to entry and thereby reducing the threat of new entrants. New entrants can reduce an industry's profitability, because they add new production capacity, leading to increase in supply of the product, sometimes even at a lower price and can substantially erode existing firm's market share position. However, New entrants are always a powerful source of competition. The new capacity and product range they bring in throws up a new competitive pressure. The bigger the new entrant, the more severe the competitive effect. New entrants also place a limit on prices and affect the profitability of existing players, which is known as Price War.

Question 23

What are the five competitive forces in an industry as identified by Michael Porter? (RTP May '22, PYP 5 Marks ,May '18, Old SM)

Answer 23

Five forces model of Michael Porter is a powerful and widely used tool for systematically diagnosing the significant competitive pressures in the market and assessing their strength and importance. The model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market. These five forces are:

1. **Threat of new entrants:** New entrants are always a powerful source of competition. The new capacity and product range they bring in throw up new competitive pressure. And the bigger the new entrant, the more severe the competitive effect. New entrants also place a limit on prices and affect the profitability of existing players.
2. **Bargaining power of customers:** This is another force that influences the competitive condition of the industry. This force will become heavier depending on the possibilities of the buyers' forming groups or cartels. Mostly, this is a phenomenon seen in industrial products. Quite often, users of

industrial products come together formally or informally and exert pressure on the producer. The bargaining power of the buyers influences not only the prices that the producer can charge but also influences in many cases, costs and investments of the producer because powerful buyers usually bargain for better services which involve costs and investment on the part of the producer.

3. **Bargaining power of suppliers:** Quite often suppliers, too, exercise considerable bargaining power over companies. The more specialized the offering from the supplier, greater is his clout. And, if the suppliers are also limited in number, they stand a still better chance to exhibit their bargaining power. The bargaining power of suppliers determines the cost of raw materials and other inputs of the industry and, therefore, industry attractiveness and profitability.
4. **Rivalry among current players:** The rivalry among existing players is quite obvious. This is what is normally understood as competition. For any player, the competitors influence strategic decisions at different strategic levels. The impact is evident more at functional level in the prices being charged, advertising, and pressures on costs, product and so on.
5. **Threats from substitutes:** Substitute products are a latent source of competition in an industry. In many cases they become a major constituent of competition. Substitute products offering a price advantage and/or performance improvement to the consumer can drastically alter the competitive character of an industry. And they can bring it about all of a sudden. **For example**, coir suffered at the hands of synthetic fiber. Wherever substantial investment in R&D is taking place, threats from substitute products can be expected. Substitutes, too, usually limit the prices and profits in an industry.

The five forces together determine industry attractiveness/profitability. This is so because these forces influence the causes that underlie industry attractiveness/ profitability. **For example**, elements such as cost and investment needed for being a player in the industry decide industry profitability, and all such elements are governed by these forces. The collective strength of these five competitive forces determines the scope to earn attractive profits. The strength of the forces may vary from industry to industry.

Question 24

Rajiv Arya is owner of an electrical appliance company that specializes in manufacturing of domestic vacuum cleaners. There are four other manufacturers with similar products and sales volume. Current rival firms also own a number of patents related to the product. The supplier base for procurement of raw material is also very large as there are multiple suppliers. Identify Porter's Five Forces that may be classified as significant for the company? Explain. (RTP Nov'22)(MTP 5 Marks Oct '23)

Answer 24

The competitive rivalry will be a significant force in case of company of Rajiv Arya as all the rivals are similar in sizes and are manufacturing similar products. It is difficult for any single manufacturer to dominate the market. Large number of patents will make it difficult for new entrants to break into the market. Further, as there are a large number of small suppliers the power that suppliers can exert will also be low.

There is no information relating to substitutes and bargaining power of customers in the information given in scenario. However, a domestic vacuum cleaner will directly compete with other options such as house maids. Availability of house maids at low cost can significantly disturb the sales of products.

Further, as the products are similar customers can easily shift from one company to another. This will only enhance competitive rivalry.

The competitive rivalry will be significant in Rajiv Arya's dealing industry as all rivals are similar in sizes and manufacture similar products, making it difficult for anyone manufacturer to dominates the market or gain market share. The large number of patents will make it hard for new entrants to break into the market, while the fact that Rajiv Arya buys from a large number of small suppliers suggests that supplier power is also low. Finally, there is no information relating to substitutes and bargaining power of customers in the information given in scenario.

Question 25

A startup company is thinking of launching of a low cost detergent powder in the market. The market of the said product is already dominated by a big FMCG player.

You are advised to put forward your suggestions to the management of the company to deal with the problems of 'Entry Barrier' while launching the low cost detergent powder. (RTP Nov'22)

Answer 25

There are number of factors that can act as entry barrier for the start-up company. An FMCG, big in size, is already dominating the market space and will act as a strong deterrent for the new start-up. The following will be some suggestions to the management of the start-up to deal with the problem of entry barriers:

1. The company is working on producing low cost detergent. Keeping other expenses also on the lower side the management can create price advantage that is competitive to the existing established players including the large FMCG.
2. The company focussing on single product in comparison to multiple products of an FMCG can develop competencies to produce and sell the low cost detergent that are difficult to deploy by the FMCG by its strategy that addresses needs of multiple products.
3. The start-up needs to have strong financial strength to sustain the onslaught from the dominant FMCG and other players. The start-up can identify sources of capital well in advance and be able to use it judiciously to their advantage.
4. The start-up should identify the customer segments that are likely to switch to the product well in advance so as to target the same and generate the initial hold on the market. Once the product gets some hold and their brands get some identity, the market can be further developed to address other customers.
5. The start-up should identify the environmental factors that go to their advantage. These may include special scheme of the government to encourage entrepreneurs, tax holiday, low interest rates, advantages available to small and medium sized enterprises alike.
6. It has to create an image in the market that its products are qualitative and 'Made in India' to attract a particular segment of customers.
7. They need to have a team of experts and dedicated management professionals who can implement strategies formulated by top management.

PP

Question 26

What do you mean by "Economies of Scale"? (PYP 2 Marks, Nov'18 & May '18)

Answer 26

Economies of scale refer to the decline in the per unit cost of production as volume grows. A large firm that enjoys economies of scale can produce high volume of goods at lower costs. This tends to discourage new entrants.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

While many candidates were able to explain the concept of economies of scale, some candidates wrote vague answers such as discussing about economy of the country.

Question 27

Why companies should go global? Mention any five reasons. (PYP 5 Marks, Nov'20)

Answer 27

There are several reasons why companies go global. These are discussed as follows:

- ◆ One reason could be the **rapid shrinking of time and distance across the globe** - thanks to faster communication, speedier transportation, growing financial flows and rapid technological changes.
- ◆ It is being realized that the **domestic markets are no longer adequate and rich**. Companies globalize to take advantage of opportunities available elsewhere.
- ◆ A new product may **gradually get acceptance and grow locally and then globally**. This may initially be

in form of exports and then later production facilities may begin in other countries.

- ◆ Organizations may go global **to take advantage of cheaper raw material and Labour costs.**
- ◆ Companies often **set up overseas plants to reduce high transportation costs.**
- ◆ The motivation to go global in **high-tech industries** is slightly different. Companies in electronics and telecommunications must spend large sums on research and development for new products and thus may be compelled to seek **ways to improve sales volume to support high overhead expenses.**
- ◆ The companies may also go global **to take advantage of local taxation laws.**
- ◆ **To form strategic alliances to ward off economic and technological threats** and leverage their respective comparative and competitive advantages.

Question 28

Mohan has joined as the new CEO of XYZ Corporation and aims to make it a dominant technology company in the next five years. He aims to develop competencies for managers for achieving better performance and a competitive advantage for XYZ Corporation. Mohan is well aware of the importance of resources and capabilities in generating competitive advantage.

Discuss the four major characteristics of resources and capabilities required by XYZ Corporation to sustain the competitive advantage and its ability to earn profits from it. (PYP 5 Marks, Jan'21, Old SM, PYP May'23 5 Marks)

Answer 28

XYZ Corporation is aiming to transform into a dominant technology company under the leadership of Mohan, the new CEO. He aims to develop competencies for managers for achieving better performance and a competitive advantage for the corporation. Mohan is also well aware of the importance of resources and capabilities in generating and sustaining the competitive advantage. Therefore, he must focus on characteristics of resources and capabilities of the corporation.

The sustainability of competitive advantage and a firm's ability to earn profits from it depends, to a great extent, upon four major characteristics of resources and capabilities which are as follows:

1. **Durability:** The period over which a competitive advantage is sustained depends in part on the rate at which a firm's resources and capabilities deteriorate. In industries where the rate of product innovation is fast, product patents are quite likely to become obsolete. Similarly, capabilities which are the result of the management expertise of the CEO are also vulnerable to his or her retirement or departure. On the other hand, many consumer brand names have a highly durable appeal.
2. **Transferability:** Even if the resources and capabilities on which a competitive advantage is based are durable, it is likely to be eroded by competition from rivals. The ability of rivals to attack position of competitive advantage relies on their gaining access to the necessary resources and capabilities. The easier it is to transfer resources and capabilities between companies, the less sustainable will be the competitive advantage which is based on them.
3. **Imitability:** If resources and capabilities cannot be purchased by a would-be imitator, then they must be built from scratch. How easily and quickly can the competitors build the resources and capabilities on which a firm's competitive advantage is based? This is the true test of imitability. Where capabilities require networks of organizational routines, whose effectiveness depends on the corporate culture, imitation is difficult.
4. **Appropriability:** Appropriability refers to the ability of the firm's owners to appropriate the returns on its resource base. Even where resources and capabilities are capable of offering sustainable advantage, there is an issue as to who receives the returns on these resources.

Question 29

There are many companies in the market offering COVID vaccine. Analyze the product in terms of threat of new entrants. (PYP 5 Marks, July'21)

Answer 29

There are three companies offering a vaccine for COVID-19 in India and a fourth company is awaiting approval from authorities.

This product involves huge capital requirements and hence not every existing pharma company is likely to get into the competition. However, once approved for use, the entire world is the target market. This would lead to economies of scale helping the company to recover the investments made. The product

differentiation is in terms of the low after effect of the vaccine and the effectiveness of the vaccine in controlling COVID-19. Brand identity is becoming very important with people preferring international brands compared to a home – grown company. **Factors like switching cost, access to distribution channels and possibility of aggressive retaliation do not apply at present** because governments across the world are controlling these factors and the vaccine has not entered the phase of free competition.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Examinees were not able to provide expected answers as they lacked proper knowledge of the concept. The answers given by them were very vague. Being a skill application- oriented question, majority of the examinees were not able to correlate even the correct points with the threats of new entrants to COVID vaccine market.

Question 30

What are the factors which determine the nature of rivalry in an industry? (PYP 5 Marks Dec '21)

OR

Discuss in what conditions rivalry among competitors tends to be cut-throat and profitability of the industry goes down. (PYP 5 Marks, Nov'19)

Answer 30

The intensity of rivalry in an industry is a significant determinant of an industry's attractiveness and profitability. The intensity of rivalry can influence the costs of suppliers, distribution, and of attracting customers and thus, can directly affect the profitability. "The more intensive the rivalry, the less attractive is the industry". Rivalry among competitors tends to be cutthroat and an industry's profitability is low when;

- (i) An industry has no clear leader. Therefore, continuous war for leadership.
- (ii) Competitors in the industry are numerous.
- (iii) Competitors operate with high fixed costs. Thus, aiming for better Return on Investment with more fierce tactics.
- (iv) Competitors face high exit barriers, and therefore, continue to fight for market share.
- (v) Competitors have little opportunity to differentiate their offerings.
- (vi) The industry faces slow or diminished growth.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES: DEC'21

Performance was average. Majority of the examinees lacked proper knowledge of reasons for the difficulty of strategic evaluation. They were not able to write answers on expected lines. In the second option, determinants of rivalry were presented properly by most of the examinees.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES: NOV'19

Examinees were not able to provide expected answers as they lacked proper knowledge of the concept. They were able to give the points but unable to explain it correctly.

Question 31

"The bargaining power of suppliers determines an industry's attractiveness and profitability."

Discuss. (PYP 5 Marks May'22)

Answer 31

Quite often, suppliers too, exercise considerable bargaining power over purchasing companies. The more specialised the offering from the supplier, greater may be its clout. Further, when the suppliers are limited in number, they may openly exhibit their bargaining power. The bargaining power of

suppliers determines the cost of raw materials and other inputs of the industry, and therefore, an industry's attractiveness and profitability. Suppliers can influence the profitability of an industry in a number of ways. Suppliers can command bargaining power over a firm when;

- (i) Their products are crucial to the buyer and substitutes are not available.
- (ii) They can erect/ensure high switching costs.
- (iii) They are more concentrated than their buyers. Less suppliers, more buyers.

Question 32

Buyers of an industry's products or services can sometimes exert considerable pressure on the company. In the light of the five forces as propagated by Michael Porter explain this force. Also state as to when this leverage is evident. (PYP 5 Marks May '23)

Answer 32

Bargaining Power of Buyers: This is another force that influences the competitive condition of an industry. This force becomes heavier depending on the possibility of buyers forming groups or cartels. Mostly, this is a phenomenon seen in industrial products. Quite often, users of industrial products come together formally or even informally and exert pressure on the producer. The bargaining power of the buyers influences not only the prices that the producer can charge but also influences costs and investments of the producer. This is because powerful buyers usually bargain for better services which involves more investment on the part of the producer.

Buyers of an industry's products or services can sometimes exert considerable pressure on existing firms to secure lower prices or better services. This leverage is particularly evident when;

- (i) Buyers have full knowledge of the source(s) of products and their substitutes. Thus, challenging the price being charged by producers.
- (ii) They spend a lot of money on the industry's products i.e. they are big buyers. Thus, in a position to demand favourable terms of contract.

The industry's product is not perceived as critical to the buyer's needs and buyers are more concentrated than firms supplying the product. They can easily switch to the substitutes available.

MULTIPLE CHOICE QUESTIONS

1. Competitive landscape requires the application of:

- (a) Competitive advantage
- (b) Competitive strategy
- (c) Competitive acumen
- (d) Competitive intelligence **(MTP-Oct. '19, 1 Mark, New SM)**

Ans: (d)

2. During which stage of the Product Life Cycle will marketing strategies need to concentrate on differentiating a product from competing products, building brand loyalty and offering incentives to attract competitor's customers to switch?

- (a) Decline
- (b) Growth
- (c) Maturity



(d) Introduction (MTP 2 Marks Nov 21)

Ans: (c)

3. Imagine you are tasked with analyzing the competitive landscape for a new product launch. In this context, which of the following factors is not relevant to understanding the competitive landscape?

- (a) Identifying the competitor
- (b) Understanding the customer
- (c) Determining the strength of the competitors
- (d) Determining the weakness of the competitors (MTP 2 Marks Sep '23)

Ans(b)

4. What will happen in case many new businesses enter a market?

- (a) Barriers to entry will rise.
- (b) Competitive rivalry will intensify.
- (c) Capacity of industry will fall.
- (d) Industry will become more lucrative. (RTP May'19)

Ans: (d)

5. ABC Ltd. has identified that all three of its main products are at the maturity phase of the product life cycle. Which of the following is ABC Ltd. likely to be experiencing due to this?

- (a) High, but declining sales
- (b) Growing numbers of competitors
- (c) Product diversification and differentiation strategies
- (d) Adoption of price skimming strategies. (RTP May'21)

Ans: (c)

6. Halder & Sons have invested in latest technology in terms of latest printing machines from Germany and Israel. But recent advent of internet has posed a big threat to their printing business as majority of their clients have now turned to more environment friendly options. They are not able to sell off their machines which are now redundant. What condition are they facing right now? (RTP May '22)

- (a) Improper market analysis
- (b) Exit Barriers
- (c) Paralysis of Strategic Vision
- (d) Weak SWOT Analysis

Ans: (b)

7. Raju started a samosa stall in a local market and the existing momos and bhelpuri stall owners started creating problems for him. This is an example of-(May 23)

- (a) Bargaining power of suppliers
- (b) Threat of new entrants
- (c) Substitute products
- (d) Nature of rivalry in industry (Chapter Business Level Strategies)

Ans: (b)

Chapter 3

Strategic Analysis: Internal Environment

Question 1

A century-old footwear company “Mota Shoes” had an image of being the footwear choice for formal occasions. In an attempt to reinvent its brand, it tied up with a foreign footwear giant “Buffering” to manufacture and sell its Hide seek brand in the country. Putting its best foot forward, it launched extra soft, casual and relaxed footwear for young. Aiming at a brand and image makeover the “Mota Shoes” decided to price the Hide Seek products at premium. What kind of Michael Porter business level strategy is being used by “Mota Shoe company”? State its advantages. (RTP Nov’19, Old & New SM)

Answer 1

Mota shoes is trying to use differentiation. This strategy is aimed at broad mass market and involves the creation of a product or service that is perceived by the customers as unique. The uniqueness can be associated with product design, brand image, features, technology, dealer network or customer service. Because of differentiation, the business can charge a premium for its product.

A differentiation strategy has definite advantages as it may help to remain profitable even with rivalry, new entrants, suppliers’ power, substitute products, and buyers’ power.

- i. **Rivalry:** Brand loyalty acts as a safeguard against competitors. It means that customers will be less sensitive to price increases, as long as the firm satisfies the needs of its customers.
- ii. **Buyers:** They do not negotiate for price as they get special features and also, they have fewer options in the market.
- iii. **Suppliers:** Because differentiators charge a premium price, they can afford to absorb higher costs of supplies and customers are willing to pay extra too.
- iv. **New entrants:** Innovative features are expensive to copy. So, new entrants generally avoid these features because it is tough for them to provide the same product with special features at a comparable price.
- v. **Substitutes:** Substitute products can’t replace differentiated products which have high brand value and enjoy customer loyalty.

Question 2

Infant care is a successful store chain that caters products for expectant mothers and new moms. They offer everything from nursing classes to strollers, toys, infant clothes, diapers and baby furniture. Due to a one-stop shop for infants, they are charging a premium for its products. Identify and explain how the strategy adopted by infant care. [MTP-March ‘19, 5 Marks, New & Old SM]

Answer 2

Infant care is opting for differentiation strategy. A one-stop shop is a benefit for this type of customers, seeking convenience in a time. Infant care is catering the products only related to infants that is perceived by the customers as unique. Because of differentiation, the Infant care is charging a premium for its product.

Question 3

Gennex is a company that designs, manufactures and sells computer hardware and software. Gennex is well known for its innovative products that has helped the company to have advantage over its competitors. It also spends on research and development and concerned with innovative softwares. Often the unique features of their product helps them to gain competitive advantage. Gennex using the strategy is consistently gaining its position in the industry over its competitors. Identify and explain the strategy which Gennex has opted to gain the competitive advantage. [MTP-April ‘19, 5 Marks, New & Old SM , RTP Nov ‘18]

Answer 3

According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter called these base generic strategies.

Gennex has opted differentiation strategy. Its products are designed and produced to give the

customer value and quality. They are unique and serve specific customer needs that are not met by other companies in the industry. Highly differentiated and unique hardware and software enables Gennex to charge premium prices for its products hence making higher profits and maintain its competitive position in the market.

Differentiation strategy is aimed at broad mass market and involves the creation of a product or service that is perceived by the customers as unique. The uniqueness can be associated with product design, brand image, features, technology, dealer network or customer service.

Question 4

Write short note on Advantages of cost leadership strategy. [MTP-Aug. '18, 5 Marks, RTP May '18]

Answer 4

Advantages of Cost leadership strategy

Earlier we have discussed Porter's Five Forces Model in detail. A cost leadership strategy may help to remain profitable even with: rivalry, new entrants, suppliers' power, substitute products, and buyers' power.

1. **Rivalry** – Competitors are likely to avoid a price war, since the low cost firm will continue to earn profits after competitors compete away their profits.
2. **Buyers** – Powerful buyers/customers would not be able to exploit the cost leader firm and will continue to buy its product.
3. **Suppliers** – Cost leaders are able to absorb greater price increases before it must raise price to customers.
4. **Entrants** – Low cost leaders create barriers to market entry through its continuous focus on efficiency and reducing costs.
5. **Substitutes** – Low cost leaders are more likely to lower costs to induce customers to stay with their product, invest to develop substitutes, purchase patents.

Question 5

Distinguish between cost leadership and differentiation strategies. (MTP 5 Marks Mar'18, May 20 & Oct 20 & April '22, RTP Nov '18 & Nov '20, Old SM)

Answer 5

According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Cost leadership emphasizes producing standardized products at a very low per-unit cost for consumers who are price-sensitive. Differentiation is a strategy aimed at producing products and services considered unique industry wide and directed at consumers who are relatively price-insensitive.

A primary reason for pursuing forward, backward, and horizontal integration strategies is to gain cost leadership benefits. But cost leadership generally must be pursued in conjunction with differentiation. Different strategies offer different degrees of differentiation. A differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product. A successful differentiation strategy allows a firm to charge a higher price for its product and to gain customer loyalty.

Question 6

X-Olympus is a gaming software company specializing in developing games for ZBox and GameStation- The company is facing stiff competition due to saturation of market and price wars, which has excessively favor and highlight their dependence on gaming console manufacturers. Thereby, the company desires to establish a competitive advantage over industry rivals by enhancing the gaming experience by expanding into Edge-Cloud Gaming Service on a monthly subscription basis. This service offering does not require dedicated gaming consoles yet provide customers game streaming in 4K resolution with an ample range of games to select from. This move is expected to insulate X-Olympus from price wars and provide a competitive advantage. Identify and explain the generic strategies adopted by X-Olympus? (MTP 5 Marks March '21)

**Answer 6**

According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter called these base generic strategies.

X-Olympus is facing cutthroat competition due to saturation of market and price wars as there is no clear leader out of the numerous competitors. For this, the strategy adopted by X-Olympus is Product Differentiation by introducing a unique product to cater the customer needs at a lesser cost which would insulate it from the fierce competition and never-ending price wars.

Question 7

Domolo is a premium cycles and cycling equipments brand which targets high spending customer with a liking for quality and brand name. Their cycles range from rupees fifteen thousand to rupees one lac. The recent trend of fitness through cycling has created humongous demand for cycles and peripherals like helmets, lights, braking systems, fitness applications, etc. The customer base has grown 150% in the last three months. Mr. Vijay, who is an investor wants to tap in this industry and bring about cheaper options to people who cannot spend so much. Which business level strategy would best suit for Mr. Vijay's idea and what are the major sub- strategies that can be implemented to capture maximum market? (MTP 5 Marks April 21)(RTP May '23, Old SM)

Answer 7

The Best Cost Provider strategy would ensure a better reach to the not so affluent customers and provide them with good quality cycles and equipments, thus tapping in on the increasing trend of cycling.

Two sub-strategies that can be implemented are:

1. Offering lower prices than rivals for the same quality of products
2. Charging same prices for better quality of products

The idea of Mr. Vijay is to provide almost same quality of products in terms of functionality if not so in terms of branding, to customer who do not have huge sums of money to pay. Thus, sub- strategy number one, offering lower prices for almost same quality should be implemented to become the best cost provider of cycles and related equipments in the market.

Question 8

Spacetek Pvt. Ltd. is an IT company. Although there is cut throat competition in the IT sector, Spacetek deals with distinctive niche clients and is generating high efficiencies for serving such niche market. Other rival firms are not attempting to specialize in the same target market. Identify the strategy adopted by Spacetek Pvt. Ltd. and also explain the advantages and disadvantages of that strategy. (MTP 5 Marks Oct 21, PYP 5 Marks Jan'21, Old & New SM)

Answer 8

Spacetek Pvt. Ltd. company has adopted Focus strategy which is one of the Michael Porter's Generic strategies. Focus strategies are most effective when consumers have distinctive preferences or requirements and when rival firms are not attempting to specialize in the same target segment. An organization using a focus strategy may concentrate on a particular group of customers, geographic markets, or on particular product-line segments in order to serve a well- defined but narrow market better than competitors who serve a broader market.

Advantages of Focus Strategy

1. Premium prices can be charged by the organizations for their focused product/services.
2. Due to the tremendous expertise about the goods and services that organizations following focus strategy offer, rivals and new entrants may find it difficult to compete.

Disadvantages of Focus Strategy

1. The firms lacking in distinctive competencies may not be able to pursue focus strategy.
2. Due to the limited demand of product/services, costs are high which can cause problems.
3. In the long run, the niche could disappear or be taken over by larger competitors by acquiring the same distinctive competencies.

Question 9

BHAVNAV is a business which makes and sells laptop computers in France. In recent years it has been struggling to compete with its rivals and has seen a significant fall in its market share. BHAVNAV's managers identify that majority of its products launched by BHAVNAV's rivals were high specification, with good quality materials and many innovative design features. Products with inferior quality, such as those sold by BHAVNAV have not sold well in France. This information led BHAVNAV's management team to decide to select a new business strategy based on Porter's Generic Strategic Model. Identify and suggest the best business strategy BHAVNAV's management has to opt for? (MTP 5 Marks Nov 21)

Answer 9

According to Porter, the three different business strategies are: cost leadership, differentiation, and focus. Porter called these base generic strategies.

The information about competitor activities indicates that the market is uninterested in low-cost items, so a cost leadership approach is unlikely to be successful for BHAVNAV. It is suggested to adopt a differentiation strategy and find some way of enabling its laptops to stand out from its rivals. Differentiation strategy is aimed at broad mass market and involves the creation of a product or service that is perceived by the customers as unique. The uniqueness can be associated with product design, brand image, features, technology, dealer network or customer service.

Question 10

'Coffee Beans' is a coffeehouse chain that operates across the globe in different countries. 'Coffee Beans' has adopted a strategy to build business by establishing product uniqueness or qualities and gain competitive advantage based on features of its offerings in coffee business. Which type of strategy 'Coffee Beans' has adopted? (MTP 5 Marks Oct '19)

Answer 10

Coffee Beans is opting for differentiation strategy. This strategy is aimed at broad mass market and involves the creation of a product or service that is perceived by the customers as unique. The uniqueness can be associated with product design, brand image, features, technology, dealer network or customer service. Because of differentiation, Coffee Beans can charge a premium for its product.

Question 11

A private Moneyload Ltd. Bank that targets high worth individuals. They offer a premium service with many additional and personal services not normally available through other banks. They charge a significant annual fee for these services. The company makes full use of information technology throughout its operations in order to minimize costs. Identify and explain the generic strategy adopted by Moneyload Ltd. Bank? (MTP 5 Marks Mar '22)

Answer 11

According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter called these base generic strategies. Moneyland Ltd. Bank targets a narrow segment of the market, offering unique and desirable products. The bank will want to keep its costs under control, but it will not reduce costs at the expenses of reducing the quality levels of the customer service it offers. By maintaining high quality levels, it will still be able to charge a premium for its services. Thus, the strategy adopted by Moneyland Ltd. Bank is Focused Differentiation. A focused differentiation strategy requires offering unique features that fulfil the demands of a narrow market. Some firms using a focused differentiation strategy concentrate their efforts on a particular sales channel, such as selling over the internet only. Others target particular demographic groups. Firms that compete based on uniqueness and target a narrow market are following a focused differentiations strategy.

Question 12

What do you mean by differentiation strategy? How is it achieved? (MTP 5 Marks Sep'22, PYP 5 Marks May'19)

Answer 12

Differentiation strategy is aimed at broad mass market and involves the creation of a product or service that is perceived by the customers as unique. The uniqueness can be associated with product design, brand image, features, technology, dealer network or customer service. Because of differentiation, the business can charge a premium for its product.

Differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product that features the desired attributes.

To achieve differentiation, following measures can be adopted by an organization:

1. Offer utility for the customers and match the products with their tastes and preferences.
2. Elevate the performance of the product.
3. Offer the promise of high quality product/service for buyer satisfaction.
4. Rapid product innovation.
5. Taking steps for enhancing image and its brand value.
6. Fixing product prices based on the unique features of the product and buying capacity of the customer.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

performance was average as the answers were conceptually lacking. The examinees had insufficient knowledge on differentiation strategy.

Question 13

What are the various alternative strategies which the managers need to identify that will create and sustain a competitive advantage in the business? Discuss. (MTP 5 Marks Oct'22)

Answer 13

According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. These bases form different generic strategies as follows:

- **Cost leadership** emphasizes producing standardized products at a very low per-unit cost for consumers who are price-sensitive. It frequently results from productivity increases and aggressive pursuit of cost reduction throughout the development, production, marketing, and distribution processes. It allows a firm to earn higher profits than its competitors.
- **Differentiation** is a strategy aimed at producing products and services considered unique industry wide and directed at consumers who are relatively price-insensitive. It concerns with distinguishing a product/service from that of its competitors through unique design features, technological leadership, unique uses of products and attributes like quality, environmental impact and customer service.
- **Focus** means producing products and services that fulfill the specific needs of small groups of consumers. It involves selecting or focusing a market or customer segment in which to operate.

Question 14

Explain in brief the various basis of differentiation strategy. (MTP 5 Marks March '23, RTP Nov '21 & Nov '23)

Answer 14

There are several basis of differentiation, major being: Product, Pricing and Organization.

Product: Innovative products that meet customer needs can be an area where a company has an advantage over competitors. However, the pursuit of a new product offering can be costly – research and development, as well as production and marketing costs can all add to the cost of production and distribution. The payoff, however, can be great as customer's flock to be among the first to have the new product.

Pricing: It fluctuates based on its supply and demand and may also be influenced by the customer's

ideal value for a product. Companies that differentiate based on product price can either determine to offer the lowest price or can attempt to establish superiority through higher prices.

Organisation: Organisational differentiation is yet another form of differentiation. Maximizing the power of a brand or using the specific advantages that an organization possesses can be instrumental to a company's success. Location advantage, name recognition and customer loyalty can all provide additional ways for a company differentiate itself from the competition.

Question 15

Telecom industry is growing at a rapid speed in India. There is a cut throat competition among the service providers in the industry. Identify the capabilities that will best serve as a source of competitive advantage for a firm over its rivals? (MTP-Oct '19, Apr'22 5 Marks, Old SM)

Answer 15

Core competencies are capabilities that serve as a source of competitive advantage for a firm over its rivals. Core competency as the collective learning in the organization, especially coordinating diverse production skills and integrating multiple streams of technologies. An organization's combination of technological and managerial know-how, wisdom and experience are a complex set of capabilities and resources that can lead to a competitive advantage compared to a competitor.

Question 16

'Speed' is a leading retail chain, on account of its ability to operate its business at low costs. The retail chain aims to further strengthen its top position in the retail industry. The Chief executive of the retail chain is of the view that to achieve the goals they should focus on lowering the costs of procurement of products. Highlight and explain the core competence of the retail chain. [MTP-April '19, 5 Marks, RTP Nov'18 & Nov '20, Old SM]

Answer 16

A core competence is a unique strength of an organization which may not be shared by others. Core competencies are those capabilities that are critical to a business achieving competitive advantage. In order to qualify as a core competence, the competency should differentiate the business from any other similar businesses. A core competency for a firm is whatever it does is highly beneficial to the organisation. 'Speed' is the leader on account of its ability to keep costs low. The cost advantage that 'Value for Money' has created for itself has allowed the retailer to price goods lower than competitors. The core competency in this case is derived from the company's ability to generate large sales volume, allowing the company to remain profitable with low profit margin.

Question 17

Explain competitive advantage. [MTP-Oct. '18, 3 Marks, MTP-March '18, 2 Marks] (May'20 5 Marks)(PP May '18)

Answer 17

Competitive advantage is the position of a firm to maintain and sustain a favorable market position when compared to the competitors. Competitive advantage is ability to offer buyers something different and thereby providing more value for the money. It is the result of a successful strategy. This position gets translated into higher market share, higher profits when compared to those that are obtained by competitors operating in the same industry. Competitive advantage may also be in the form of low cost relationship in the industry or being unique in the industry along dimensions that are widely valued by the customers in particular and the society at large.

Question 18

Which of the following statements are 'correct' and which are 'incorrect'? Give reasons, in brief, for your answer:

- (i) **A core competence is a unique strength of an organization which may not be shared by others.**
[MTP-Aug. '18, 2 Marks]

Answer 18

- (i) **Correct:** A core competence is a unique strength of an organization which may not be shared by others. If business is organized on the basis of core competence, it is likely to generate

competitive advantage. A core competence provides potential access to a wide variety of markets. Core competencies should be such that it is difficult for competitors to imitate them.

Question 19

Why is it necessary to do a SWOT analysis before selecting a particular strategy for a business organization? (MTP-Aug '18, 5 Marks, RTP May 20, Old SM)

Answer 19

An important component of strategic thinking requires the generation of a series of strategic alternatives, or choices of future strategies to pursue, given the company's internal strengths and weaknesses and its external opportunities and threats. The comparison of strengths, weaknesses, opportunities, and threats is normally referred to as SWOT analysis.

- **Strength:** Strength is an inherent capability of the organization which it can use to gain strategic advantage over its competitors.
- **Weakness:** A weakness is an inherent limitation or constraint of the organization which creates strategic disadvantage to it.
- **Opportunity:** An opportunity is a favourable condition in the organisation's environment which enables it to strengthen its position.
- **Threat:** A threat is an unfavourable condition in the organisation's environment which causes a risk for, or damage to, the organisation's position.

SWOT analysis helps managers to craft a business model (or models) that will allow a company to gain a competitive advantage in its industry (or industries). Competitive advantage leads to increased profitability, and this maximizes a company's chances of surviving in the fast-changing, competitive environment. Key reasons for SWOT analyses are:

- It provides a logical framework.
- It presents a comparative account.
- It guides the strategist in strategy identification.

Question 20

What is a strategic group? Discuss the procedure for constructing a strategic group map. (MTP 5 Marks April 21 & May 18, PYP 5 Marks, July'21, RTP May '19, Old SM)

Answer 20

A strategic group consists of those rival firms which have similar competitive approaches and positions in the market. Companies in the same strategic group can resemble one another in any of the several ways – have comparable product-line breadth, same price/quality range, same distribution channels, same product attributes, identical technological approaches, offer similar services and technical assistance and so on.

The procedure for constructing a strategic group map and deciding which firms belong in which strategic group is as follows:

- ◆ Identify the competitive characteristics that differentiate firms in the industry typical variables are price/quality range (high, medium, low); geographic coverage (local, regional, national, global); degree of vertical integration (none, partial, full); product -line breadth (wide, narrow); use of distribution channels (one, some, all); and degree of service offered (no-frills, limited, full).
- ◆ Plot the firms on a two-variable map using pairs of these differentiating characteristics.
- ◆ Assign firms that fall in about the same strategy space to the same strategic group.
- ◆ Draw circles around each strategic group making the circles proportional to the size of the group's respective share of total industry sales revenues.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Majority of the examinees were not able to correctly identify the correct strategic approaches. Better strategic approach was identified correctly but arguments advanced in support of the strategy were not correct. Hence, the performance was average.

**Question 21**

Define the term 'Marketing'. Distinguish between social marketing and service marketing. (MTP 5 Marks Sep'22, RTP Nov'23, PYP 5 Marks May'18)

Answer 21

In general, marketing is an activity performed by business organizations. In the present day for business, it is considered to be the activities related to identifying the needs of customers and taking such actions to satisfy them in return of some consideration. The term marketing constitutes different processes, functions, exchanges and activities that create perceived value by satisfying needs of individuals.

Social marketing and service marketing are marketing strategies primarily with different orientations. Social Marketing refers to the design, implementation, and control of programs seeking to increase the acceptability of a social ideas, cause, or practice among a target group. For instance, the publicity campaign for prohibition of smoking or encouraging girl child, etc.

Question 22

BudgetSmart Retailers, a renowned supermarket chain, faced fierce competition in the grocery retail sector due to escalating operational expenses. Rising costs from rent, labor, and inventory management challenged their profitability amidst the emergence of discount stores and online competitors. To counter this, BudgetSmart Retailers optimized their supply chain through bulk procurement, revamped store layouts for cost efficiency and customer experience, embraced lean operational practices to minimize waste, and conducted comprehensive staff training to boost productivity and customer service efficiency. Identify and explain the strategy adopted by BudgetSmart Retailers to enhance the profitability. (MTP 5 Marks Sep '23)

Answer 22

Budget Smart Retailers adopted a cost leadership strategy to enhance profitability in the fiercely competitive grocery retail sector. It is a low-cost competitive strategy that aims at broad mass market. It requires vigorous pursuit of cost reduction in the areas of procurement, production, storage and distribution of product or service and also economies in overhead costs. Because of its lower costs, the cost leader is able to charge a lower price for its products than most of its competitors and still earn satisfactory profits.

By negotiating bulk procurement deals with suppliers, BudgetSmart Retailers lowered their cost of goods, allowing them to offer competitive prices to customers. The revamping of store layouts aimed to maximize space utilization and product placement, reducing operational costs and improving the overall shopping experience. Embracing lean principles minimized waste in the supply chain, reducing unnecessary expenses and improving efficiency. Comprehensive staff training boosted employee productivity and customer service efficiency, contributing to cost reduction and enhanced customer satisfaction.

Question 23

Explain Best-cost provider strategy (RTP May'18)

Answer 23

Best-cost provider strategy involves providing customers more value for the money by emphasizing low cost and better-quality difference. It can be done:

- (a) through offering products at lower price than what is being offered by rivals for products with comparable quality and features or
- (b) charging similar price as by the rivals for products with much higher quality and better features.

Question 24

Airlines industry in India is highly competitive with several players. Businesses face severe competition and aggressively market themselves with each other. Luxury Jet is a private Delhi based company with a fleet size of 9 small aircrafts with seating capacity ranging between 6 seats to 9 seats. These aircrafts are chartered by big business houses and high net worth individuals for their personalised use. With customised tourism packages their aircrafts are also often hired by foreigners. Identify and explain the Michael Porter's Generic Strategy followed by Luxury Jet. (RTP Nov'22, RTP May'18, RTP Nov'20, Old & New SM)

Answer 24

The Airlines industry faces stiff competition. However, Luxury Jet has attempted to create a niche market by adopting focused differentiation strategy. A focused differentiation strategy requires offering unique features that fulfil the demands of a narrow market.

Luxury Jet compete in the market based on uniqueness and target a narrow market which provides business houses, high net worth individuals to maintain strict schedules. The option of charter flights provided several advantages including, flexibility, privacy, luxury and many a times cost saving. Apart from conveniences, the facility will provide time flexibility. Travelling by private jet is the most comfortable, safe and secure way of flying your company's senior business personnel.

Chartered services in airlines can have both business and private use. Personalized tourism packages can be provided to those who can afford it.

Question 25

A differentiation strategy may help to remain profitable even with rivalry, new entrants, suppliers' power, substitute products, and buyers' power. Explain. (RTP May'20)

Answer 25

A differentiation strategy may help to remain profitable even with: rivalry, new entrants, suppliers' power, substitute products, and buyers' power.

1. **Rivalry** - Brand loyalty acts as a safeguard against competitors. It means that customers will be less sensitive to price increases, as long as the firm can satisfy the needs of its customers.
2. **Buyers** – They do not negotiate for price as they get special features and also they have fewer options in the market.
3. **Suppliers** – Because differentiators charge a premium price, they can afford to absorb higher costs of supplies and customers are willing to pay extra too.
4. **Entrants** – Innovative features are an expensive offer. So, new entrants generally avoid these features because it is tough for them to provide the same product with special features at a comparable price.
5. **Substitutes** – Substitute products can't replace differentiated products which have high brand value and enjoy customer loyalty.

Question 26

Write a short note on the concept of cost leadership strategy and how to achieve it? (RTP May'19, RTP May'21, PYP 5 Marks ,Nov '19)

Answer 26

Cost leadership strategy requires vigorous pursuit of cost reduction in the areas of procurement, production, storage and distribution of product or service and also economies in overhead costs. Accordingly, the cost leader is able to charge a lower price for its products than its competitors and still make satisfactory profits. The low cost leadership should be such that no competitors are able to imitate so that it can result in sustainable competitive advantage to the cost leader firm.

To achieve cost leadership, following are the actions that could be taken:

1. Forecast the demand of a product or service promptly.
2. Optimum utilization of the resources to get cost advantages.
3. Achieving economies of scale leads to lower per unit cost of product/service.
4. Standardization of products for mass production to yield lower cost per unit.
5. Invest in cost saving technologies and try using advance technology for smart working.
6. Resistance to differentiation till it becomes essential.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Examinees were not clear about the concept and nature of business process re-engineering. Accordingly, answers to the first alternative were vague and ambiguous. However, the examinees who chose to explain the concept of cost leadership were able to do reasonable justice to their answers.

Question 27

Explain the meaning of cost leadership strategy. (RTP Nov'18)

Answer 27

A number of cost elements affect the relative attractiveness of generic strategies. A successful cost leadership strategy usually permeates the entire firm, as evidenced by high efficiency, low overhead cost, and waste reduction. The low cost leadership should be such that no competitors are able to imitate so that it can result in sustainable competitive advantage to the cost leader firm.

Question 28

A business consultancy firm specializes in environment management consultancy. It advises client companies on how to set up environmental management accounting systems. For measuring recording and analyzing environmental costs. A large part of its business involves performing environmental audits to check whether companies have achieved an international assurance standard in environmental management; this is something that rival consultancy firms do not do. The firm also carries out other management consultancy projects for client, but these make up only a small proportion of its total annual fee income. Identify the strategy categories by Michael Porter which best describes the strategy of this firm. (RTP May '22)

Answer 28

By concentrating mainly on the 'market' for consultancy services in environmental management, the firm is pursuing a focus strategy. By offering audit services, which rival firms do not, this indicates a differentiation strategy within this chosen market niche. Hence, the firm is following Focus differentiation strategy. A focused differentiation strategy requires offering unique features that fulfil the demands of a narrow market. Similar to focused low-cost strategy, narrow markets are defined in different ways in different settings. Some firms using a focused differentiation strategy concentrate their efforts on a particular sales channel, such as selling over the internet only. Others target particular demographic groups. Firms that compete based on uniqueness and target a narrow market are following a focused differentiations strategy.

Question 29

What is an opportunity? (RTP May'18)

Answer 29

An opportunity is a favorable condition in the organization's environment which enables it to consolidate and strengthen its position. An example of opportunity is growing demand for the products or services that are offered by company.

Question 30

Rohitha Patel is having a small chemist shop in the central part of Ahmedabad. What kind of competencies Rohitha can build to gain competitive advantage over online medic in sellers? (RTP May'19, Old SM)

Answer 30

Capabilities that are valuable, rare, costly to imitate, and non-substitutable are core competencies. A small chemist shop has a local presence and functions within a limited geographical area. Still it can build its own competencies to gain competitive advantage. Rohitha Patel can build competencies in the areas of:

- (i) Developing personal and cordial relations with the customers.
- (ii) Providing home delivery with no additional cost.
- (iii) Developing a system of speedy delivery that can be difficult to match by online sellers. Being in central part of city, he can create a network to supply at wider locations in the city.
- (iv) Having extended working hours for convenience of buyers.
- (v) Providing easy credit or a system of monthly payments to the patients consuming regular medicines.

Question 31

Capabilities that are valuable, rare, costly to imitate, and non-substitutable are core competencies. Explain these four specific criteria of sustainable competitive advantage that firms can use to determine those capabilities that are core competencies. (May'20, PYP May '22)

Answer 31

Four specific criteria of sustainable competitive advantage that firms can use to determine those capabilities that are core competencies. Capabilities that are valuable, rare, costly to imitate, and non-substitutable are core competencies.

- i. **Valuable:** Valuable capabilities are the ones that allow the firm to exploit opportunities or avert the threats in its external environment. A firm created value for customers by effectively using capabilities to exploit opportunities. Finance companies build a valuable competence in financial services. In addition, to make such competencies as financial services highly successful require placing the right people in the right jobs. Human capital is important in creating value for customers.
- ii. **Rare:** Core competencies are very rare capabilities and very few of the competitors possess this. Capabilities possessed by many rivals are unlikely to be sources of competitive advantage for any one of them. Competitive advantage results only when firms develop and exploit valuable capabilities that differ from those shared with competitors.
- iii. **Costly to imitate:** Costly to imitate means such capabilities that competing firms are unable to develop easily. *For example:* Intel has enjoyed a first-mover advantage more than once because of its rare fast R&D cycle time capability that brought SRAM and DRAM integrated circuit technology, and brought microprocessors to market well ahead of the competitor. The product could be imitated in due course of time, but it was much more difficult to imitate the R&D cycle time capability.
- iv. **Non-substitutable:** Capabilities that do not have strategic equivalents are called non- substitutable capabilities. This final criterion for a capability to be a source of competitive advantage is that there must be no strategically equivalent valuable resources that are themselves either not rare or imitable.

Question 32

Write a short note on SWOT analysis. (RTP May'21, Nov'18, PP May '18)(MTP 5 Marks Sep '23)

Answer 32

SWOT analysis is a tool used by organizations for evolving strategic options for the future. The term SWOT refers to the analysis of strengths, weaknesses, opportunities and threats facing a company. Strengths and weaknesses are identified in the internal environment, whereas opportunities and threats are located in the external environment.

- (a) **Strength:** Strength is an inherent capability of the organization which it can use to gain strategic advantage over its competitor.
- (b) **Weakness:** A weakness is an inherent limitation or constraint of the organization which creates a strategic disadvantage to it.
- (c) **Opportunity:** An opportunity is a favorable condition in the external environment which enables it to strengthen its position.
- (d) **Threat:** An unfavorable condition in the external environment which causes a risk for, or damage to the organization's position.

The major purpose of SWOT analysis is to enable the management to create a firm - specific business model that will best align, fit or match an organizational resources and capabilities to the demands for environment in which it operates.

Question 33

Core competencies provide edge to a business over its competitors. .(RTP Nov'21, PYP 5 Marks , Jan '21)

OR

Major core competencies are identified in three areas - competitor differentiation, customer value and application to other markets. Discuss. (RTP Nov'19)

Answer 33

A core competence is a unique strength of an organization which may not be shared by others. Core competencies are those capabilities that are critical to a business achieving competitive advantage. In order to qualify as a core competence, the competency should differentiate the business from any other similar businesses. An organization's combination of technological and managerial know-how, wisdom and experience are a complex set of capabilities and resources that can lead to a competitive advantage compared to a competitor.

According to C.K. Prahalad and Gary Hamel, major core competencies are identified in following three areas:

1. **Competitor differentiation:** The Company can consider having a core competence if the competence is unique and it is difficult for competitors to imitate. This can provide a company an edge compared

to competitors. It allows the company to provide better products and services to market with no fear that competitors can copy it.

2. **Customer value:** When purchasing a product or service it has to deliver a fundamental benefit for the end customer in order to be a core competence. It will include all the skills needed to provide fundamental benefits. The service or the product has to have real impact on the customer as the reason to choose to purchase them. If customer has chosen the company without this impact, then competence is not a core competence and it will not affect the company's market position.
3. **Application of competencies to other markets:** Core competence must be applicable to the whole organization; it cannot be only one particular skill or specified area of expertise. Therefore, although some special capability would be essential or crucial for the success of business activity, it will not be considered as core competence if it is not fundamental from the whole organization's point of view. Thus, a core competence is a unique set of skills and expertise, which will be used throughout the organization to open up potential markets to be exploited.

Question 34

State with reasons of the following statements are correct/incorrect:

Tele-shopping is an instance of direct marketing. (RTP Nov'18)

Answer 34

Correct: Strategies may require changes in structure as the structure dictates how resources will be allocated. Structure should be designed to facilitate the strategic pursuit of a firm and, therefore, should follow strategy. Without a strategy or reasons for being, companies find it difficult to design an effective structure.

Question 35

Sohan and Ramesh are two friends who are partners in their business of making biscuits. Sohan believe in making profits through selling more volume of products. Hence, he believes in charging lesser price to the customers. Ramesh, however of the opinion that higher price should be charged to create an image of exclusivity and for this, he proposes that the product to undergo some change.

Analyze the nature of generic strategy used by Sohan and Ramesh. (PYP 5 Marks, Nov'18, Old & New SM)

Answer 35

Considering the generic strategies of Porter there are three different bases: cost leadership, differentiation and focus. Sohan and Ramesh are contemplating pricing for their product.

Sohan is trying to have a low price and high volume are thereby trying for cost leadership. Cost leadership emphasizes producing standardised products at a very low per unit cost for consumers who are price sensitive.

Ramesh desires to create perceived value for the product and charge higher prices. He is trying to adopt differentiation. Differentiation is aimed at producing products and services considered unique industry wide and directed at consumers who are relatively price insensitive.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Majority of the candidates were able to correctly identify the generic strategies. However, there were also vague and incorrect answers. Some of the answers have also unnecessarily covered pricing strategies.

Question 36

ABC Ltd. is a beverage manufacturing company. It chiefly manufactures soft drinks. The products are priced on the lower side which has made the company a leader in the business. Currently it is holding 35 percent market share. The R & D of company developed a formula for manufacturing sugar free beverages. On successful trial and approval by the competent authorities, company was granted to



manufacture sugar free beverages. This company is the pioneer to launch sugar free beverages which are sold at a relatively higher price. This new product has been accepted widely by a class of customers. These products have proved profitable for the company. Identify the strategy employed by the company ABC Ltd. and mention what measures could be adopted by the company to achieve the employed strategy.

(PYP 5 Marks, Nov'20, Old & New SM)

Answer 36

According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter called these base generic strategies.

ABC Ltd. has opted Differentiation Strategy. The company has invested huge amount in R & D and developed a formula for manufacturing sugar free beverages to give the customer value and quality. They are pioneer and serve specific customer needs that are not met by other companies in the industry. The new product has been accepted by a class of customers. Differentiated and unique sugar free beverages enable ABC Ltd. to charge relatively higher for its products hence making higher profits and maintain its competitive position in the market.

Sugar free beverage of ABC Ltd. is being accepted widely by a class of customers. Differentiation strategy is aimed at broad mass market and involves the creation of a product or service that is perceived by the customers as unique. The uniqueness can be associated with product design, brand image, features, technology, and dealer network or customer service.

Achieving Differentiation Strategy

To achieve differentiation, following strategies are generally adopted by an organization:

1. Offer utility to the customers and match products with their tastes and preferences.
2. Elevate/Improve performance of the product.
3. Offer the high-quality product/service for buyer satisfaction.
4. Rapid product innovation to keep up with dynamic environment.
5. Taking steps for enhancing brand image and brand value.
6. Fixing product prices based on the unique features of product and buying capacity of the customer.

Question 37

Inspite of high commodity inflation, shortage of components and the threat of third wave of COVID-19 pandemic in India, manufacturers of packaged goods, home appliances and consumer electronics are expecting the business to grow by 12 to 25 percent in the coming months. After one-and-a-half years of disruption, manufacturers are now confident about managing their inventories better, keeping their supply channels well-stocked and preparing themselves to minimize the impact of any COVID related restrictions even as they gear up for the festive season, which usually accounts for 25 to 35 percent of their yearly sales.

The home appliances sector could be an example. After a dismal April-June quarter in the year 221; producers of air conditioners, refrigerators and washing machines are expecting their business to grow by 15-20 percent in the months to come. All the companies operating in the sector have geared up to grab the opportunities available in the market.

A leading company in the home appliances domain, XXP India, is planning to launch various innovative product designs and offer loyalty programmes to lure consumers.

With reference to Michael Porter's generic strategies, identify which strategy XXP India has planned for? Explain how this strategy will be advantageous to the company to remain profitable? (PYP 5 Marks Dec '21)

Answer 37

According to Michael Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter called these base generic strategies. XXP India Ltd. has planned for Differentiation Strategy. The company is planning to launch various innovative product designs and offer loyalty programmes to lure customers. Differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product that features the desired attributes. A successful differentiation strategy allows a firm to charge a higher price for its product and to gain customer loyalty, because consumers may become strongly attached to the

differentiated features.

Advantages of Differentiation Strategy

A differentiation strategy may help an organisation to remain profitable even with rivalry, new entrants, suppliers' power, substitute products, and buyers' power.

1. Rivalry - Brand loyalty acts as a safeguard against competitors. It means that customers will be less sensitive to price increases, as long as the firm can satisfy the needs of its customers.
2. Buyers – They do not negotiate for price as they get special features, and they have fewer options in the market.
3. Suppliers – Because differentiators charge a premium price, they can afford to absorb higher costs of supplies as the customers are willing to pay extra too.
4. Entrants – Innovative features are an expensive offer. So, new entrants generally avoid these features because it is tough for them to provide the same product with special features at a comparable price.
5. Substitutes – Substitute products can't replace differentiated products which have high brand value and enjoy customer loyalty.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Majority of the examinees were not able to correctly identify the strategy. Those who had identified correctly, they were not able to clearly explain the advantages of differentiation strategy. Hence, the performance was average.

Question 38

Quick N Sturdy Inc., a multinational company, is undergoing feasibility study to introduce new luxury and sports car for specific group of customers. The product is meant for customers with distinctive preferences and special requirements. The product is not a standard one and as such the target market is also narrow. Company knows that demand for the product is large enough to be profitable for the company, but small enough to be ignored by other major industry players. The company wants to position itself in the niche market with the prime consideration to offer unique features in the product for the target market.

In the given situation, identify the generic strategy as suggested by Michael Porter. Also state the advantages and disadvantages of such strategy. (PYP 5 Marks Nov 22)

Answer 38

Quick N Sturdy Inc. has adopted Focused Differentiation Strategy which is one of the Michael Porter's Generic strategies. A focused differentiation strategy requires offering unique features that fulfil the demands of a narrow market. Some firms using a focused differentiation strategy concentrate their efforts on a particular sales channel, such as selling over the internet only. Others target particular demographic groups. Firms that compete based on uniqueness and target a narrow market are following a focused differentiation strategy.

Advantages of Focused Strategy

1. Premium prices can be charged by the organisations for their focused product/services.
2. Due to the tremendous expertise in the goods and services that the organisations following focus strategy offer, rivals and new entrants may find it difficult to compete.

Disadvantages of Focused Strategy

1. The firms lacking in distinctive competencies may not be able to pursue focus strategy.
2. Due to the limited demand of product/services, costs are high, which can cause problems.
3. In the long run, the niche could disappear or be taken over by larger competitors by acquiring the same distinctive competencies.

Question 39

What is cost leadership strategy? Under what circumstances an organization can gain competitive advantages from cost leadership strategy? Is there any risk in pursuing cost leadership strategy? (PYP 5 Marks Nov 22)

Answer 39

Cost leadership strategy emphasizes producing standardized products at a very low per-unit cost for consumers who are price-sensitive. It frequently results from productivity increases and aggressive pursuit of cost reduction throughout the development, production, marketing, and distribution processes. It allows a firm to earn higher profits than its competitors.

The circumstances in which an organization can gain competitive advantages from cost leadership strategy are:

- ◆ when the market is composed of many price-sensitive buyers.
- ◆ when there are few ways to achieve product differentiation.
- ◆ when buyers do not care much about differences from brand to brand.
- ◆ when there are a large number of buyers with significant bargaining power.

The basic idea is to underprice competitors and thereby gain market share driving some of the competitors out of the market.

Some risks of pursuing cost leadership are:

- ◆ that competitors may imitate the strategy, therefore driving overall industry profits down
- ◆ that technological breakthroughs in the industry may make the strategy ineffective; or that buyer interests may swing to other differentiating features besides price.

Question 40

STU's association with India goes back to 1967, when it played a key role in constructing a very long highway in India spreading over multiple states. Since then, it is contributing in many ways to the country's growth story. Now it is looking at playing an active role in the key projects taken up by the central government. Suggest few Opportunities and Threats that the company should consider. (PYP 5 Marks Dec '21)

Answer 40

Faced with a constantly changing environment, each business unit needs to develop a marketing information system to track trends and developments, which can be categorized as an opportunity or a threat. The company has to review its strength and weakness in the background of environment's opportunities and threat, i.e., an organization's SWOT analysis.

STU is looking at playing an active role in the key projects taken up by the central government. Following are the potential opportunities and threats to STU:

Potential STU's Opportunities:

- ◆ Alliances or joint ventures with central government that expand the STU's market coverage or boost its competitive capability.
- ◆ Possibilities of working on the future projects of central government.
- ◆ Serving additional customer groups or expanding into new geographic markets.
- ◆ Utilizing existing company skills or technological know-how to enter new projects.
- ◆ Openings to take market share away from rivals.
- ◆ Openings to exploit emerging new technologies.
- ◆ Integrating forward or backward.

Potential STU's Threats:

- ◆ Due to COVID-19 pandemic, companies can have face the lockdown situation.



- ◆ Economic factors such as recession etc.
- ◆ Likely entry of potent new competitors.
- ◆ Technological changes/innovations in construction equipment.
- ◆ Costly new regulatory requirements.
- ◆ Growing bargaining power of suppliers.
- ◆ Vulnerability to industry driving forces.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

The performance was average as examinees were able to give only a few opportunities & threats and not commensurate with the required answer.

Question 41

Explain the meaning of core competencies. . (PYP 2 Marks, May'18)

Answer 41

A core competency a unique strength of an organization which may not be shared by others. It is defined as a combination of skills and techniques rather than individual skill or separate technique. Core competencies are those capabilities that are critical to a business achieving competitive advantage. In order to qualify as a core competence, the competency should differentiate the business from any other similar businesses.

Question 42

Define Augmented Marketing. Give two examples. (PYP 2 Marks, Nov'18)

Answer 42

Augmented Marketing is provision of additional customer services and benefits built around the core and actual products that relate to introduction of hi-tech services like movies on demand, online computer repair services, etc. Such innovative offerings provide a set of benefits that promise to elevate customer service to unprecedented levels.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Some candidates were not aware of the concept of Augmented Marketing

MULTIPLE CHOICE QUESTIONS

1. In Michael Porter's generic strategy____emphasizes producing standardized products at a very low per unit-cost for consumers who are price sensitive.
 - (a) Cheap leadership
 - (b) Inferior product leadership
 - (c) Cost leadership
 - (d) Cost benefit (MTP-Oct '19, 1 Mark, New SM)

Ans: (c)

2. Best-cost provider strategy involves providing customers more value for the money by emphasizing:



- (a) Low cost and low quality difference
- (b) Low cost and better quality difference
- (c) High cost and low quality difference
- (d) High cost and better quality difference (MTP-Oct '19, 1 Mark)

Ans: (b)

3. A firm successfully implementing a differentiation strategy would expect:

- (a) Customers to be sensitive to price increases.
- (b) To charge premium prices.
- (c) Customers to perceive the product as standard.
- (d) To automatically have high levels of power over suppliers. (MTP-March '19, Apr'21 1 Mark, New SM)

Ans: (b)

4. Michael Porter Generic strategies to gain competitive advantage include all except:

- (a) Cost leadership
- (b) Differentiation
- (c) Focus
- (d) Revenue generation (MTP-April '19, 1 Mark)

Ans: (d)

5. Perscopter, a manufacturer of private helicopter offers unique features that fulfill the demands of a narrow market. It competes in market based on its uniqueness and custom-oriented private helicopters. Perscopter provides limited number of high-end helicopters with ultimate features. Which business strategy is being followed by Perscopter?

- (a) Differentiation
- (b) Focused differentiation
- (c) Cost leadership
- (d) Focused cost leadership (MTP 2 Marks May 20)

Ans: (b)

6. Low cost, differentiation and focus are:

- (a) SBU level strategies
- (b) Corporate level strategies
- (c) Business level strategies
- (d) Functional level strategies (MTP 1 Mark Oct 20)

Ans: (c)

7. D Mart sells fast moving consumer goods at wholesale prices to retail customers, is a strategy of?

- (a) Market Penetration
- (b) Cost Differentiation
- (c) Cost Leadership

- (d) Market Development (MTP 1 Mark Oct 21 & March '23)

Ans: (c)

8. Best Cost provider strategies

- (a) Seek to attract buyers on the basis of charging low price for low quality
- (b) Aim at giving customers less value for more money
- (c) Seek to attract buyers on the basis of charging high price for high quality
- (d) Aim to giving customers low cost and better quality (MTP 1 Mark Mar '22 & March '23)

Ans: (d)

9. Which one out of the following, is not a generic strategy as suggested by Michael Porter?

- (a) Focus Strategy
- (b) Differentiation Strategy
- (c) Cost Leadership Strategy
- (d) Best-Cost Provider Strategy (MTP 1 Mark April '23)

Ans: (d)

10. Anything that a firm does especially well compared to rival firms is referred to as.

- (a) Competitive advantage
- (b) Comparative advantage
- (c) Opportunity cost
- (d) Sustainable advantage (MTP-Oct. '19, Mar'19 1 Mark)

Ans: (a)

11. Internal _____ are activities in an organization that are performed especially well.

- (a) Opportunities
- (b) Competencies
- (c) Strengths
- (d) Management (MTP-March '19, 1 Mark, New SM)

Ans: (c)

12. Which of the following is not part of external analysis:

- (a) Customer segments.
- (b) Organizational constraints.
- (c) Entry barriers.
- (d) Competitors. (MTP-April'19, 1 Mark)

Ans: (b)

13. A core competence is all except?

- (a) Valuable
- (b) Rare
- (c) Impossible to imitate



- (d) Non-substitutable (MTP-April '19, 1 Mark)

Ans: (c)

14. 'Strategic group mapping' helps in-

- (a) Identifying the strongest rival companies
- (b) Identifying weakest rival companies
- (c) Identifying weakest and strongest rival companies
- (d) None of the above (MTP 1 Mark Oct 20, RTP May'20, New SM)

Ans: (c)

15. Marketing and Sales of Hindustan Unilever Limited and lowering of operating cost by Walmart are examples of what?

- (a) Competitive Advantage
- (b) Core Competency
- (c) Strategic Planning
- (d) Key Performance Indicators (KPIs) (1 Mark Nov 21)

Ans: (b)

16. Dharam, an organic farming expert was consulting a group of farmers to build sustainable brand of their corn produce. He suggested to follow the strategy of the biggest player in this business. Which of the following can be used to identify such a player?

- (a) BCG Matrix
- (b) ADL Matrix
- (c) Dominant Force Analysis of the Industry
- (d) Strategic Group Mapping (2 Marks April 22)

Ans: (d)

17. Tomtom a sneaker brand wanted to understand their competitive landscape and thus were looking for the weakest competitors to buy them and thereby decrease competition. Which of the following will be most helpful for them to begin with their plans?

- (a) Mergers and Acquisition Planning
- (b) BCG Growth Matrix
- (c) Strategic Group Mapping
- (d) GE Stop Light Matrix (MTP 2 Marks March '23)

Ans: (c)

18. In case of home appliances, the concept of offering additional customer services and benefits to the customers, can be considered as

- (a) Social Marketing
- (b) Augmented Marketing
- (c) Concentrated Marketing
- (d) Differential Marketing (MTP 1 Mark April '23)

Ans: (b)

19. The process of creating, maintaining, and enhancing strong, value-laden relationships with customers and other stakeholder is:

- (a) Social marketing
- (b) Augmented marketing
- (c) Direct marketing
- (d) Relationship marketing **(MTP 1 Mark May 20)**

Ans: ((d))

20. A renowned coffee chain offers a loyalty program where customers earn points for every purchase, which can be redeemed for free drinks or snacks. This marketing technique is known as:

- (a) Augmented Marketing
- (b) Synchro Marketing
- (c) Social Marketing
- (d) Relationship Marketing **(MTP 1 Mark Sep '23)**

Ans:(d)

21. ABC Fashion provides early access and exclusive designs to its exclusive clientele, emphasizing personalized experiences. Which marketing type does this exemplify?

- (a) Augmented marketing
- (b) Service marketing
- (c) Person marketing
- (d) Relationship marketing **(MTP 2 Marks Oct '23)**

Ans:(d)

22. According to Porter, which of the following is important to achieve competitive advantage?

- (a) Differentiation and cost advantage.
- (b) Outsourcing activities.
- (c) Having strong relationship with buyer and sellers.
- (d) Focus on most competitive businesses. **(RTP May'19)**

Ans:(a)

23. In the questions given below select the best answer out of options (a), (b), (c), or (d): Differentiation Strategy can be achieved by following measures:

- 1. Match products with tastes and preferences of customers.**
- 2. Elevate the performance of the product.**
- 3. Rapid product innovation Which of the above is true?**

- (a) 1and (2)
- (b) (1) and (3)
- (c) (2) and (3)
- (d) (1), (2) and (3) **(RTP May'20, New SM)**

Ans:(d)

24. In the questions given below select the best answer out of options (a), (b), (c), or (d): Competitive rivalry has the most effect on the firm's strategies than the firm's other strategies.



- (a) Business level
- (b) Corporate level
- (c) Functional level
- (d) All of these **(RTP May'20)**

Ans: (a)

25. Sanjivni Pharmaceuticals Limited manufactures a cough syrup Zeus. It has modified Zeus syrup, claiming that the Zeus cough syrup is sugar-free, and the consumer will not feel drowsiness after consuming this cough syrup. Consumers found this product as unique. The sales of Zeus cough syrup have increased as expected. The price of this sugar-free syrup is higher by 20% than the earlier syrup. Identify the strategy adopted by Sanjivni Pharmaceuticals Limited.

- (a) Focus strategy
- (b) Best cost provider strategy
- (c) Differentiation strategy
- (d) Cost leadership strategy. **(RTP May'21)**

Ans: (c)

26. In the questions given below select the best answer out of options (A), (B), (C), or (D): Best-cost provider strategy is related to providing customers more value for money by:

- (a) Highlighting low cost and low quality difference.
- (b) Emphasizing low cost and better quality difference.
- (c) Producing high cost and low quality difference.
- (d) Managing high cost and low quality difference. **(RTP Nov'19)**

Ans: (b)

27. In the questions given below select the best answer out of options (A), (B), (C), or (D): Porter's cost leadership is a strategy

- (a) Functional level
- (b) Business level
- (c) Corporate level
- (d) Implementation **(RTP Nov'19)**

Ans: (b)

28. Trekking Poles is a small company based in the Himalayan ranges in India. It is known in the region for its hill walking sticks. Trekking Poles sell specialist walking equipment in their small shop at the foot of the mountains. They do not have a website yet are able to sell their products at premium prices. Which of the following one of Porter's generic strategies best fits Trekking Poles?

- (a) Cost leadership
- (b) Differentiation
- (c) Focused cost leadership
- (d) Focused differentiation. **(RTP Nov'21)**

Ans: (d)

29. A Ltd. has recently decided to install a new IT system to improve the efficiency of its payroll function. A Ltd.

believes this will reduce the cost of running the payroll system by 20%. Which one of the following levels of strategy is the above IT system most closely linked to?

- (a) Corporate level
- (b) Functional level
- (c) Business level
- (d) Strategic level (RTP Nov'21)

Ans: (b)

30. Airlines providing special lounge access to loyal customers is a type of which marketing? (RTP May '22, RTP May'23)

- (a) Augmented Marketing
- (b) Direct Marketing
- (c) Relationship Marketing
- (d) Services Marketing

Ans: (c)

31. A _____ consists of those rival firms which have similar competitive approaches and positions in the market.

- (a) BCG Matrix.
- (b) Strategic group.
- (c) Strategy Map.
- (d) Industry (RTP May'19).

Ans: (b)

32. According to C.K. Prahalad and Gary Hamel, major core competencies are identified in three areas - _____, and application to other markets.

- (a) Competitor differentiation, customer value.
- (b) Competitor differentiation, focus.
- (c) Cost leadership, differentiation.
- (d) Profits, growth (RTP May'19).

Ans: (a)

33. A thing that a firm does especially well in comparison to the rival firms is:

- (a) Opportunity availed.
- (b) Successful leadership.
- (c) Competitive advantage.
- (d) Comparative advantage. (RTP May'19)

Ans: (c)

34. ABC is a marketing consultancy business. ABC's most recent corporate analysis has identified that three new businesses have recently entered its market and started aggressively targeting ABC's key client. As part of ABC's corporate analysis, these three new businesses would be a

- (a) Strength
- (b) Opportunity



- (c) Weakness
- (d) Threat. **(RTP Nov'21)**

Ans: (d)

35. The activity of identifying the strongest and weakest companies is known as: (RTP May 23)

- (a) Strategic Audit
- (b) Portfolio Analysis
- (c) Strategic Surveillance
- (d) Strategic Group mapping **(Chapter Dynamics of Competitive Strategy)**

Ans: (d)

36. Big retail stores (e.g., Big Bazaar) and supermarkets have special core competencies in the areas of:

- A. Merchandising
 - B. Securing supplies at lower cost
 - C. In-house activity management
 - D. Computerized stock ordering and billing systems
 - E. Own brand labels
- Select the correct options:

- (a) A, C, D
- (b) B, D, E
- (c) A, B, C, D
- (d) A, B, D, E **(RTP Nov'23)**

Ans:(d)

37. XYZ is a high-end department store chain that is struggling to survive. A number of other department store chains compete with it and are also struggling. How should XYZ best analyse the industry in order to work out how to increase performance?

- (a) Identify groups of department stores that compete in a similar way.
- (b) Show the competitive pathways that various competitors will adopt.
- (c) Determine the combined effect of all the stores' different strategies.
- (d) Ignore key success factors that affect discount stores. **(RTP Nov'23)**

38. In the questions given below select the best answer out of options (A), (B), (C), or (D):

Which of the following is not true for core competency?

- (a) It distinguishes a company competitively.
- (b) It is a source of competitive advantage.
- (c) It is an individual skill and separate technique.
- (d) It is often visible in the form of organizational functions. **(RTP Nov'19)**

Ans: (c)

39. In the questions given below select the best answer out of options (a), (b), (c), or (d): The marketing strategy which is used to reduce or shift the demand is:

- (a) Enlightened Marketing



- (b) Synchro-Marketing
- (c) Place Marketing
- (d) Demarcating (RTP May'20)

Ans: (d)

40. Indian Company plans to offer snack during travel through ropeways and two free movies tickets on completion of the travel. This marketing technique is known as_____

- (a) Augmented marketing
- (b) Synchro
- (c) Social
- (d) Demarketing (RTP Nov'23)

Ans: (a)





Chapter 4

Strategic Choices

Question 1

Write a short note on need for turn around strategy. (MTP-Oct '19, Oct'18 5 marks)

Answer 1

Turnaround is needed when an enterprise's performance deteriorates to a point that it needs a radical change of direction in strategy, and possibly in structure and culture as well. It is a highly targeted effort to return an organization to profitability and increase positive cash flows to a sufficient level. It is used when both threats and weaknesses adversely affect the health of an organization so much that its basic survival is difficult. The overall goal of turnaround strategy is to return an under performing or distressed company to normalcy in terms of acceptable levels of profitability, solvency, liquidity and cash flow. To achieve its objectives, turnaround strategy must reverse causes of distress, resolve the financial crisis, achieve a rapid improvement in financial performance, regain stakeholder support, and overcome internal constraints and unfavourable industry characteristics.

Question 2

Leatherite Ltd., was started as a leather company to manufacture footwear. Currently, they are in the manufacturing of footwears for males and females. The top management desires to expand the business in the leather manufacturing goods. To expand they decided to purchase more machines to manufacture leather bags for males and females. Identify and explain the strategy opted by the top management of Leatherite Ltd. (MTP-March '19, 5 Marks, RTP Nov'21)

Answer 2

Leatherite Ltd. is currently manufacturing footwears for males and females and its top management has decided to expand its business by manufacturing leather bags for males and females. Both the products are similar in nature within the same industry. The strategic diversification that the top management of Leatherite Ltd. has opted is concentric in nature. They were in business of manufacturing leather footwears and now they will manufacture leather bags as well. They will be able to use existing infrastructure and distribution channel. Concentric diversification amounts to related diversification.

In concentric diversification, the new business is linked to the existing businesses through process, technology or marketing. The new product is a spin-off from the existing facilities and products/processes. This means that in concentric diversification too, there are benefits of synergy with the current operations.

Question 3

A company manufactures computers that are of low in production cost, competitive price, and quality to their competitor's product. Profits and market share are declining day by day. Shree, a senior executive realizes that drastic strategies have to be created for the survival of a company. After SWOT analysis by assessing the strengths and weaknesses, they come up with the conclusion that they cannot compete in the computers with the competitors. The management directs Shree to act quick and develop a suitable strategic plan. Discuss the strategy which can be opted by Shree. (MTP-April '19, Mar'18 5 Marks, Old SM)

Answer 3

Shree can opt for turnaround strategy which is a highly-targeted effort to return the company to profitability and increase positive cash flows to a sufficient level. Organizations those have faced a significant crisis that has negatively affected operations require turnaround strategy. Once turnaround is successful the organization may turn to focus on growth.

Conditions for turnaround strategies

When firms are losing their grips over market, profits due to several internal and external factors, and if they have to survive under the competitive environment they have to identify danger signals as early as possible and undertake rectification steps immediately. These conditions may be, inter alia cash flow problems, lower profit margins, high employee turnover and decline in market share, capacity underutilization, low morale of employees, recessionary conditions, mismanagement, raw material supply problems and so on.



Action plan for turnaround strategy

- Stage One – Assessment of current problems
- Stage Two – Analyze the situation and develop a strategic plan
- Stage Three – Implementing an emergency action plan
- Stage Four – Restructuring the business
- Stage Five – Returning to normal

Question 4

What do you understand by co-generic merger? (MTP-March '18, 2 Marks, PYP 2 Marks May'18)

Answer 4

In co-generic merger two or more merging organizations are associated in some way or the other related to the production processes, business markets, or basic required technologies. Such merger includes the extension of the product line or acquiring components that are required in the daily operations. It offers great opportunities to business to diversify around a common set of resources and strategic requirements.

Question 5

Which of the following statements are 'correct' and which are 'incorrect'? Give reasons, in brief, for your answer: Divesting a major product line or market is termed as retrenchment strategy. (MTP-Oct '18, 2 Marks)

Answer 5

Correct: An organization can redefine its business by divesting a major product line or market. The divesting can be termed as retrenchment strategy. The enterprise may withdraw from marginal markets, withdraw some brands or sizes of products. It may also withdraw some of slow moving products. In an extreme manner, it may seek retirement either from the production or the marketing activity.

Question 6

Explain in brief the reasons to adopt turnaround strategy. (MTP 5 Marks May 20)

Answer 6

Reasons to adopt Turnaround Strategy:

1. Turnaround is needed when an enterprise's performance deteriorates to a point that it needs a radical change of direction in strategy, and possibly in structure and culture as well.
2. It is a highly targeted effort to return an organization to profitability and increase positive cash flows to a sufficient level.
3. It is used when both threats and weaknesses adversely affect the health of an organization so much that its basic survival is difficult.
4. The overall goal of turnaround strategy is to return an underperforming or distressed company to normalcy in terms of acceptable levels of profitability, solvency, liquidity and cash flow.
5. To achieve its objectives, turnaround strategy must reverse causes of distress, resolve the financial crisis, achieve a rapid improvement in financial performance, regain stakeholder support, and overcome internal constraints and unfavourable industry characteristics.

Question 7

Write short note on expansion through acquisitions and mergers. (MTP 5 Marks Oct 20, RTP May '20, Old & New SM)

Answer 7

Acquisitions and mergers are basically combination strategies. Some organizations prefer to grow through mergers. Merger is considered to be a process when two or more companies come



together to expand their business operations. In such a case the deal gets finalized on friendly terms and both the organizations share profits in the newly created entity. In a merger, two organizations combine to increase their strength and financial gains along with breaking the trade barriers.

When one organization takes over the other organization and controls all its business operations, it is known as acquisition. In this process of acquisition, one financially strong organization overpowers the weaker one. Acquisitions often happen during recession in economy or during declining profit margins. In this process, one that is financially stronger and bigger establishes its power. The combined operations then run under the name of the powerful entity. A deal in case of an acquisition is often done in an unfriendly manner, it is more or less a forced association where the powerful organization either consumes the operation or a company in loss is forced to sell its entity.

Question 8

Justify the statement "Stability strategy is opposite of Expansion strategy". (MTP 5 Marks March '21, RTP May'21)

Answer 8

Stability strategies, as name suggests, are intended to safeguard the existing interests and strengths of business. It involves organizations to pursue established and tested objectives, continue on the chosen path, maintain operational efficiency and so on. A stability strategy is pursued when a firm continues to serve in the same or similar markets and deals in same products and services. In stability strategy, few functional changes are made in the products or markets, however, it is not a 'do nothing' strategy. This strategy is typical for mature business organizations. Some small organizations also frequently use stability as a strategic focus to maintain comfortable market or profit position. On the other hand, expansion strategy is aggressive strategy as it involves redefining the business by adding the scope of business substantially, increasing efforts of the current business. In this sense, it becomes opposite to stability strategy. Expansion is a promising and popular strategy that tends to be equated with dynamism, vigor, promise and success. Expansion also includes diversifying, acquiring and merging businesses. This strategy may take the enterprise along relatively unknown and risky paths, full of promises and pitfalls.

Question 9

Distinguish between the following:

Divestment and liquidation strategy. (MTP 5 Marks Nov 21, Oct '19, & April 21, Old SM, PYP 5 Marks Nov '20)

Answer 9

| Divestment Strategy | Liquidation Strategy |
|---|--|
| Divestment strategy involves the sale or liquidation of a portion of business, or a major division, profit center or SBU. | It involves closing down a firm and selling its assets. |
| Divestment is usually a part of rehabilitation or restructuring plan and is adopted when a turnaround has been attempted but has proved to be unsuccessful. Option of a turnaround may even be ignored if it is obvious that divestment is the only answer. | Liquidation becomes only option in case of severe and critical conditions where either turnaround and divestment are not seen as solution or have been attempted but failed. |
| Efforts are made for the survival of organization. | Liquidation as a form of retrenchment strategy is considered as the most extreme and unattractive. |
| Survival of organization helps in retaining personnel, at least to some extent. | There is loss of employment with stigma of failure. |

Question 10

There has been fierce demand for both Gecko and FlyBee for the last 3 years. Gecko makes mass



consumption pens while FlyBee is a notebook and diary brand - both being complementary goods of each other. But to grow further, FlyBee decided to take up competition with Gecko in pens segment and thereby launched, FlyPens. Identify and explain the growth strategy opted by FlyBee? (MTP 5 Marks March '22)

Answer 10

FlyBee is a notebook and diary brand. But to grow further, FlyBee decided to take up competition with Gecko in pens segment and thereby launched, FlyPens. FlyBee that is hitherto not into producing pens starts producing them and other similar products is following concentric diversification which is basically related diversification.

In this form of diversification, the new business is linked to the existing businesses through existing systems such as processes, technology or marketing. The new product is a spin-off from the existing facilities and products/processes. There are benefits of synergy with the current operations. The most common reasons for pursuing a concentric diversification are that opportunities in existing line of business are available.

Question 11

X Pvt. Ltd. had recently ventured into the business of co-working spaces when the global pandemic struck. This has resulted in the business line becoming unprofitable and unviable, and a failure of the existing strategy. However, the other businesses of X Pvt. Ltd. are relatively less affected by the pandemic as compared to the recent co-working spaces. Suggest a strategy for X Pvt. Ltd. with reasons to justify your answer. (MTP 5 Marks April 22, Old & New SM, PYP 5 Marks Jan '21)

Answer 11

It is advisable that divestment strategy should be adopted by X Pvt. Ltd.

In the given situation where the business of co-working spaces became unprofitable and unviable due to Global pandemic, the best option for the company is to divest the loss-making business.

Retrenchment may be done either internally or externally. Turnaround strategy is adopted in case of internal retrenchment where emphasis is laid on improving internal efficiency of the organization, while divestment strategy is adopted when a business turns unprofitable and unviable due to some external factors. In view of the above, the company should go for divestment strategy.

Further, divestment helps address issues like:

1. Persistent cash flows from loss making segment could affect other profit-making segments, which is the case in the given scenario.
2. Inability to cope from the losses, which again is uncertain due to pandemic.
3. Better investment opportunity, which could be the case if X Pvt. Ltd. can invest the money it generates from divestment.

Question 12

Jynklo Ltd. is an established online children gaming company in Japan. They are performing good in the gaming industry. The management of Jynklo Ltd. has decided to expand its business. They decided to start a premium sports drink named JynX for athletes. Identify and explain the growth strategy adopted by Jynklo Ltd.? (MTP 5 Marks Sep'22, RTP Nov '23)

Answer 12

Currently Jynklo Ltd. is performing in the children gaming industry. But now its management has decided to expand their business by starting a premium sports drink named JynX for athletes. As there are no linkages in both products with respect to customer groups, customer functions, or the technologies being used, so Jynklo Ltd. have opted Conglomerate diversification.

Jynklo Ltd. diversify in a business that is not related to their existing line of product and can be termed as conglomerate diversification. In conglomerate diversification, the new businesses/ products are disjointed from the existing businesses/products in every way; it is a unrelated diversification. In process/ technology/ function, there is no connection between the new products and the existing ones. Conglomerate diversification has no common thread at all with the firm's present position.

**Question 13**

Diversification endeavours can be categorized into four broad classifications. State the basis for this classification and name the four categories. How is concentric diversification different from vertically diversification? Explain. (MTP 5 Marks Oct'22, RTP May'22)

Answer 13

Diversification strategy involves expansion into new businesses that are outside the current business and markets of an organisation. Based on the nature and extent of their relationship to existing businesses, diversification can be classified into four broad categories:

- (i) Vertically integrated diversification
- (ii) Horizontally integrated diversification
- (iii) Concentric diversification
- (iv) Conglomerate diversification

Concentric diversification takes place when the products are related. The new product is a spin-off from the existing facilities and products/processes. This means that in concentric diversification too, there are benefits of synergy with the current operations. However, concentric diversification differs from vertically integrated diversification in the nature of the linkage the new product has with the existing ones.

In vertically integrated diversification, firms opt to engage in businesses that are related to the existing business of the firm. The firm remains vertically within the same process. Sequence moves forward or backward in the chain and enters specific product/process steps with the intention of making them into new businesses for the firm. The new product falls within the firm's current process-product chain. In concentric diversification, there is a departure from this vertical linkage, a new related product is added to the existing business. The new product is only connected in a loop-like manner at one or more points in the firm's existing process/technology/product chain.

Question 14

Jeff Inc., a leading USA based Mobile company decides to make India a hub for the company's Android Mobile having largest storage memory to be manufactured in collaboration with the Desi Group, a leading Indian mobile manufacturer. The production is to be exported to the company's home market as well as to other European countries.

What is this growth strategy called? Point out the most important advantages both the companies expect from such strategy/collaboration. (MTP 5 Marks March '23, PYP Dec '21 & Nov '19)

OR

What are the advantages of a strategic alliance? (MTP 5 Marks Nov'21)

OR

Strategic alliances are formed if they provide an advantage to all the parties in the alliance. Do you agree? Explain in brief the advantages of a strategic alliance. (RTP May'18, May'19)

Answer 14

Jeff Inc. of USA and Desi group of India opted for strategic alliance as their growth strategy. A strategic alliance is a relationship between two or more businesses that enables each to achieve certain strategic objectives which neither would be able to achieve on its own. Strategic alliances are often formed in the global marketplace between businesses that are based in different regions of the world.

A strategic alliance is a relationship between two or more businesses that enables each to achieve certain strategic objectives which neither would be able to achieve on its own. The strategic partners maintain their status as independent and separate entities, share the benefits and control over the partnership, and continue to make contributions to the alliance until it is terminated

Advantages of Strategic Alliance

Strategic alliance usually is only formed if they provide an advantage to all the parties in the alliance. These advantages can be broadly categorised as follows:

1. **Organizational:** Strategic alliance helps to learn necessary skills and obtain certain capabilities

from strategic partners. Strategic partners may also help to enhance productive capacity, provide a distribution system, or extend supply chain. Having a strategic partner who is well -known and respected also helps add legitimacy and credibility to a new venture.

2. **Economic:** There can be reduction in costs and risks by distributing them across the members of the alliance. Greater economies of scale can be obtained in an alliance, as production volume can increase, causing the cost per unit to decline. Finally, partners can take advantage of co - specialization, creating additional value, such as when a leading computer manufacturer bundles its desktop with a leading monitor manufacturer's monitor.
3. **Strategic:** Rivals can join together to cooperate instead of competing with each other. Vertical integration can be created where partners are part of supply chain. Strategic alliances may also be useful to create a competitive advantage by the pooling of resources and skills. This may also help with future business opportunities and the development of new products and technologies. Strategic alliances may also be used to get access to new technologies or to pursue joint research and development.
4. **Political:** Sometimes strategic alliances are formed with a local foreign business to gain entry into a foreign market either because of local prejudices or legal barriers to entry. Forming strategic alliances with politically influential partners may also help improve your own influence and position.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Answers, in general, were correct as most of the students were identified the advantages of strategic alliance and explained it properly.

Question 15

Which of the following statements are 'correct' and which are 'incorrect'? Give reasons, in brief, for your answer:

- (i) "B" in BCG Matrix stands for balance. (MTP Aug 18 2 Marks)

Answer 15

- (i) **Incorrect:** The acronym BCG stands for Boston Consulting Group, an organization that developed a matrix to portray an organizational corporate portfolio of investment. This matrix depicts growth of business and the business share enjoyed by an organization. The matrix is also known for its cow and dog metaphors and is popularly used for resource allocation in a diversified company.

Question 16

Distinguish between the following:

Market Development and Product Development under Ansoff's Product Market Growth Matrix. (MTP 5 Marks March '21 & April '23, RTP Nov '22)

Answer 16

Following are the differences between the market development and product development:

| Market Development | Product Development |
|---|---|
| <ul style="list-style-type: none"> Meaning <p>It refers to a growth strategy where the business seeks to sell its existing products into new markets. It is a strategy for company growth by identifying and developing new markets for current company products.</p> <ul style="list-style-type: none"> Strategy Application <p>It may be achieved through new geographical markets, new product dimensions or</p> | <ul style="list-style-type: none"> Meaning <p>It refers to a growth strategy where business aims to introduce new products into existing markets. It is a strategy for company growth by offering modified or new products to current markets.</p> <ul style="list-style-type: none"> Strategy Application <p>It is for company's growth and requires the development of new competencies and the</p> |

packaging, new distribution channels or different pricing policies to attract different customers or create new market segments.

business to develop modified products which can appeal to existing markets.

Question 17

How Ansoff's Product Market Growth Matrix is a useful tool for business organizations? (MTP 5 Marks Oct 21 & April '19, RTP May'18)

Answer 17

The Ansoff's product market growth matrix (proposed by Igor Ansoff) is a useful tool that helps businesses decide their product and market growth strategy. With the use of this matrix a business can get a fair idea about how its growth depends in new or existing products in both new and existing markets.

Companies should always be looking to the future. Businesses that use the Ansoff matrix can determine the best strategy. The matrix can help them to decide how to do this by demonstrating their options clearly, breaking them down into four strategies, viz., Market Penetration, Market Development, Product Development, Diversification. Determining which of these is best for their business will depend on a number of variables including available resources, infrastructure, market position, location and budget.

Question 18

Sky chemical industry intends to grow its business. Advise the company on the available options using Ansoff's product market growth matrix. (MTP 5 Marks March '22, MTP 5 Marks Oct'22, RTP May 23, Old SM)

Answer 18

The Ansoff's product market growth matrix (proposed by Igor Ansoff) is a useful tool that helps businesses decide their product and market growth strategy. With the use of this matrix, a business can get a fair idea about how its growth depends upon its markets in new or existing products in both new and existing markets.

The Ansoff's product market growth matrix is as follows:

| | Existing Products | New Products |
|------------------|--------------------|---------------------|
| Existing Markets | Market Penetration | Product Development |
| New Markets | Market Development | Diversification |

Ansoff's Product Market Growth Matrix

Sky chemical industry can adopt market penetration, product development, market development or diversification simultaneously for its different products.

Market penetration refers to a growth strategy where the business focuses on selling existing products into existing markets. It is achieved by making more sales to present customers without changing products in any major way.

Market development refers to a growth strategy where the business seeks to sell its existing products into new markets. It is a strategy for company growth by identifying and developing new markets for



the existing products of the company.

Product development refers to a growth strategy where business aims to introduce new products into existing markets. It is a strategy for company growth by offering modified or new products to current markets.

Diversification refers to a growth strategy where a business markets new products in new markets. It is a strategy by starting up or acquiring businesses outside the company's current products and markets.

As market conditions change overtime, a company may shift product-market growth strategies. For example, when its present market is fully saturated a company may have no choice other than to pursue new market.

Question 19

"XYZ Ltd., a multi-product company, has been experiencing consistent losses in recent years, leading to a significant erosion of its net worth. What strategic options should the management consider addressing the company's current situation? Provide recommendations along with supporting reasons."
(MTP 5 Marks Oct '23)

Answer 19

XYZ Ltd. is a sick company with accumulated losses that have eroded its net worth. The multi-product company may analyse its various products to take decisions on the viability of each. The company may consider a retrenchment strategy. Retrenchment becomes necessary for coping with hostile and adverse situations in the environment and when any other strategy is likely to be suicidal.

Retrenchment strategy is adopted because of continuous losses and unviability and stability can be ensured by reallocation of resources from unprofitable to profitable businesses.

Retrenchment strategy is followed when an organization substantially reduces the scope of its activity. This is done through an attempt to find out the problem areas and diagnose the causes of the problems. Next, steps are taken to solve the problems. These steps result in different kinds of retrenchment strategies as follows:

Turnaround strategy: If the organization chooses to transform itself into a leaner structure and focuses on ways and means to reverse the process of decline, it adopts a turnaround strategy. It may try to reduce costs, eliminate unprofitable outputs, generate revenue, improve coordination, better control, and so on.

Divestment Strategy: Divestment strategy involves the sale or liquidation of a portion of business, or a major division, profit centre or SBU. Divestment is usually a part of a rehabilitation or restructuring plan and is adopted when a turnaround has been attempted but has proved to be unsuccessful.

Liquidation Strategy: In the retrenchment strategy, the most extreme and unattractive is liquidation strategy. It involves closing down a firm and selling its assets. It is considered as the last resort because it leads to serious consequences such as loss of employment for workers and other employees, termination of opportunities where a firm could pursue any future activities, and the stigma of failure.

The management of multiproduct sick company manufacturing various items need to understand pros and cons of each strategic option. The decision will depend upon the specific circumstances of each product and the management goals of the company.

Question 20

Explain the meaning of the Combination strategies (RTP May'18 & Nov '18)

Answer 20

Combination Strategies refer to a mix of different strategies like stability; expansion, diversification or retrenchment to suit particular situations that an enterprise is facing. For instance, a strategy of diversification/acquisition may call for retrenchment in some obsolete product lines.

Question 21

**State with reasons if the following statement is correct/incorrect:
Turnaround should succeed liquidation strategy. (RTP May'18)**

Answer 21

Incorrect: A retrenchment strategy considered the most extreme and unattractive is liquidation strategy, which involves closing down a firm and selling its assets. It is considered as the last resort because it leads to serious consequences such as loss of employment for workers and other employees, termination of opportunities where a firm could pursue any future activities, and the stigma of failure. In an ideal scenario, turnaround should be attempted first and should precede option of liquidation n.

Question 22

Swift Insurance is a company engaged in the business of providing medical insurance maintaining a market share of 25 to 30 per cent in last five years. Recently, the company decided to enter into the business of auto insurance by having foreign collaboration. Identify the strategy being followed by the Swift Insurance with its advantages. (RTP May'18, Old SM)

Answer 22

Overall Swift Insurance is following growth or expansion strategy as it is redefining the business and enlarging its scope. The step will also substantially increase investment in the business.

The new business is related and at the same time caters to a different segment and accordingly can be termed as related diversification. The new business falls within the scope of general insurance and horizontally related to the existing business.

In the process of expansion, the company will be able to exploit:

- ◆ Its brand name.
- ◆ The marketing skills available.
- ◆ The existing sales and distribution infrastructure.
- ◆ Research and development.
- ◆ Economies of scale

Question 23

With the global economic recession Soft Cloth Ltd. incurred significant losses in all its previous five financial years. Currently, they are into manufacturing of cloth made of cotton, silk, polyester, rayon, lira and blends. Competition is also intense on account of cheap imports. The company is facing cash crunch and has not been able to pay the salaries to its employees in the current month.

Suggest a grand strategy that can be opted by Soft Cloth Ltd. (RTP May'19, Old & New SM)

Answer 23

Soft Cloth Ltd. is facing internal as well as external challenges. The external environment is in economic recession and the organization is facing cash crunch. The company needs to work on retrenchment / turnaround strategy. The strategy is suitable in case of issues such as:

- ◆ Persistent negative cash flow.
- ◆ Uncompetitive products or services
- ◆ Declining market share
- ◆ Deterioration in physical facilities
- ◆ Overstaffing, high turnover of employees, and low morale
- ◆ Mismanagement

The company may consider to substantially reduce the scope of its activity. This is done through an attempt to find out the problem areas and diagnose the causes of the problems. Next, steps are taken to solve the problems.

These steps result in different kinds of retrenchment strategies. If the organization chooses to focus on ways and means to reverse the process of decline, it adopts a turnaround strategy. If it cuts off the loss-making units, divisions, or SBUs, curtails its product line, or reduces the functions performed, it adopts a



divestment strategy. If none of these actions work, then it may choose to abandon the activities totally, resulting in a liquidation strategy.

Question 24

Distinguish between the following:

Mergers and acquisitions. (RTP May'19 & May '18)

Answer 24

Merger and acquisition in simple words are defined as a process of combining two or more organizations together.

Some organizations prefer to grow through mergers. Merger is considered to be a process when two or more companies come together to expand their business operations. In such a case the deal gets finalized on friendly terms and both the organizations share profits in the newly created entity. In a merger two organizations combine to increase their strength and financial gains along with breaking the trade barriers.

When one organization takes over the other organization and controls all its business operations, it is known as acquisitions. In this process of acquisition, one financially strong organization overpowers the weaker one. Acquisitions often happen during recession in economy or during declining profit margins. In this process, one that is financially stronger and bigger establishes its power. The combined operations then run under the name of the powerful entity. A deal in case of an acquisition is often done in an unfriendly manner, it is more or less a forced association.

Question 25

Oregano is a large supermarket chain. It is considering the purchase of a number of farms that provides Oregano with a significant amount of its fresh produce. Oregano feels that by purchasing the farms, it will have greater control over its supply chain. Identify and explain the type of diversification opted by Oregano? (RTP May'20)

Answer 25

Oregano is a large supermarket chain. By opting backward integration and purchase a number of farms, it will have greater control over its supply chain. Backward integration is a step towards creation of effective supply by entering business of input providers. Strategy employed to expand profits and gain greater control over production of a product whereby a company will purchase or build a business that will increase its own supply capability or lessen its cost of production.

Question 26

Mini theatre Ltd. was a startup venture of three young IIM graduates. They developed an application to watch web-based content like web series, TV Shows, theatre shows, etc. after purchasing their exclusive rights. They were successful in getting many consumers enrolled with them. After a certain span of time, the company realized that some regional content like 'Bangla movies', 'Gujarati shows' etc. we're having high cost and less viewership. The leadership team of Mini Theatre Ltd. decided to sell the rights and curtail any further content development in these areas. Identify and explain the corporate strategy adopted by the leadership team of Mini Theatre Ltd. (RTP May'21)

Answer 26

The leadership team of Mini Theatre Ltd. decided to cut off the loss-making units, reduce the functions performed that some of regional content like 'Bangla movies', 'Gujarati shows' etc. we're having high cost and less viewership, it adopts a divestment strategy. The leadership team of Mini Theatre Ltd. decided to sell the rights and curtail any further content development in these areas.

Divestment strategy involves the sale or liquidation of a portion of business, or a major division, profit center or SBU. Divestment is usually a part of rehabilitation or restructuring plan and is adopted when a turnaround has been attempted but has proved to be unsuccessful. The option of a turnaround may even be ignored if it is obvious that divestment is the only answer.

Question 27

State with reasons which of the following statements are correct/incorrect:

Stability strategy is not a 'do-nothing' strategy. (RTP Nov'18)

**Answer 27**

Correct: Porter's five forces model considers new entrants as major source of competition. The new capacity and product range that the new entrants bring in throw up new competitive pressure. The bigger the new entrant, the more severe the competitive effect. New entrants also place a limit on prices and affect the profitability of existing players.

Question 28

Forward integration and backward integration. (RTP Nov'18)

Answer 28

Forward and backward integration form part of vertically integrated diversification. In vertically integrated diversification, firms opt to engage in businesses that are vertically related to the existing business of the firm. The firm remains vertically within the same process. While diversifying, firms opt to engage in businesses that are linked forward or backward in the chain and enters specific product/process steps with the intention of making them into new businesses for the firm. Backward integration is a step towards creation of effective supply by entering business of input providers. Strategy employed to expand profits and gain greater control over production of a product whereby a company will purchase or build a business that will increase its own supply capability or lower its cost of production. On the other hand, forward integration is moving forward in the value chain and entering business lines that use existing products. Forward integration will also take place where organizations enter into businesses of distribution channels.

Question 29

Vastralok Ltd., was started as a textile company to manufacture cloth. Currently, they are in the manufacturing of silk cloth. The top management desires to expand the business in the cloth manufacturing. To expand they decided to purchase more machines to manufacture cotton cloth. Identify and explain the strategy opted by the top management of Vastralok Ltd. (RTP Nov'18, Old SM)

Answer 29

Vastralok Ltd. is currently manufacturing silk cloth and its top management has decided to expand its business by manufacturing cotton cloth. Both the products are similar in nature within the same industry. The strategic diversification that the top management of Vastralok Ltd. has opted is concentric in nature. They were in business of manufacturing silk and now they will manufacture cotton as well. They will be able to use existing infrastructure and distribution channel. Concentric diversification amounts to related diversification.

In concentric diversification, the new business is linked to the existing businesses through process, technology or marketing. The new product is a spin-off from the existing facilities and products/processes. This means that in concentric diversification too, there are benefits of synergy with the current operations

Question 30

Pizza Galleria was India's first pizza delivery chain enjoying monopoly for several years. However, after entry of Molino and Uncle Jack it is struggling to compete. Both Molino and Uncle Jack have opened several eateries and priced the product aggressively. In last four years the chain has suffered significant losses. The chain wishes to know whether they should go for turnaround strategy. List out components of action plan for turnaround strategy. (RTP Nov'19, Old SM)

Answer 30

Pizza Chain may choose to have turnaround strategy if there are:

- ◆ Persistent negative cash flow from business.
- ◆ Uncompetitive products or services.
- ◆ Declining market share.
- ◆ Deterioration in physical facilities.
- ◆ Over-staffing, high turnover of employees, and low morale.
- ◆ Mismanagement.

For turnaround strategies to be successful, it is imperative to focus on the short and long- term financing needs as well as on strategic issues. The chain may attempt to leverage the potential Indian market by

engaging a new logistics partner. It may bring innovation in food items, as well as quality and improvements in the overall dine-in and delivery experience. During the turnaround, the “product mix” may be changed, requiring the organization to do some repositioning.

A workable action plan for turnaround would involve:

Stage One – Assessment of current problems: The first step is to assess the current problems and get to the root causes and the extent of damage the problem has caused.

Stage Two – Analyze the situation and develop a strategic plan: Before making any major changes; determine the chances of the business’s survival. Identify appropriate strategies and develop a preliminary action plan.

Stage Three – Implementing an emergency action plan: If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive. A positive operating cash flow must be established as quickly as possible and enough funds to implement the turnaround strategies must be raised.

Stage Four – Restructuring the business: The financial state of the organization’s core business is particularly important. If the core business is irreparably damaged, then the outlook for the entire organization may be bleak. Efforts to be made to position the organization for rapid improvement.

Stage Five – Returning to normal: In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added. Emphasis is placed on a number of strategic efforts such as carefully adding new products and improving customer service, creating alliances with other organizations, increasing the market share, etc.

Question 31

What is a stability strategy? What are the reasons to pursue stability strategy? (RTP Nov’19 & Nov ‘23)

Answer 31

One of the important goals of a business enterprise is stability - to safeguard its existing interests and strengths, to pursue well established and tested objectives, to continue in the chosen business path, to maintain operational efficiency on a sustained basis, to consolidate the commanding position already reached, and to optimize returns on the resources committed in the business. A stability strategy is pursued by a firm when:

- ◆ It continues to serve in the same or similar markets and deals in same or similar products and services.
- ◆ The strategic decisions focus on incremental improvement of functional performance.

Major reasons for stability strategy are as follows:

- ◆ A product has reached the maturity stage of the product life cycle.
- ◆ It is less risky as it involves less changes and the staff feels comfortable with things as they are.
- ◆ The environment faced is relatively stable.
- ◆ Expansion may be perceived as being threatening.
- ◆ Consolidation is sought through stabilizing after a period of rapid expansion.

Question 32

General public is discerning from buying air conditioning units based on the Health Ministry guidelines regarding emergence of a contagious viral pandemic. Consequently, Nebula Pvt. Ltd, a manufacturer of evaporation coils used in air conditioning units has faced significant loss in working capital due to sharp fall in demand. The company conducted financial assessment and developed a workable action plan based on short and long term financial needs. But for immediate needs, an emergency plan has been implemented. It includes selling scrap, asset liquidation and overheads cost reduction. Further, to avoid any such untoward event in future, they plan to diversify into newer business areas along with its core business. Identify and explain the strategy opted by M/s. Nebula Pvt. Ltd.? (RTP Nov’20)

Answer 32

M/s. Nebula Pvt Ltd has opted Turnaround Strategy as the company while facing serious working capital crunch persistently conducted an assessment of current problem and developed a workable action plan based on short and long term financial needs and strategic issues. A workable action plan for turnaround

would involve:

Stage One – Assessment of current problems: In the first step, assess the current problems and get to the root causes and the extent of damage.

Stage Two – Analyze the situation and develop a strategic plan: Identify major problems and opportunities, develop a strategic plan with specific goals and detailed functional actions.

Stage Three – Implementing an emergency action plan: If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive.

Stage Four – Restructuring the business: If the core business is irreparably damaged, then the outlook for the entire organization may be bleak. Efforts to be made to position the organization for rapid improvement.

Stage Five – Returning to normal: In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added.

Question 33

What is Divestment strategy? When is, it adopted? (RTP Nov'20, Nov'18, Old SM)

Answer 33

Divestment strategy involves the sale or liquidation of a portion of business, or a major division, profit center or SBU. For a multiple product company, divestment could be a part of rehabilitating or restructuring plan called turnaround.

- ◆ A divestment strategy may be adopted due to various reasons:
- ◆ When a turnaround has been attempted but has proved to be unsuccessful.
- ◆ A business that had been acquired proves to be a mismatch and cannot be integrated within the company.
- ◆ Persistent negative cash flows from a particular business create financial problems for the whole company.
- ◆ Severity of competition and the inability of a firm to cope with it.
- ◆ Technological upgradation is required if the business is to survive but where it is not possible for the firm to invest in it.
- ◆ A better alternative may be available for investment.

Question 34

Explain the term Merger and Acquisition as a growth strategy. Differentiate between both of them. State the situations in which such strategies are considered by any organization. (RTP Nov'21)

Answer 34

Acquisition or merger with an existing concern is an instant means of achieving expansion. It is an attractive and tempting proposition in the sense that it circumvents the time, risks and skills involved in screening internal growth opportunities, seizing them and building up the necessary resource base required to materialize growth.

Apart from the urge to grow, acquisitions and mergers are resorted to for purposes of achieving a measure of synergy between the parent and the acquired enterprises. Synergy may result from such bases as physical facilities, technical and managerial skills, distribution channels, general administration, research and development and so on.

Many organizations in order to achieve quick growth, expand or diversify with the use of mergers and acquisitions strategies. Merger and acquisition in simple words are defined as a process of combining two or more organizations together. There is a thin line of difference between the two terms but the impact of combination is completely different in both the cases.

Merger is considered to be a process when two or more organizations join together to expand their business operations. In such a case the deal gets finalized on friendly terms. Owners of pre-merged entities have right over the profits of new entity. In a merger two organizations combine to increase their strength and financial gains.

While, when one organization takes over the other organization and controls all its business operations, it is known as acquisition. In the process of acquisition, one financially strong organization overpowers the



weaker one. Acquisitions often happen during economic recession or during declining profit margins. In this process, one that is financially stronger and bigger establishes its power. The combined operations then run under the name of the powerful entity. A deal in case of an acquisition is often done in an unfriendly manner, it is more or less a forced association.

Question 35

Racers Ltd. manufactures bicycles. Until recently it has adopted a differentiation strategy, offering high quality bicycles which Racers Ltd. sells at a high profit margin.

In recent years, Racers Ltd. has entered a period of decline due to the market becoming flooded with cheaper, high quality bicycles from abroad, where labour costs are lower.

Racers Ltd. has therefore decided to adjust its strategy and adopt a focus approach, targeting its bicycles towards professional athletes. This will allow Racers Ltd. to continue earning high margins, though the size of its potential market will likely fall.

Identify and explain the need of adopting this strategy by Racers Ltd. to manage decline?(RTP May '22)

Answer 35

Racers Ltd. has adopted Turnaround strategy. This involves Racers Ltd. repositioning itself in the market in an attempt to once again gain competitive advantage.

Turnaround is needed when an enterprise's performance deteriorates to a point that it needs a radical change of direction in strategy, and possibly in structure and culture as well. It is a highly targeted effort to return an organization to profitability and increase positive cash flows to a sufficient level. It is used when both threats and weaknesses adversely affect the health of an organization so much that its basic survival is difficult.

The overall goal of turnaround strategy is to return an underperforming or distressed company to normalcy in terms of acceptable levels of profitability, solvency, liquidity and cash flow. To achieve its objectives, turnaround strategy must reverse causes of distress, resolve the financial crisis, achieve a rapid improvement in financial performance, regain stakeholder support, and overcome internal constraints and unfavourable industry characteristics.

Question 36

Write a short note on Merger and Acquisition Strategy. (RTP Nov'22)

Answer 36

Merger and acquisition in simple words are defined as a process of combining two or more organizations together. There is a thin line of difference between the two terms but the impact of combination is completely different in both the cases.

Merger is considered to be a process when two or more companies come together to expand their business operations. In such a case the deal gets finalized on friendly terms and both the organizations share profits in the newly created entity. In a merger two organizations combine to increase their strength and financial gains along with breaking the trade barriers.

When one organization takes over the other organization and controls all its business operations, it is known as acquisitions. In this process of acquisition, one financially strong organization overpowers the weaker one. Acquisitions often happen during recession in economy or during declining profit margins. In this process, one that is financially stronger and bigger establishes its power. The combined operations then run under the name of the powerful entity. A deal in case of an acquisition is often done in an unfriendly manner, it is more or less a forced association where the powerful organization either consumes the operation or a company in loss is forced to sell its entity.

Question 37

Redefinition of business is involved in both "Expansion" and "Retrenchment" strategy, however, method involved in their execution is completely different. Explain. (RTP May 23)(MTP 5 Marks Sep '23)

Answer 37



Expansion strategy is implemented by redefining the business by adding the scope of business substantially increasing the efforts of the current business. On the other hand, Retrenchment strategy involves redefinition of business by divesting a major product line or market.

Expansion is a promising and popular strategy that tends to be equated with dynamism, vigour, promise and success. Retrenchment or retreat becomes necessary or expedient for coping with particularly hostile and adverse situations in the environment and when any other strategy is likely to be suicidal.

Expansion may take the enterprise along relatively unknown and risky paths, full of promises and pitfalls. Retrenchment involves regrouping and recouping of the resources.

Question 38

ABC Inc. a successful company in the healthcare industry, was facing a decline due to outdated technology and lack of innovation. The company was losing market share and struggling to retain customers. In an effort to reverse the trend, the management decided to implement a strategy. They hired new talent, invested in research and development, and streamlined their operations to increase efficiency. Through these efforts, ABC Inc. was able to introduce new products and services, reposition themselves in the market, and eventually regain their competitive edge. The company's revenue and profits increased, and they were once again on the path to success. Discuss the strategy which has been implemented by the management of ABC Inc. (RTP May 23)

Answer 38

The management of ABC Inc. implemented turnaround strategy which is a highly-targeted effort to return ABC Inc. to profitability and increase positive cash flows to a sufficient level. Organizations those have faced a significant crisis that has negatively affected operations require turnaround strategy. Once turnaround is successful the organization may turn to focus on growth.

Conditions for turnaround strategies

When firms are losing their grips over market, profits due to several internal and external factors, and if they have to survive under the competitive environment they have to identify danger signals as early as possible and undertake rectification steps immediately. These conditions may be, inter alia cash flow problems, lower profit margins, high employee turnover and decline in market share, capacity underutilization, low morale of employees, recessionary conditions, mismanagement, raw material supply problems and so on.

Action plan for turnaround strategy

- Stage One – Assessment of current problems
- Stage Two – Analyze the situation and develop a strategic plan
- Stage Three – Implementing an emergency action plan
- Stage Four – Restructuring the business
- Stage Five – Returning to normal

Question 39

Ajanta & Sons Limited are manufacturers of domestic household security alarms for high income group homeowners in India. The company is currently reviewing two strategic options.

Option 1: Selling the same alarms although with different coverings to smaller and low- income group households at a lower price.

Option 2: Development of new, more sophisticated alarms and a wide range of security services (guards and surveillance) for sale to industrial clients for higher prices.

The senior management team of Ajanta & Sons Limited are keen to analyze the two options using Ansoff's matrix. .(Nov'21)

Answer 39

Selling the same alarms with different coverings to smaller and low income group households at a lower

price represents Market Development as the same products are being sold into a new market. Market development refers to a growth strategy where the business seeks to sell its existing products into new markets. It is a strategy for company growth by identifying and developing new markets for the existing products of the company.

While the development of new and more sophisticated alarms and a wide range of security services (guards and surveillance) for sale to industrial clients for higher prices is classified as Diversification, because it involves a new product, being sold in a new market. Diversification refers to a growth strategy where a business markets new products in new markets. It is a strategy by starting up or acquiring businesses outside the company's current products and markets.

Question 40

Explain the strategic implications of each of the following types of business in a corporate portfolio:

- (a) Stars
- (b) Question Marks
- (c) Cash Cows
- (d) Dogs (RTP May '22)

Answer 40

In the BCG growth-share matrix portfolio of investments are represented in two-dimensional space. The vertical axis represents market growth rate, and the horizontal axis represents relative market share. The strategic implications for various business types under BCG in the corporate portfolio are:

Stars are products or businesses that are growing rapidly and are best opportunity for expansion. Stars may follow build strategy. They need heavy investments to maintain their position and finance their rapid growth potential.

Cash Cows are low-growth, high market share businesses or products. They generate cash and have low costs. They are established, successful, and need less investment to maintain their market share. Strategic alternative advocated for cash cows is harvest.

Question Marks are low market share business in high-growth markets. Strategic option for them is hold for which they need heavy investments. Question marks if left unattended are capable of becoming cash traps.

Dogs are low-growth, low-share businesses and products. Relevant strategy is divest. Dogs may generate enough cash to maintain themselves, but do not have much future. Dogs should be minimized by means of divestment or liquidation.

Question 41

Explain the role of ADL Matrix in assessing competitive position of a firm. (RTP May '22, Nov'20)

Answer 41

The ADL matrix has derived its name from Arthur D. Little which is a portfolio analysis method based on product life cycle. The approach forms a two-dimensional matrix based on stage of industry maturity and the firm's competitive position, environmental assessment and business strength assessment. The role of ADL matrix is to assess the competitive position of a firm based on an assessment of the following criteria:

- ◆ **Dominant:** This is a comparatively rare position and in many cases is attributable either to a monopoly or a strong h
- ◆ **Strong:** By virtue of this position, the firm has a considerable degree of freedom over its choice of strategies and is often able to act without its market position being unduly threatened by its competitors.
- ◆ **Favorable:** This position, which generally comes about when the industry is fragmented and no one competitor stand out clearly, results in the market leaders a reasonable degree of freedom.
- ◆ **Tenable:** Although the firms within this category are able to perform satisfactorily and can justify staying in the industry, they are generally vulnerable in the face of increased competition from stronger and more proactive companies in the market.



- ♦ **Weak:** The performance of firms in this category is generally unsatisfactory although opportunities for improvement do exist.

Question 42

ABC Corporation is a conglomerate with a diverse portfolio of businesses. One of its businesses is a well-established division in a mature and stable market. The division has maintained a high market share over the years but is experiencing slow growth due to market saturation. The management team is contemplating the best course of action for this division. How should ABC Corporation approach this division according to the BCG growth-share matrix, and what would be the rationale behind it? (RTP Nov '23)

Answer 42

According to the BCG growth-share matrix, the division in a mature and stable market falls into the "Cash Cows" category. "Cash Cows" are low-growth, high market share businesses that generate cash with low costs. The recommended approach for ABC Corporation would be to adopt the "Hold" strategy. This means the company should preserve the market share of the division and continue generating cash with low costs. Since the market is mature and growth opportunities are limited, the division's focus should be on maintaining profitability and using the generated cash to support other high-potential businesses within the conglomerate. By holding onto the "Cash Cow" division, ABC can leverage its stability and cash flow to invest strategically in other areas of the business for future growth and innovation.

Question 43

Woodworld Ltd. is a company manufactures a variety of household furniture items. They offered traditional designs, low cost furniture items to low income group customers. During the last couple of years, the company has been observing a fall in the market share. This is due to the change in the taste and preferences, designing, better quality, increase in purchasing power of buyers towards the household furniture. The customers are switching away traditional designs and material that have been the backbone of Woodworld Ltd.

As a CEO of Woodworld Ltd., what can be the strategic options available with you. (RTP Nov'22)(MTP 5 Marks Oct '23)

Answer 43

Woodworld is having a product portfolio that is evidently in the decline stage. The product is being replaced with the latest designs with better quality of the product. Strategically, the company should minimize their dependence on the existing products and identify other avenues for the survival and growth. As a CEO of Woodworld Ltd., following can be the strategic options available with the CEO:

- Invest in new product development and switchover to the latest designs. Woodworld Ltd. also need time to invest in hiring interior designers.
- They can acquire or takeover a competitor, provided they have or are able to generate enough financial resources.
- They may also consider unrelated growth and identify other areas for expansion. This will enable Woodworld Ltd. to spread their risks.
- In longer run, they should divest the existing products. However, they may continue with the existing products in a limited manner for such time there is demand for the product.

Question 44

Explain the meaning of Directional Strategy. (PYP 2 Marks, May'18)

Answer 44

Directional strategies, also called **grand strategies**, provide basic directions for strategic actions towards achieving strategic goals. Such strategies are formulated at the corporate level so are also **known as corporate strategies**. The corporate strategies a firm can adopt have been **classified into four broad categories: stability, expansion, retrenchment, and combination**.



Question 45

XYZ Ltd. is a multi-product company, suffering from continuous losses since last few years and has accumulated heavy losses which have eroded its net worth.

What strategic option is available to the management of this sick company? Advise with reasons. (PYP 5 Marks, May'18, Old SM)

Answer 45

XYZ Ltd. is a sick company with accumulated losses that have eroded its net worth. The multi-product company may analyse its various products to take decisions on the viability of each. **The company may consider retrenchment strategy.** Retrenchment becomes necessary for coping with hostile and adverse situations in the environment and when any other strategy is likely to be suicidal.

Retrenchment strategy is adopted because of continuous losses and unviability and stability can be ensured by reallocation of resources from unprofitable to profitable businesses.

Retrenchment strategy is followed when an organization substantially reduces the scope of its activity. This is done through an attempt to find out the problem areas and diagnose the causes of the problems. Next, steps are taken to solve the problems.

These steps result in different kinds of retrenchment strategies as follows:

Turnaround strategy: If the organization chooses to transform itself into a leaner structure and focuses on ways and means to reverse the process of decline, it adopts a turnaround strategy. It may try to reduce costs, eliminate unprofitable outputs, generate revenue, improve coordination, better control, and so on.

Divestment Strategy: Divestment strategy involves the sale or liquidation of a portion of business, or a major division, profit center or SBU. Divestment is usually a part of rehabilitation or restructuring plan and is adopted when a turnaround has been attempted but has proved to be unsuccessful.

Liquidation Strategy: In the retrenchment strategy, the most extreme and unattractive is liquidation strategy. It involves closing down a firm and selling its assets. It is considered as the last resort because it leads to serious consequences such as loss of employment for workers and other employees, termination of opportunities where a firm could pursue any future activities, and the stigma of failure.

The management of multiproduct sick company manufacturing various items need to understand pros and cons of each strategic option. The decision will depend upon the specific circumstances of each product and management goals of the company.

Question 46

List the advantages of Strategic Alliances. (PYP 2 Marks, Nov'18)

Answer 46

Advantages of strategic alliance are:

- (i) **Organizational:** learn skills and obtain capabilities from strategic partners.
- (ii) **Economic:** Sharing of costs and risks by members of alliance.
- (iii) **Strategic:** Rivals can join together to cooperate rather than compete.
- (iv) **Political:** Alliance with partners with political influence improve overall power position of the organization.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Answers were lacking as either the areas of advantages of Strategic Alliance or their explanations were missing. Students were not able to do justice to their answers.

Question 47

Which of the following statements are correct and which are incorrect? Give reasons in brief for your answer.

Acquiring of ambulance services by a hospital is an example of forward integration strategy. (PYP 2 Marks, Nov'18)

Answer 47



Incorrect: Acquiring of ambulance services by hospital is an example of backward integration strategy. Backward integration is a step towards creation of effective supply by entering business of input providers. Forward integration is moving forward in the value chain.

Question 48

Which of the following statements are correct and which are incorrect? Give reasons in brief for your answer.

There is no such thing as backward integration. (PYP 2 Marks, Nov'18)

Answer 48

Incorrect: Organizations may diversify into new businesses that are vertically integrated with their existing business. Backward integration firms create effective supply by entering business of input providers. This strategy is employed to expand profits and gain greater control over production.

Question 49

Gautama and Siddhartha two brothers are the owners of a cloth manufacturing unit located in Faridabad. They are doing well and have substantial surplus funds available within the business. They have different approaches regarding corporate strategies to be followed to be more competitive and profitable in future.

Gautama is interested in acquiring another industrial unit located in Faridabad manufacturing stationery items such as permanent markers, notebooks, pencils and pencil sharpeners, envelopes and other office supplies. On the other hand, Siddhartha desires to start another unit to produce readymade garments.

Discuss the nature of corporate strategies being suggested by two brothers and risks involved in it. (PYP 5 Marks May '19, Old & New SM)

Answer 49

Gautama wishes to diversify in a business that is not related to their existing line of product and can be termed as conglomerate diversification. He is interested in acquiring another industrial unit located in Faridabad manufacturing stationery items such as permanent markers, notebooks, pencils and pencil sharpeners, envelopes and other office supplies, which is not related to their existing product. In conglomerate diversification, the new businesses/ products are disjointed from the existing businesses/products in every way; it is an unrelated diversification. In process/ technology/ function, there is no connection between the new products and the existing ones. Conglomerate diversification has no common thread at all with the firm's present position.

On the other hand, Siddhartha seeks to move forward in the chain of existing product by adopting vertically integrated diversification/ forward integration. The cloth being manufactured by the existing processes can be used as raw material of garments manufacturing business. In such diversification, firms opt to engage in businesses that are related to the existing business of the firm. The firm remains vertically within the same process and moves forward or backward in the chain. It enters specific product/process steps with the intention of making them into new businesses for the firm. The characteristic feature of vertically integrated diversification is that here; the firm does not jump outside the vertically linked product-process chain.

Both types of diversifications have their own risks. In conglomerate diversification, there are no linkages with customer group, customer marketing functions and technology used, which is a risk. In the case of vertical integrated diversification, there is a risk of lack of continued focus on the original business.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Majority of the examinees were not able to correctly identify the correct corporate strategy. Hence, the performance was average.

Question 50

An XYZ Company is facing continuous losses. There is decline in sales and product market share. The products of the company became uncompetitive and there is persistent negative cash flow. The physical



facilities are deteriorating and employees have low morale. At the board meeting, the board members decided that they should continue the organization and adopt such measures that the company functions properly. The board has decided to hire young executive Shyamalan for improving the functions of the organization. What corporate strategy should Shyamalan adopt for this company and what steps to be taken to implement the corporate strategy adopted by Shyamalan? (PYP 5 Marks, Nov'19, Old & New SM)

OR

The CEO of a textile mill is convinced that his loss making company can be turned around. Suggest an action plan for a turnaround to the CEO. (PYP 5 Marks, July'21)

Answer 50

XYZ Company is facing continuous losses, decline in sales and product market share, persistent negative cash flow, uncompetitive products, declining market share, deterioration in physical facilities, low morale of employees. In such a scenario, Shyamalan may choose turnaround strategy as this strategy attempts to reverse the process of decline and bring improvement in organizational health. This is also important as Board has decided to continue the company and adopt measures for its proper functioning.

For success, Shyamalan needs to focus on the short and long-term financing needs as well as on strategic issues. During the turnaround, the "product mix" may be changed, requiring the organization to do some repositioning. A workable action plan for turnaround would involve:

Stage One – Assessment of current problems: In the first step, assess the current problems and get to the root causes and the extent of damage.

Stage Two – Analyze the situation and develop a strategic plan: Identify major problems and opportunities, develop a strategic plan with specific goals and detailed functional actions.

Stage Three – Implementing an emergency action plan: If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive.

Stage Four – Restructuring the business: If the core business is irreparably damaged, then the outlook for the entire organization may be bleak. Efforts to be made to position the organization for rapid improvement.

Stage Five – Returning to normal: In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Majority of the examinees were able to correctly identify the turnaround strategy but not very clear about the steps to be taken to implement the turnaround strategy. Hence, the performance was average.

Question 51

"There are certain conditions or indicators which point out that a turnaround is needed if the company has to survive". Discuss. (PYP 5 Marks Dec '21)

Answer 51

Rising competition, business cycles and economic volatility have created a climate where no business can take viability for granted. Turnaround strategy is a highly targeted effort to return an organization to profitability and increase positive cash flows to a sufficient level. Organizations that have faced a significant crisis that has negatively affected operations requires turnaround strategy. Turnaround strategy is used when both threats and weaknesses adversely affect the health of an organization so much that its basic survival is a question. When organization is facing both internal and external pressures making things difficult then it has to find something which is entirely new, innovative and different. Being organization's first objective is to survive and then grow in the market; turnaround strategy is used when organization's survival is under threat. Once turnaround is successful the organization may turn to focus on growth.

Conditions for turnaround strategies: When firms are losing their grips over market, profits due to several internal and external factors, and if they have to survive under the competitive environment, they have to identify danger signals as early as possible and undertake rectification steps immediately. These are certain conditions or indicators which point out that a turnaround is needed if the company has to survive. These danger signals are:

- ◆ Persistent negative cash flow from business.
- ◆ Uncompetitive products or services.
- ◆ Declining market share.
- ◆ Deterioration in physical facilities.
- ◆ Over-staffing, high turnover of employees, and low morale.
- ◆ Mismanagement.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Performance was above average. Examinees were not able to write the meaning of turnaround strategy properly, but the danger signals were mentioned accurately by most of them.

Question 52

ABC Steel Industries finds out that its products have reached at maturity stage and already has overcapacity. Therefore, it concentrates on maintaining operational efficiency of its plants. Identify the strategy implemented by ABC Steel Industries along with reasons. (PYP 5 Marks May'22)

Answer 52

ABC Steel Industries has opted to implement Stability strategy. Stability strategies are intended to safeguard the existing interests and strengths of business. It involves organisations to pursue established and tested objectives, continue on the chosen path, maintain operational efficiency and so on. A stability strategy is pursued when a firm continues to serve in the same or similar markets and deals in same products and services. In stability strategy, few functional changes are made in the products or markets, however, it is not a 'do nothing' strategy. This strategy is typical for mature business organizations. Some small organizations also frequently use stability as a strategic focus to maintain comfortable market or profit position.

Major reasons for Stability strategy are:

- ◆ A product has reached the maturity stage of the product life cycle.
- ◆ The staff feels comfortable with the status quo as it involves less changes and less risks.
 - (a) It is opted when the environment in which an organisation is operating is relatively stable.
 - (b) Where it is not advisable to expand as it may be perceived as threatening.
 - (c) After rapid expansion, a firm might want to stabilize and consolidate itself.

Question 53

What do you understand by diversification? Distinguish between concentric and conglomerate diversification. (PYP 5 Marks May'22, Old SM)

Answer 53

Diversification is defined as entry into new products or product lines, new services or new markets, involving substantially different skills, technology and knowledge. Diversification endeavours can be related or unrelated to existing businesses of the firm.

Following are the differences between the concentric diversification and conglomerate diversifications:

| Concentric Diversification | Conglomerate Diversification |
|--|--|
| <p>Meaning: It occurs when a firm adds related products or markets.</p> <p>Linkage: The new business is linked to the existing businesses through process, technology or marketing.</p> <p>Reasons for pursuing: The most common reason for pursuing a concentric diversification is that opportunities in a firm's existing line of business are available.</p> | <p>Meaning: It occurs when a firm diversifies into areas that are unrelated to its current line of business.</p> <p>Linkage: Here no such linkages exist; the new business/product is disjointed from the existing businesses/products.</p> <p>Reasons for pursuing: The common reason for pursuing a conglomerate growth strategy is that opportunities in a firm's current line of business are limited or opportunities outside are highly lucrative.</p> |

Question 54

A company started its operation in 2015 with Product Alpha. In early 2021, with intent to have its better presence in the market, the company diversifies by acquiring a company with product Beta. After sometime, it was observed that product Beta is not faring well. Aggressive competition was therein market for the product. It was also revealed that though customers are not price sensitive, but product was not keeping pace with the fast changing unique features as expected by its customers.

Company has tried one of the retrenchment strategies by putting efforts to improve its internal efficiency, but could not get desired results. In the situation, company is of a considered view to remain and grow in product alpha and to decouple with product Beta from its portfolio.

As a strategist, suggest the retrenchment strategy to be adopted by the company. Also delineate reasons why a company should adopt such strategy? (PYP 5 Marks Nov 22)

Answer 54

As per the facts of the case, company had tried to improve its internal efficiency. In other words, had tried turnaround strategy but could not get the desired results.

Company does not want to go for complete close down of business. Rather it wants to continue and grow in its original business i.e. product Alpha.

As a strategist, it is advisable that the company should adopt divestment strategy. In the given situation where the business of product Beta is not faring well and became unprofitable and unviable due to aggressive competition in the market, the best option for the company is to divest the product Beta which is loss-making business.

Retrenchment may be done either internally or externally. Turnaround strategy is adopted in case of internal retrenchment where emphasis is laid on improving internal efficiency of the organization, while divestment strategy is adopted when a business turns unprofitable and unviable due to some external factors. In view of the above, the company should go for divestment strategy.

A divestment strategy may be adopted due to various reasons:

1. A business that had been acquired proves to be a mismatch and cannot be integrated within the company.
2. Persistent negative cash flows from a particular business create financial problems for the whole company, creating the need for divestment of that business.
3. Severity of competition and the inability of a firm to cope with it may cause it to divest.
4. It is not possible for the business to do Technological up-gradation that is required for the business to survive, a preferable option would be to divest.



5. A better alternative may be available for investment, causing a firm to divest a part of its unprofitable business.

Question 55

Health Pharma Pvt. Ltd. (HPPL) a one person company with limited liability is manufacturing generic and medicinal drugs in India.

Hygiene Laboratories Plc. (HLP) a multinational company with its strong financial position is one of the major players in pharmaceutical sector.

Individually, each company has its own core competencies. However, additional focus by the state on generic medicine with renewed regulatory requirements are posing challenges in fierce competitive environment.

Considering benefits of synergies, both the companies are considering to join hands for better growth opportunities. Earlier, they tried to go for joint venture or strategic alliance but the arrangement could not materialize.

In view of the facts given above:

- (i) If HPPL and HLP join hands and make new entity named Health N Hygiene Pharma Ltd., what type of growth strategy will this strategic development be?**
- (ii) In case, HLP is sold out to HPPL and HLP ceased to exist, what type of growth strategy will this strategic deal be?**
- (iii) What are the differences between the above two identified growth strategies? (PYP 5 Marks May '23)**

Answer 55

- i) If HPPL and HLP join hands and form a new entity named Health N Hygiene Pharma Ltd., this strategic development would be considered a Merger growth strategy. A merger is a combination of two or more companies to form a new entity with shared ownership and control.**
- ii) If HLP is sold out to HPPL and HLP ceases to exist, this strategic deal would be categorized as an Acquisition growth strategy. An acquisition occurs when one company purchases another, resulting in the acquiring company gaining control over the acquired company's assets, operations, and intellectual property.**
- iii) Many organizations in order to achieve quick growth, expand or diversify with the use of mergers and acquisitions strategies. Merger and acquisition in simple words are defined as a process of combining two or more organizations together. There is a thin line of difference between the two terms, but the impact of combination is completely different in both the cases.**

Merger is considered to be a process when two or more organizations join together to expand their business operations. In such a case the deal gets finalized on friendly terms. Owners of pre-merged entities have right over the profits of new entity. In a merger two organizations combine to increase their strength and financial gains.

While, when one organization takes over the other organization and controls all its business operations, it is known as acquisition. In the process of acquisition, one financially strong organization overpowers the weaker one. Acquisitions often happen during economic recession or during declining profit margins. In this process, one that is financially stronger and bigger establishes its power. The combined operations then run under the name of the powerful entity. A deal in case of an acquisition is often done in an unfriendly manner; it is more or less a forced association.

MULTIPLE CHOICE QUESTIONS

1. If suppliers are unreliable or too costly, which of these strategies may be appropriate?

- (a) Horizontal integration
- (b) Backward integration
- (c) Market penetration
- (d) Forward integration **(MTP-Oct '19, 1 Mark, New SM, RTP May'21)**

Ans: (b)

2. Which strategy is implemented after the failure of turnaround strategy?

- (a) Expansion strategy
- (b) Diversification strategy
- (c) Divestment strategy
- (d) Growth strategy **(MTP-Oct '19, Apr'21, 1 Mark, New SM)**

Ans: (c)

3. Vertical integration may be beneficial when

- (a) Lower transaction costs and improved coordination are vital and achievable through vertical integration.
- (b) Flexibility is reduced, providing a more stationary position in the competitive environment.
- (c) Various segregated specializations will be combined.
- (d) The minimum efficient scales of two corporations are different. **(MTP-March '19, 1 Mark, New SM, RTP May'20)**

Ans: (a)

4. Stability strategy is a strategy. _____

- (a) SBU level
- (b) Corporate level
- (c) Business level
- (d) Functional level **(MTP-March '19, 1 Mark, RTP May'19, New SM)**

Ans: (b)

5. Conglomerate diversification is another name for which of the following?

- (a) Related diversification
- (b) Unrelated diversification
- (c) Portfolio diversification
- (d) Acquisition diversification **(MTP-March '19, 1 Mark, New SM, MTP 1 Mark Oct'22)**

Ans: (d)

6. Which of the following can be used in retrenchment strategy?

- (a) Reducing assets.
- (b) Operational improvement.
- (c) Cutting cost.



- (d) All of the above. (MTP-April '19, 1 Mark)

Ans: (d)

7. Conglomerate diversification can also be explained as:

- (a) Merger
- (b) Combination strategy
- (c) Related diversification
- (d) Unrelated diversification (MTP-April '19, 1 Mark)

Ans: (d)

8. Dee Limited is an international clothing retailer. The company is making the following decisions:

- i. Should another range of shops be established?
- ii. Should the company float more share capital?
- iii. How will the premises be fitted out for the new range of shops? Which of the above decisions will be taken by corporate level managers?

- (a) Only (i)
- (b) Only (ii)
- (c) (i) & (ii)
- (d) (ii) & (iii) (MTP 1 Mark Oct 20)

Ans: (c)

9. When two organizations combine to increase their strength and financial gains along with reducing competition is called --.

- (a) Hostile takeover
- (b) Liquidation
- (c) Merger
- (d) Acquisition (MTP 1 Mark Oct 20)

Ans: (c)

10. Beta Company, a car manufacturer is buying up a supplier so that it gets a dedicated supplier with both guaranteed quality and price. The material could be manufactured when required by Beta Company leading to lower inventory levels. Which strategy has Beta Company adopted?

- (a) Backward integration
- (b) Forward integration
- (c) Conglomerate diversification
- (d) Horizontal integrated diversification (MTP 2 Marks March '21)

Ans: (a)

11. Baba Pvt Ltd has seventeen factories, nine of which they recently gave to other producers on lease. This has increased their cash inflows to a great extent, and they are enjoying this surplus by investing the same in financial assets. Such a strategy can be termed as which of the following?

- (a) Divest



- (b) Harvest
- (c) Hold
- (d) Build (MTP 2 Marks Oct 21)

Ans: (b)

12. Mixfix was having a tough time with its operations and wanting to restructure itself from scratch. For this, they consult a veteran in business strategy, Mrs. Sunita K, who post analysis of their business said, “your dead business is worth more than alive”. What did Mrs. Sunita hint at?

- (a) Restructuring Business
- (b) Liquidation
- (c) Business Process Re-engineering
- (d) Divestment (MTP 2 Marks Oct 21)

Ans: (b)

13. A rubber manufacturer starts making shoe soles and gum can be termed as?

- (a) Conglomerate Diversification
- (b) Concentric Diversification
- (c) Horizontal Integration
- (d) Vertical Integration (MTP 1 Mark Nov 21)

Ans: (b)

14. The business news anchor said that “chillfrix’s dead business is worth more than alive”. What did she hint at?

- (a) Restructuring Business
- (b) Liquidation
- (c) Business Process Re-engineering
- (d) Divestment (MTP 1 Mark Sep’22)

Ans:(b)

15. Acquisition of a company producing readymade garments by a company manufacturing yarn is .

- (a) Horizontal integration
- (b) Horizontal Diversification
- (c) Forward integration
- (d) Backward integration (MTP 1 Mark April ‘19)

Ans : (c)

16. Merger of two organisations that are operating in the same industry but at different stages of production and distribution system is called: -

- (a) Horizontal Merger
- (b) Vertical Merger
- (c) Co-generic Merger
- (d) Conglomerate Merger (MTP 1 Mark March ‘23)

Ans: (b)

17. A company that produces and sells athletic shoes may acquire or merge with another athletic shoe



manufacturer in order to increase their market share and reduce competition is an example of -

- (a) Horizontal integration
- (b) Backward integration
- (c) Market penetration
- (d) Forward integration **(MTP 2 Marks April '23)**

Ans: (a)

18. What does Dogs symbolize in BCG matrix?

- (a) Invest
- (b) Harvest
- (c) Build
- (d) Divest **(MTP-March '19, 1 Mark)**

Ans: (d)

19. The Specialist Clothing Company (SCC) is a manufacturer of a wide range of clothing. Fashion is one of the five divisions of SCC. Fashion is operating in a market with high growth and is a market leader. By the next year, it is predicted to have 10% of the market share in a growing market. Fashion should be classified as which of the following according to the BCG matrix.

- (a) Star
- (b) Dog
- (c) Cash cow
- (d) Question mark **(2 Marks March '21)**

Ans: (a)

20. A beverage company has more than 500 soft drink brands, but none of them is anywhere close to its premium brand One Sip in awareness, revenue and profits. As per BCG's Matrix, One Sip brand for the beverage company is?

- (a) Star
- (b) Dog
- (c) Cash cow
- (d) Question mark **(2 Marks April 21)**

Ans: (c)

21. In context to BCG matrix, which of the following statements is not correct?

- (a) The BCG assumes that all products will grow and mature.
- (b) The BCG can be used to examine a company's current product portfolio.
- (c) A company with only cash cows and dogs has limited long-term prospects.
- (d) All of the above **(1 Mark Nov 21)**

Ans: (a)

22. Dogs in BCG Matrix can be minimized through?

- (a) Converting to Cash Cows
- (b) Liquidating or Divesting
- (c) Foreign Direct Investment Opportunity



(d) Bad Debt Writing off (MTP 1 Mark Sep'22)

Ans: (b)

23. You have been appointed as a strategic manager at ABC Company, which is currently facing a situation where one of its products has entered the maturity stage of its Product Life Cycle (PLC). The company has made a deliberate decision to maintain its existing business operations and is content with achieving incremental growth for this product aligns with which of the following strategies?

- (a) Expansion strategy
- (b) Stability strategy
- (c) Retrenchment strategy
- (d) Combination strategy (MTP 2 Marks Sep '23)

Ans: (b)

24. XYZ Corporation is a multinational conglomerate operating in various industries. They have a diverse portfolio of businesses, including a leading consumer electronics division, a growing e - commerce platform, a mature industrial machinery division, and a newly established software development unit. Which division of XYZ Corporation would most likely be classified as a "Star" in the BCG Growth-Share Matrix?

- (a) Consumer Electronics Division
- (b) E-commerce Platform
- (c) Industrial Machinery Division
- (d) Software Development Unit (MTP 2 Marks Oct '23)

Ans: (b)

25. Which of the following is not a type of diversification strategy?

- (a) Vertical diversification.
- (b) Concentric diversification.
- (c) Conglomerate diversification.
- (d) Co-generic diversification. (RTP May'19)

Ans : (d)

26. An organization acquires its supplier is an example of:

- (a) Horizontal integrated diversification.
- (b) Forward integrated diversification.
- (c) Backward integrated diversification.
- (d) Conglomerate diversification. (RTP May'19)

Ans: (c)

27. In the questions given below select the best answer out of options (a), (b), (c), or (d):
Retrenchment strategy in the organization can be explained as

- (a) Reducing trenches (gaps) created between individuals.
- (b) Divesting a major product line or market.
- (c) Removal of employees from job through the process of reorganization.
- (d) Removal of employees from job in one business to relocate them in other business. (RTP May'20, New SM)

Ans: (b)



**28. In the questions given below select the best answer out of options (A), (B), (C), or (D):
Arrange divestment, liquidation, stability and turnaround strategies in order of preference for adoption by a typical organization.**

- (a) Turnaround, stability, liquidation and divestment.
- (b) Divestment, liquidation, stability and turnaround.
- (c) Stability, turnaround, liquidation and divestment.
- (d) Stability, turnaround, divestment and liquidation. **(RTP Nov'19)**

Ans: (d)

**29. In the questions given below select the best answer out of options (A), (B), (C), or (D):
Acquisition of another organization that was using your product in their manufacturing is:**

- (a) Horizontal integrated diversification
- (b) Forward integrated diversification
- (c) Backward integrated diversification
- (d) conglomerate diversification **(RTP Nov'19)**

Ans: (b)

30. Velvet Limited is a full-service airline. The company is making the following decisions:

- (i) Should a 'no-frills', 'low-fare' subsidiary be set-up?
- (ii) If it is set-up, how should the cabin staff be recruited?

Which of the above decisions will be taken by corporate level managers?

- (a) Only (i)
- (b) Only (ii)
- (c) Both (i) & (ii)
- (d) Neither (i) nor (ii) **(RTP Nov'20)**

Ans: (a)

31. The Niche strategy is the best way to enter a:

- (a) New market
- (b) Growing market
- (c) Matured market
- (d) None of the above **(RTP Nov'20)**

Ans: (c)

32. A tea farm owners plan to open tea cafes in tourist spots and to sell their own premium tea to build a brand. Which of the following can this be termed as?

- (a) Backward Integration
- (b) Forward Integration
- (c) Diversification
- (d) Horizontal Integration **(RTP May '22)**

Ans: (b)

33. Hupo a honey brand decided to start a new brand for making honey ginger candies to meet the rising demand. Identify their growth strategy?

- (a) Conglomerate Diversification



- (b) Concentric Diversification
- (c) Vertical Integration
- (d) Horizontal Integration (RTP Nov'22)

Ans: (a)

34. Sumedha has a home-grown brand which makes traditional lehengas. She thought of expanding her business and added linen jackets and cotton trousers to her product line. Which strategy is she working on?

- (a) Backward integration
- (b) Intensification
- (c) Diversification
- (d) Horizontal Diversification (Chapter Corporate Level Strategies) (RTP May 23)

Ans: (b)

35. Under BCG an SBU with products having little market share but in an attractive industry is referred to as:

- (a) Cash cow.
- (b) Star.
- (c) Dog. (RTP May'19)

Ans: (b)

36. Nom-Nom is a fast-food brand and has been facing a lot of competition from American brands and has decided to NOT go very aggressive but to just preserve market share? Which of the strategy Nom-Nom is following?

- (a) Build
- (b) Hold
- (c) Harvest
- (d) Divest (RTP May '22)

Ans: (b)

37. Sanjay guided the team of young entrepreneurs to hold to the current position in the market till they get a big opportunity. What could be their business termed as basis Sanjay's advice?

- (a) Question Mark
- (b) Cash Cow
- (c) Star
- (d) Dog (Chapter Dynamics of Competitive Strategy) (RTP May 23)

Ans: (a)

Chapter 5

Strategy Implementation and Evaluation

Question 1

Strategic Planning and Operational Planning. (MTP 5 Marks March '22 & Oct '23, RTP May'22)

Answer 1

| Strategic planning | Operational planning |
|---|---|
| Strategic planning shapes the organisation and its resources. | Operational planning deals with current deployment of resources. |
| Strategic planning assesses the impact of environmental variables. | Operational planning develops tactics rather than strategy. |
| Strategic planning takes a holistic view of the organisation. | Operational planning projects current operations into the future. |
| Strategic planning develops overall objectives and strategies. | Operational planning makes modifications to the business functions but not fundamental changes. |
| Strategic planning is concerned with the long-term success of the organisation. | Operational planning is concerned with the short-term success of the organisation. |
| Strategic planning is a senior management responsibility. | Operational planning is the responsibility of functional managers. |

Question 2

HQ is a service company? Two years back the company hired a reputed management consultant to formulate its strategy. The consultant recommended an aggressive expansion plan. Now in an internal review meeting the company finds that many of the suggestions are not even fully considered. Which part of strategic management process is missing in HQ? (MTP-APRIL-2019-5 Marks)

Answer 2

Strategy implementation is missing in HQ. It is concerned with the managerial exercise of putting a chosen strategy into action. It deals with the managerial exercise of supervising the ongoing pursuit of strategy, making it work, improving the competence with which it is executed and showing measurable progress in achieving the targeted results.

Strategic implementation is concerned with translating a strategic decision into action, which presupposes that the decision itself (i.e., the strategic choice) was made with some thought being given to feasibility and acceptability. The allocation of resources to new courses of action will need to be undertaken, and there may be a need for adapting the organization's structure to handle new activities as well as training personnel and devising appropriate systems.

It is crucial to realize the difference between the formulation and implementation because they both require very different skills. Also, a company will be successful only when the strategy formulation is sound and implementation is excellent.

Question 3

What is implementation control? Discuss its basic forms. (MTP-MARCH-2019 & OCT-2018 5 Marks, RTP May'18, Nov'19, Nov'21, Nov'23)

Answer 3

Implementation Control: Managers implement strategy by converting major plans into concrete, sequential actions that form incremental steps. Implementation control is directed towards assessing the need for changes in the overall strategy in light of unfolding events and results associated with incremental steps and actions.

Strategic implementation control is not a replacement to operational control. Strategic implementation control, unlike operational controls continuously monitors the basic direction of the strategy. The two basic forms of implementation control are:



- i) **Monitoring strategic thrusts:** Monitoring strategic thrusts help managers to determine whether the overall strategy is progressing as desired or whether there is need for readjustments.
- ii) **Milestone Reviews:** All key activities necessary to implement strategy are segregated in terms of time, events or major resource allocation. It normally involves a complete reassessment of the strategy. It also assesses the need to continue or refocus the direction of an organization.

Question 4

Dr. Raman has been running a nursing home for about twenty two years now, and has gained enormous name for his benevolence in Balram district of Chhattisgarh. Recently, his daughter, Dr. Radhika completed her medicine degree from the United States of America and returned to her hometown to be a part of her father's practice. She has been given the baton to promote modern medicine and retain the local skilled youth in their practice. However, their nursing home's skilled youth has been more inclined to E-Commerce employment opportunities. Dr. Radhika has taken it as a challenge to imbibe the very essence of service in them, by being employed as nurses and caretakers of the ill. This shall be very crucial in growing the practice as desired. Which of the following phases of Kurt Lewin's Model of Change will be most challenging for Dr. Radhika to strategically positioning her father's nursing home? (MTP 5 Marks May 20)

Answer 4

Kurt Lewin's Model of Change proposes three phases of change process to make the change lasting. They are Compliance, Identification and Internalization.

For Dr. Radhika, Compliance and Identification will not a big challenge, as her father has been one of the most sort after personalities serving the ill in their district. And her return from the USA to serve her country, especially her district, will help the workforce identify her as a role model and there would actually be no need for compliance, i.e. Reward and Punishment for bringing about a change. However, the new lucrative E-Commerce employment opportunities will have to be fought through Internalization, i.e. internal changing of the individual's thought process, to give them freedom to learn and succeed. Thus, Internalization will be the most challenging phase.

Question 5

Distinguish between Strategy Formulation and Strategy Implementation. (MTP 5 Marks March '21 & March '23, Old SM, PYP 3 Marks May '19)

Answer 5

Although inextricably linked, strategy implementation is fundamentally different from strategy formulation in the following ways:

| Strategy Formulation | Strategy Implementation |
|---|---|
| <ul style="list-style-type: none">◆ Strategy formulation focuses on effectiveness.◆ Strategy formulation is primarily an intellectual process.◆ Strategy formulation requires conceptual intuitive and analytical skills.◆ Strategy formulation requires coordination among the executives at the top level. | <ul style="list-style-type: none">◆ Strategy implementation focuses on efficiency.◆ Strategy implementation is primarily an operational process.◆ Strategy implementation requires motivation and leadership skills.◆ Strategy implementation requires coordination among the executives at the middle and lower levels. |

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Overall performance of the examinees was good in both the alternatives related to hourglass structure and difference between strategy formulation and strategy implementation.

**Question 6**

Explain the steps for initiating strategic change. (MTP 5 Marks March '22, RTP Nov '21) (PYP 5 Marks May '23)

Answer 6

The changes in the environmental forces often require businesses to make modifications in their existing strategies and bring out new strategies. Strategic change is a complex process that involves a corporate strategy focused on new markets, products, services and new ways of doing business.

Three steps for initiating strategic change are:

- (i) **Recognise the need for change** – The first step is to diagnose the which facets of the present corporate culture are strategy supportive and which are not.
- (ii) **Create a shared vision to manage change** – Objectives of both individuals and organisation should coincide. There should be no conflict between them. This is possible only if the management and the organisation members follow a shared vision.
- (iii) **Institutionalise the change** – This is an action stage which requires the implementation of the changed strategy. Creating and sustaining a different attitude towards change is essential to ensure that the firm does not slip back into old ways of doing things.

Question 7

Sanya Private Limited is an automobile company. For the past few years, it has been observed that the progress of the company has become stagnant. When scrutinized, it was found that the planning department was performing fairly well but the plans could not be implemented due to improper use of resources, undesirable tendencies of workers and non-conformance to norms and standards. You are hired as a Strategic Manager. Suggest the elements of process of control to overcome the problem. (MTP 5 Marks April 22, Old & New SM)

Answer 7

Sanya Private Limited deteriorating performance due to poor implementation of plans that is improper use of resources, undesirable tendencies of the workers, and non-conformance to norms and standards, all point towards weak controls in the organization. Implementation of plans cannot assure results unless strong and sufficient controls are put in place. The management of the company should focus diligently on developing controls especially in the identified problem areas.

The process of control has the following elements:

- (a) Objectives of the business system which could be operationalized into measurable and controllable standards.
- (b) A mechanism for monitoring and measuring the performance of the system.
- (c) A mechanism (i) for comparing the actual results with reference to the standards (ii) for detecting deviations from standards and (iii) for learning new insights on standards themselves.
- (d) A mechanism for feeding back corrective and adaptive information and instructions to the system, for effecting the desired changes to set right the system to keep it on course.

Above elements of control would ensure a proper check on improper use of resources, undesirable tendencies of the workers, and non-conformance to norms and standards and ensure a result oriented implementation of plans.

Question 8

Why is strategy evaluation more difficult? Give reasons. (MTP 5 Marks Sep'22, PYP 5 Marks Dec '21)

Answer 8

Strategic evaluation involves measuring and evaluating performance. The goals achieved are compared with the desired goals to identify deviations and make necessary adjustments in strategies or in the efforts being put to achieve those strategies.

Reasons why strategy evaluation is more difficult today include the following trends:



- ◆ A dramatic increase in the environment's complexity.
- ◆ The increasing difficulty of predicting the future with accuracy.
- ◆ The increasing number of variables in the environment.
- ◆ The rapid rate of obsolescence of even the best plans.
- ◆ The increase in the number of both domestic and world events affecting organizations.
- ◆ The decreasing time span for which planning can be done with any degree of certainty.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Performance was average. Majority of the examinees lacked proper knowledge of reasons for the difficulty of strategic evaluation. They were not able to write answers on expected lines. In the second option, determinants of rivalry were presented properly by most of the examinees.

Question 9

Distinguish between Operational Control and Management Control. (MTP 5 Marks Oct'22 & Sep '23, Old & New SM)

Answer 9

Differences between Operational Control and Management Control are as under:

- (i) The thrust of operational control is on individual tasks or transactions as against total or more aggregative management functions. When compared with operational, management control is more inclusive and more aggregative, in the sense of embracing the integrated activities of a complete department, division or even entire organization, instead of mere narrowly circumscribed activities of sub-units. For example, procuring specific items for inventory is a matter of operational control, in contrast to inventory management as a whole.
- (ii) Many of the control systems in organizations are operational and mechanistic in nature. A set of standards, plans and instructions are formulated. On the other hand, the basic purpose of management control is the achievement of enterprise goals – short range and long range – in an effective and efficient manner.

Question 10

ABC Ltd. is a shoe manufacturing company. The strategic manager of ABC Ltd. is Ms. Suman. Ms. Suman hired the best designers she could find online for her ethnic shoe brand but later she found that the designers were better at leather designs. Identify and explain linkage in the given situation as she had to change her strategy basis the actual resources she had? (MTP 5 Marks Sep'22, RTP Nov '23)

Answer 10

The strategy formulation and strategy implementation are intertwined and linked with each other. Two types of linkages exist between these two phases of strategic management. The forward linkages deal with the impact of strategy formulation on strategy implementation while the backward linkages are concerned with the impact in the opposite direction.

In the given situation Ms. Suman has to follow Backward Linkages as she had to change her strategy basis the actual resources she had. While dealing with strategic choice, remember that past strategic actions also determine the choice of strategy. Organizations tend to adopt those strategies which can be implemented with the help of the present structure of resources combined with some additional efforts. Such incremental changes, over a period of time, take the organization from where it is to where it wishes to be.

Question 11

ABC Ltd. intends to grow its business. Its top management argues that its 'Corporate Strategy' will ensure the growth of the firm. Do you agree with the top management's argument? Give reasons. (MTP 5 Marks April '23)

Answer 11

Yes, agreeing with the top management's argument. Corporate strategy is basically the growth design of the firm; it spells out the growth objective- the direction, pace and timing of the firm's growth. It also spells out the strategy for achieving the growth. Corporate strategy ensures the growth of the firm because of the following arguments:

- It ensures the correct alignment of the firm with its environment. It also serves as the design for filling the strategic planning gap.
- It gives importance to combination, sequence, timing, direction and depth of various moves and action initiatives taken by managers to handle environmental uncertainties and complexities.
- It helps build the relevant competitive advantages for the firm. Masterminding and working out the right fit between the firm and its external environment.
- It is to harness the opportunities available in the environment, countering the threats embedded therein.

Question 12

To convert strategic plans into actions and results, a manager must be able to direct organizational change, motivate people, build and strengthen company competencies and competitive capabilities, create a strategy-supportive work climate, and meet or beat performance targets. Explain the principal aspects of strategy-execution process. (MTP-March '19, 5 Marks)

OR

Strategy execution is an operations-oriented activity which involves a good fit between strategy and organizational capabilities, structure, climate & culture. Enumerate the principal aspects of strategy execution process which are used in most of the situations. (MTP 5 Marks Oct 21)

OR

Describe the principal aspects of strategy-execution process, which are included in most situations. (MTP 5 Marks Sep '22 & Oct '23, PP 5 Marks May '18, Old & New SM, RTP Nov '18 & Nov '21)

OR

What are the important aspects of the process of implementation of strategy? (PYP 5 Marks Dec '21 & Jan '21)

Answer 12

In most situations, strategy-execution process includes the following principal aspects:

- Developing budgets that steer ample resources into those activities critical to strategic success.
- Staffing the organization with the needed skills and expertise, consciously building and strengthening strategy-supportive competencies and competitive capabilities, and organizing the work effort.
- Ensuring that policies and operating procedures facilitate rather than impede effective execution.
- Using the best-known practices to perform core business activities and pushing for continuous improvement.
- Installing information and operating systems that enable company personnel to better carry out their strategic roles day in and day out.
- Motivating people to pursue the target objectives energetically
- Creating a company culture and work climate conducive to successful strategy implementation and execution.
- Exerting the internal leadership needed to drive implementation forward and keep improving strategy execution. When the organization encounters stumbling blocks or weaknesses, management has to see that they are addressed and rectified quickly. Good strategy execution involves creating strong "fits" between strategy and organizational capabilities, between strategy and the reward structure, between strategy and internal operating systems, and



between strategy and the organization's work climate and culture.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Performance was below average. Majority of the examinees were not able to present good answers. The principal aspects of strategy implementation process were not expressed in the

Question 13

How can a company deal with strategic uncertainty? (MTP-Aug. '18, 3 Marks, RTP May'18)

Answer 13

Strategic uncertainty denotes the uncertainty that has crucial implications for the organisation. A typical external analysis will emerge with dozens of strategic uncertainties. To be manageable, they need to be grouped into logical clusters or themes. It is then useful to assess the importance of each cluster in order to set priorities with respect to Information gathering and analysis.

Question 14

Strategy Formulation and Strategy Implementation. (MTP 5 Marks Oct 21)

Answer 14

Although inextricably linked, strategy implementation is fundamentally different from strategy formulation in the following ways:

| Strategy Formulation | Strategy Implementation |
|--|--|
| <ul style="list-style-type: none"> ♦ Strategy formulation focuses on effectiveness. ♦ Strategy formulation is primarily an intellectual process. ♦ Strategy formulation requires conceptual intuitive and analytical skills. ♦ Strategy formulation requires coordination among the executives at the top level. | <ul style="list-style-type: none"> ♦ Strategy implementation focuses on efficiency. ♦ Strategy implementation is primarily an operational process. ♦ Strategy implementation requires motivation and leadership skills. ♦ Strategy implementation requires coordination among the executives at the middle and lower levels. |

Question 15

State with reasons the following statement is correct/incorrect:

Information gathering and deep analysis can eliminate uncertainty. (RTP May'18)

Answer 15

Incorrect: Strategic uncertainty is often represented by a future trend or event that has inherent unpredictability. Information gathering and additional analysis is not able to eliminate uncertainty.

Question 16

How can a corporate culture be both strength and weakness of an organisation? (MTP-Oct '19, Mar'19 5 Marks, MTP 5 Marks Oct'20, PYP 5 Marks Nov'18)

Answer 16

The most important phenomenon which often distinguishes one organisation with another is its corporate culture. Corporate culture refers to a company's values, beliefs, business principles, traditions, and ways of operating and internal work environment. Every corporation has a culture that exerts powerful influences on the behaviour of managers.

- As a strength:** Culture can facilitate communication, decision making and control and instill cooperation and commitment. An organization's culture could be strong and cohesive when it conducts its business according to clear and explicit set of principles and values, which the management devotes considerable time to communicating to employees and which values are shared widely across the organisation.



- (ii) **As a weakness:** Culture, as a weakness can obstruct the smooth implementation of strategy by creating resistance to change. An organization's culture could be characterised as weak when many sub-cultures exist, few values and behavioural norms are shared and traditions are rare. In such organizations, employees do not have a sense of commitment, loyalty and sense of identity.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Performance was below average. Candidates had little knowledge about corporate culture and accordingly were not able to discuss the same in terms of strength and weakness.

Question 17

Mathew & Sons Ltd. is a diversified business entity having business operations across the globe. Presently, Mr. Mathew is the CEO of Mathew & Sons Ltd. He is going to retire in next 4 months, so he has decided to change the company's leadership and hand over the pedals to his elder son Marshal. Marshal is a highly educated with an engineering degree from USA. However, being very young he is not clear about his role and responsibilities. In your view, what are the responsibilities of Marshal as CEO of Mathew & Sons Ltd. [MTP-Aug '18, 5 Marks, RTP May'20, RTP Nov'18, Old & New SM]

Answer 17

Marshal, to be an effective strategic leader of Mathew & Sons Ltd. must be able to deal with the diverse and cognitively complex competitive situations that are characteristic of today's competitive landscape. He has several responsibilities, including the following:

- Making strategic decisions.
- Formulating policies and action plans to implement strategic decision.
- Ensuring effective communication in the organisation.
- Managing human capital (perhaps the most critical of the strategic leader's skills).
- Managing change in the organisation.
- Creating and sustaining strong corporate culture.
- Sustaining high performance over time.

Question 18

Discuss the concept of Multi Divisional Structure. (MTP-April '19, 5 Marks, RTP May'19)

Answer 18

Multidivisional (M-form) structure is composed of operating divisions where each division represents a separate business to which the top corporate officer delegates responsibility for day-to-day operations and business unit strategy to division managers. By such delegation, the corporate office is responsible for formulating and implementing overall corporate strategy and manages divisions through strategic and financial controls.

Multidivisional or M-form structure was developed in the 1920s, in response to co-ordination and control-related problems in large firms. Functional departments often had difficulty dealing with distinct product lines and markets, especially in coordinating conflicting priorities among the products.

Costs were not allocated to individual products, so it was not possible to assess an individual product's profit contribution. Loss of control meant that optimal allocation of firm resources between products was difficult (if not impossible). Top managers became over-involved in solving short-run problems (such as coordination, communications, conflict resolution) and neglected long-term strategic issues. Multidivisional structure calls for:

- Creating separate divisions, each representing a distinct business
- Each division would house its functional hierarchy;
- Division managers would be given responsibility for managing day-to-day operations;
- A small corporate office that would determine the long-term strategic direction of the firm and exercise overall financial control over the semi-autonomous divisions.

Question 19

What is a strategic business unit? What are its advantages? (MTP 5 Marks May 20, New & Old SM,

RTP May'20)

Answer 19

A strategic business unit (SBU) is any part of a business organization which is treated separately for strategic management purposes. The concept of SBU is helpful in creating an SBU organizational structure. It is discrete element of the business serving product markets with readily identifiable competitors and for which strategic planning can be concluded. It is created by adding another level of management in a divisional structure after the divisions have been grouped under a divisional top management authority based on the common strategic interests.

Advantages of SBU are:

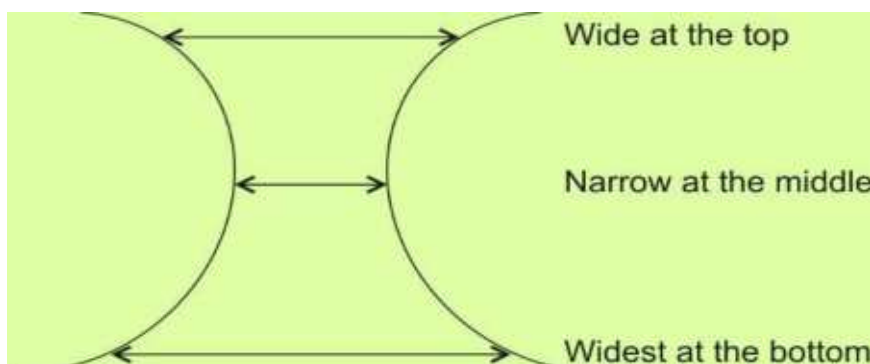
- ◆ Establishing coordination between divisions having common strategic interests.
- ◆ Facilitates strategic management and control on large and diverse organizations.
- ◆ Fixes accountabilities at the level of distinct business units.
- ◆ Allows strategic planning to be done at the most relevant level within the total enterprise.
- ◆ Makes the task of strategic review by top executives more objective and more effective.
- ◆ Helps allocate corporate resources to areas with greatest growth opportunities.

Question 20

Delta Co. is an organization specializing in Information Technology enabled Services (ITeS) and Communications business. Last year, the organization had successfully integrated an Artificial Intelligence (AI) tool named 'Zeus' into the existing ERP system. The AI tool, using Deep Learning technique provided a digital leap transformation in various business processes and operations. It has significantly diminished the role played by specialist managers of the middle management. This technological tool in addition to saving organizational costs by replacing many tasks of the middle management has also served as a link between top and bottom levels in the organization and assists in quick decision making. The skewed middle level managers now perform cross-functional duties. Which type of organizational structure is the company transitioning into? (MTP 5 Marks Oct 20, RTP Nov'20)

Answer 20

The Delta company is transitioning into the hourglass organization structure because it has used technological tools to transform various business processes and operations and has significantly diminished the role played by specialist managers of the middle management. The technological tool in addition to saving organizational costs by replacing many tasks of the middle management has also served as a link between top and bottom levels in the organization and assists in faster decision making. The skewed middle level managers now perform cross-functional duties. All these factors indicate towards hourglass organization structure.



Question 21

How can management communicate that it is committed to creating a new culture assuming that the old culture was problematic and not aligned with the company strategy? (MTP 5 Marks March '21 & Oct '22)(RTP May '21)



OR

You are appointed as a manager of a company where you find that the company's culture is out of sync with what is needed for strategic success. Discuss steps you would initiate to tackle the problem. (May 23)

Answer 21

Corporate culture refers to company's values, beliefs, business principles, traditions, ways of operating and internal work environment. Changing problem cultures is very difficult because of deeply held values and habits. It takes concerted management action over a period of time to replace an unhealthy culture with a healthy culture or to root out certain unwanted cultural obstacles and instil ones that are more strategy-supportive.

- ◆ The first step is to diagnose which facets of the present culture are strategy supportive and which are not.
- ◆ Then, managers have to talk openly and forthrightly to all concerned about those aspects of the culture that have to be changed.
- ◆ The talk has to be followed swiftly by visible, aggressive actions to modify the culture -actions that everyone will understand are intended to establish a new culture more in tune with the strategy.

Management through communication has to create a shared vision to manage changes. The menu of culture-changing actions includes revising policies and procedures, altering incentive compensation, shifting budgetary allocations for substantial resources to new strategy projects, recruiting and hiring new managers and employees, replacing key executives, communication on need and benefit to employees and so on.

Question 22

Suresh Sinha has been recently appointed as the head of a strategic business unit of a large multiproduct company. Advise Mr Sinha about the leadership role to be played by him in execution of strategy. (MTP 5 Marks April 21, Old & New SM, RTP May '18)

OR

Discuss the leadership roles played by the managers in pushing for good strategy execution. (PYP 5 Marks, May'19)

OR

You have been appointed as a Chief Executive Officer (CEO) in a company which is facing many difficulties in proper execution of its strategy. Explain the leadership roles which you should play in pushing for good strategy execution. (PYP 5 Marks Nov 22)

Answer 22

A manager as a strategic leader has many different leadership roles to play: visionary, chief entrepreneur and strategist, chief administrator, culture builder, resource acquirer and allocator, capabilities builder, process integrator, crisis solver, spokesperson, negotiator, motivator, arbitrator, policy maker and so on. Managers have five leadership roles to play in pushing for good strategy execution:

- (i) Staying on top of what is happening, closely monitoring progress, solving out issues, and learning what obstacles lie in the path of good execution.
- (ii) Promoting a culture of esprit de corps that mobilizes and energizes organizational members to execute strategy in a competent fashion and perform at a high level.
- (iii) Keeping the organization responsive to changing conditions, alert for new opportunities, bubbling with innovative ideas, and ahead of rivals in developing competitively valuable competencies and capabilities.
- (iv) Exercising ethical leadership and insisting that the company conduct its affairs like a model corporate citizen.

- (v) Pushing corrective actions to improve strategy execution and overall strategic performance.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Examinees were not able to provide expected answers as they lacked proper knowledge of the concept. The answers given by them were very vague. Instead of leadership qualities, some of the examinees mentioned the role of a manager.

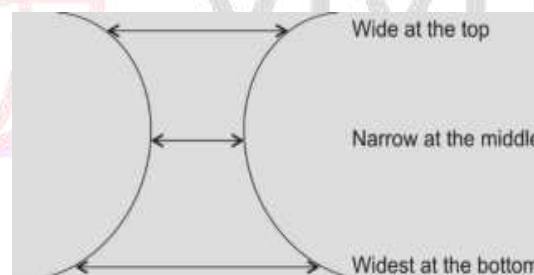
Question 23

Maadhyam, a hearing aid manufacturer recently introduced an AI based management tool in its organization which are having the qualities and capabilities of managing teams across functions. This technological tool in addition to saving organisational costs by replacing many tasks of the middle management has also served as a link between top and bottom levels in the organisation and assists in quick decision making. The skewed middle level managers now perform cross-functional duties. What could be their new organizational structure post implementation of AI based management tool? How can this structure benefit the organization? (MTP 5 Marks Oct 21, New SM)

Answer 23

In the recent years information technology and communications have significantly altered the functioning of organizations. The role played by middle management is diminishing as the tasks performed by them are increasingly being replaced by the technological tools. Hourglass organization structure consists of three layers in an organisation structure with constricted middle layer. The structure has a short and narrow middle management level.

Information technology links the top and bottom levels in the organization taking away many tasks that are performed by the middle level managers. A shrunken middle layer coordinates diverse lower level activities.



Hourglass Organization Structure

Hourglass structure has obvious benefit of reduced costs. It also helps in enhancing responsiveness by simplifying decision making. Decision making authority is shifted close to the source of information so that it is faster. However, with the reduced size of middle management, the promotion opportunities for the lower levels diminish significantly.

Question 24

Distinguish between the following:

Transformational leadership and Transactional leadership. (MTP 5 Marks Oct 21, Sept'22, Old & New SM, PYP 5 Marks Nov '19, RTP Nov'20, RTP Nov'21)

Answer 24

Following are the differences between transformational and transactional leadership:

1. Transformational leadership style uses charisma and enthusiasm to inspire people to exert them for the good of organization. Transactional leadership style uses the authority of its office to exchange rewards such as pay, status symbols etc.
2. Transformational leadership style may be appropriate in turbulent environment, in industries at the very start or end of their cycles, poorly performing organisations, when there is a need to inspire a company to embrace major changes. Transactional leadership style can be appropriate in static environment, in growing or mature industries and in organisations that are performing well.



3. Transformational leaders inspire employees by offering excitement, vision, intellectual stimulation and personal satisfaction. Transactional leaders prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement and non-achievement. Transactional leaders focus mainly to build on existing culture and enhance current practices.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Majority of the examinees were not able to distinguish between transformational leadership style and transactional leadership style. The performance was average.

Question 25

What do you understand by functional structure? (MTP5 Marks March '22)

Answer 25

Functional structure is widely used because of its simplicity and low cost. A functional structure groups tasks and activities by business function.

The functional structure consists of a chief executive officer or a managing director and limited corporate staff with functional line managers in dominant functions such as production, accounting, marketing, R&D, engineering, and human resources. Disadvantages of a functional structure are that it forces accountability to the top, minimizes career development opportunities, etc.

Question 26

Ramesh is owner of a popular brand of Breads. Yashpal, his son after completing Chartered Accountancy started assisting his father in running of business. The approaches followed by father and son in management were very different. While Ramesh preferred to use authority and having a formal system of defining goals and motivation with explicit rewards and punishments, Yashpal believed in involving employees and generating enthusiasm to inspire people to deliver in the organization. Discuss the difference in leadership style of father and son. (MTP 5 Marks April 22 & Sep '23, Old & New SM, RTP May '19)

Answer 26

Ramesh is a follower of transactional leadership style that focuses on designing systems and controlling the organization's activities. Such a leader believes in using authority of its office to exchange rewards, such as pay and status. They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement. Transactional leaders try to build on the existing culture and enhance current practices. The style is better suited in persuading people to work efficiently and run operations smoothly.

On the other hand, Yashpal is follower of transformational leadership style. The style uses charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leaders offer excitement, vision, intellectual stimulation and personal satisfaction. They inspire involvement in a mission, giving followers a 'dream' or 'vision' of a higher calling so as to elicit more dramatic changes in organizational performance. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self-confidence, and also promote innovation throughout the organization.

Question 27

Bunch Pvt Ltd. is dealing in multiproduct like electronics and FMCG and are having outlets in different cities and markets across India. Due to scale of operation, it is having technical difficulty in dealing with distinct product line and markets especially in coordination and control related problems. Identify and suggest an ideal organizational structure for Bunch Pvt Ltd in resolving the problem? (MTP 5 Marks March '23, Nov'21, RTP Nov '21)

Answer 27



To deal with the problems facing by the Bunch Pvt Ltd., we suggest Multi divisional structure for the organisation. Multidivisional (M-form) structure is composed of operating divisions where each division represents a separate business to which the top corporate officer delegates responsibility for day-to-day operations and business unit strategy to division managers. By such delegation, the corporate office is responsible for formulating and implementing overall corporate strategy and manages divisions through strategic and financial controls.

Multidivisional or M-form structure was developed in the 1920s, in response to coordination- and control-related problems in large firms. Functional departments often had difficulty dealing with distinct product lines and markets, especially in coordinating conflicting priorities among the products. Costs were not allocated to individual products, so it was not possible to assess an individual product's profit contribution. Loss of control meant that optimal allocation of firm resources between products was difficult (if not impossible). Top managers became over-involved in solving short-run problems (such as coordination, communications, conflict resolution) and neglected long-term strategic issues.

Question 28

Define Refreezing in Kurt Lewin's change process (RTP May'18)

Answer 28

Kurt Lewin proposed three phases of the change process – Unfreezing, changing and then refreezing. Refreezing occurs when the new behavior becomes a normal way of life. The new behavior must replace the former behavior completely for successful and permanent change to take place. It may be achieved through continuous reinforcement.

Question 29

State with reasons which of the following statements are correct/incorrect:

Strategic surveillance is highly focused and organized control activity. (RTP May'18)

Answer 29

Incorrect: The strategic surveillance is unfocussed. It involves general monitoring of various sources of information to uncover unanticipated information having a bearing on the organizational strategy. It involves casual environmental browsing. Reading financial and other newspapers, business magazines, attending meetings, conferences, discussions and so on. Strategic surveillance, a loose form of strategic control, is capable of uncovering information relevant to strategy.

Question 30

HQ is a service company? Two years back the company hired a reputed management consultant to formulate its strategy. The consultant recommended an aggressive expansion plan. Now in an internal review meeting the company finds that many of the suggestions are not even fully considered. Which part of strategic management process is missing in HQ? (RTP May'19, Old SM)

Answer 30

Strategy implementation is missing in HQ. Implementation is the managerial exercise of putting a chosen strategy into action. It deals with the managerial exercise of supervising the ongoing pursuit of strategy, making it work, improving the competence with which it is executed and showing measurable progress in achieving the targeted results.

Strategic implementation is concerned with translating a strategic decision into action, which presupposes that the decision itself (i.e., the strategic choice) was made with some thought being given to feasibility and acceptability. The allocation of resources to new courses of action will need to be undertaken, and there may be a need for adapting the organization's structure to handle new activities as well as training personnel and devising appropriate systems.

It is crucial to realize the difference between the formulation and implementation because they both require very different skills. Also, a company will be successful only when the strategy formulation is sound and implementation is excellent.

Question 31

Why is Strategic Control important for organizations? Discuss briefly 4 types of strategic control that can be implemented to achieve the enterprise goals. (RTP May'21)

Answer 31

Importance of strategic control: Strategic control is an important process that keeps organization on its desired path. It involves evaluating strategy as it is formulated and implemented. It is directed towards identifying problems and changes in premises and making necessary adjustments. Strategic control focuses on the dual questions of whether: (1) the strategy is being implemented as planned; and (2) the results produced by the strategy are those intended.

There are four types of strategic control:

- ◆ **Premise control:** A strategy is formed on the basis of certain assumptions or premises about the environment. Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built.
- ◆ **Strategic surveillance:** Strategic surveillance is unfocussed. It involves general monitoring of various sources of information to uncover unanticipated information having a bearing on the organizational strategy.
- ◆ **Special alert control:** At times, unexpected events may force organizations to reconsider their strategy. Sudden changes in government, natural calamities, unexpected merger/acquisition by competitors, industrial disasters and other such events may trigger an immediate and intense review of strategy.
- ◆ **Implementation control:** Managers implement strategy by converting major plans into concrete, sequential actions that form incremental steps. Implementation control is directed towards assessing the need for changes in the overall strategy in light of unfolding events and results.

Question 32

Explain premise control. (RTP Nov'18)

Answer 32

A strategy is formed on the basis of certain assumptions or premises about the complex and turbulent organizational environment. Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built. It primarily involves monitoring two types of factors:

- (i) Environmental factors such as economic (inflation, liquidity, interest rates), technology, social and regulatory.
- (ii) Industry factors such as competitors, suppliers, substitutes.

Question 33

State with reasons which of the following statements are correct/incorrect:

Control systems run parallel with strategic levels. (RTP Nov'18)

Answer 33

Correct: There are three strategic levels in an organization – corporate, business and functional. Control systems are required at all the three levels. At the top level, strategic controls are built to check whether the strategy is being implemented as planned and the results produced by the strategy are those intended. Down the hierarchy management controls and operational controls are built in the systems. Operational controls are required for day-to-day management of business.

Question 34

Discuss three methods for reassigning new patterns of behavior as proposed by H.C. Kellman. (RTP Nov'20, Old SM)

Answer 34

H.C. Kellman has proposed three methods for reassigning new patterns of behaviour. These are compliance, identification and internalisation.

- ◆ **Compliance:** It is achieved by strictly enforcing the reward and punishment strategy for good or bad behaviour. Fear of punishment, actual punishment or actual reward seems to change behaviour for the better.
- ◆ **Identification:** Identification occurs when members are psychologically impressed upon to identify themselves with some given role models whose behaviour they would like to adopt and try to become like them.
- ◆ **Internalization:** Internalization involves some internal changing of the individual's thought in order to adjust to a new environment. They have given freedom to learn and adopt



new behaviour in order to succeed in the new set of circumstances.

- i. **Formulate a redesign process plan:** Formulation of redesign plan is the real crux of the reengineering efforts. Customer focussed redesign concepts are identified and formulated. In this step alternative processes are considered and the best is selected.
- ii. **Implement the redesigned process:** It is easier to formulate new process than to implement them. Implementation of the redesigned process and application of other knowledge gained from the previous steps is key to achieve dramatic improvements.

Question 35

Glassware Ltd. is about to go through a significant restructuring. The strategic change involves moving from a decentralized to a centralized structure. This will help Glassware avoid duplication of support activities and lower its costs.

The management have held the first staff briefing in which they went to great lengths to explain that the change was necessary to equip the company to face future competitive challenges. Identify and explain the current stage of Glassware Ltd. from the Lewin's three-stage model of change? (RTP May '22)

Answer 35

Glassware Ltd. is currently in the 'unfreezing' stage, where management is attempting to explain the need for change in an attempt to maximize buy-in by employees and reduce the amount of resistance.

Unfreezing the situation: The process of unfreezing simply makes the individuals aware of the necessity for change and prepares them for such a change. Lewin proposes that the changes should not come as a surprise to the members of the organization. Sudden and unannounced change would be socially destructive and morale lowering. The management must pave the way for the change by first "unfreezing the situation", so that members would be willing and ready to accept the change.

Unfreezing is the process of breaking down the old attitudes and behaviours, customs and traditions so that they start with a clean slate. This can be achieved by making announcements, holding meetings and promoting the new ideas throughout the organization.

Question 36

What is strategic control? Briefly explain the different types of strategic control? (RTP Nov'22, RTP May'20, PYP 3 Marks, May'18, Old & New SM) (MTP 5 Marks Oct '23)

Answer 36

Strategic Control focuses on the dual questions of whether: (1) the strategy is being implemented as planned; and (2) the results produced by the strategy are those intended.

There are four types of strategic control:

- ◆ **Premise control:** A strategy is formed on the basis of certain assumptions or premises about the environment. Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built.
- ◆ **Strategic surveillance:** Strategic surveillance is unfocussed. It involves general monitoring of various sources of information to uncover unanticipated information having a bearing on the organizational strategy.
- ◆ **Special alert control:** At times, unexpected events may force organizations to reconsider their strategy. Sudden changes in government, natural calamities, unexpected merger/acquisition by competitors, industrial disasters and other such events may trigger an immediate and intense review of strategy.

Implementation control: Managers implement strategy by converting major plans into concrete, sequential actions that form incremental steps. Implementation control is directed towards assessing the need for changes in the overall strategy in light of unfolding events and results.

Question 37

With the help of a model explain strategic management process. (RTP Nov'19)

OR

Present a diagrammatic representation of a Strategic Management model. (PYP 2 Marks, Nov'18)

Answer 37

The strategic management process can best be studied and applied using a model. Identifying an

organization's vision, mission, goals and objectives, is the starting point for strategic management process. The strategic management process is dynamic and continuous. A change in any one of the major components in the model can necessitate a change in any or all of the other components. Therefore, strategy formulation, implementation, and evaluation activities should be performed on a continual basis, not just at the end of the year or semi-annually. Formulating, implementing, and evaluating strategies are the major components of the strategic management that are represented in the following model:

The strategic management process is not as cleanly divided and neatly performed in practice. Strategists do not go through the process in lockstep fashion. Generally, there is give-and-take among hierarchical levels of an organization. Many organizations conduct formal meetings semi-annually to discuss and update the firm's vision/mission, opportunities/threats, strengths/weaknesses, strategies, objectives, policies, and performance. Creativity from participants is encouraged in meeting. Good communication and feedback are needed throughout the strategic management process.

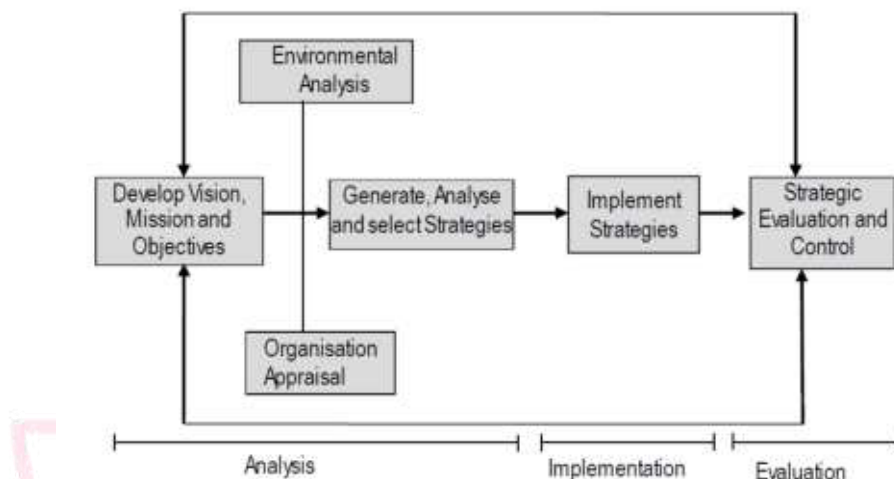


Figure: Strategic Management Model

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Many candidates failed to present the strategic Management Model diagrammatically.

Question 38

Explain the concept of Network structure (RTP May'18)

Answer 38

Network structure is a newer and somewhat more radical organizational design. The network structure could be termed as 'non-structure' as it virtually eliminates in-house business functions and outsource many of them. A corporation organized in this manner is a virtual organization because it is composed of a series of project groups or collaborations linked by constantly changing non-hierarchical, cobweb-like networks.

Question 39

State with reasons of the following statement is correct/incorrect:

Network Structures eliminate many in-house functions (RTP May'18).

Answer 39

Correct: The network structure can be termed a "non-structure" by its virtual elimination of in-house business functions. Many activities are outsourced. A corporation organized in this manner is often called a virtual organization because it is composed of a series of project groups or collaborations linked by constantly changing non-hierarchical, cobweb-like networks.

Question 40

Transformational and transactional leadership (RTP May'18)

Answer 40

Transformational leadership style use charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leadership style may be appropriate in turbulent



environments, in industries at the very start or end of their life cycles, in poorly performing organizations when there is a need to inspire a company to embrace major changes. Transformational leaders offer excitement, vision, intellectual stimulation, and personal satisfaction. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self-confidence, and also promote innovation throughout the organization.

On the other hand, transactional leadership style focus more on designing systems and controlling the organization's activities and are more likely to be associated with improving the current situation. Transactional leaders try to build on the existing culture and enhance current practices. Transactional leadership style uses the authority of its office to exchange rewards, such as pay and status. They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement. Transactional leadership style is more suitable in settled environment, in growing or mature industries, and in organizations that are performing well.

Question 41

Surah Prakash and Chandler Prakash are two brothers engaged in the business of spices. Both have different approaches to management. Surah Prakash prefers the conventional and formal approach in which authority is used for explicit rewards and punishment. While, on the other hand, Chandler Prakash believes in democratic participative management approach, involving employees to give their best. Analyze the leadership style followed by Surah Prakash and Chandler Prakash. (RTP May'21)

OR

Ram and Shyam are two brothers engaged in the business of spices. Both have different approaches to management. Ram prefers the conventional and formal approach in which authority is used for explicit rewards and punishment. While, on the other hand, Shyam believes in democratic participative management approach, involving employees to give their best.

Analyse the leadership style followed by Ram and Shyam. (PYP 5 Marks, May'18)

Answer 41

Surah Prakash is a follower of transactional leadership style that focuses on designing systems and controlling the organization's activities. Such a leader believes in using authority of its office to exchange rewards, such as pay and status. They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement. Transactional leaders try to build on the existing culture and enhance current practices. The style is better suited in persuading people to work efficiently and run operations smoothly.

On the other hand, Chandler Prakash is a follower of transformational leadership style. The style uses charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leaders offer excitement, vision, intellect teal stimulation and personal satisfaction. They inspire involvement in a mission, giving followers a 'dream' or 'vision' of a higher calling so as to elicit more dramatic changes in organizational performance. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self -confidence, and also promote innovation throughout the organization.

Question 42

Explain strategic business unit (SBUs). (RTP Nov'18)

Answer 42

A strategic business unit (SBU) is a unit of the company that has a separate mission and objectives which can be planned independently from other company businesses. SBU can be a company division, a product line within a division or even a single product/brand, specific group of customers or geographical location. The SBU is given the authority to make its own strategic decisions within corporate guidelines as long as it meets corporate objectives.

Question 43

State with reasons which of the following statements are correct/incorrect:

Strategies may require changes in organizational structure. (RTP Nov'18)

Answer 43

Incorrect: Benchmarking relates to setting goals and measuring productivity based on best industry practices. The idea is to learn from the practices of competitors and others to improve the firm's



performance. On the other hand, business process reengineering relates to analysis and redesign of workflows and processes both within and between the organizations.

Question 44

Importance of corporate culture. (RTP Nov'18)

Answer 44

A culture where creativity, embracing change, and challenging the status quo are pervasive is very conducive to successful execution of a product innovation and technological leadership strategy. A culture built around such business principles as listening to customers, encouraging employees to take pride in their work, and giving employees a high degree of decision-making responsibility is very conducive to successful execution of a strategy of delivering superior customer service.

A strong strategy-supportive culture nurtures and motivates people to do their jobs in ways conducive to effective strategy execution; it provides structure, standards, and a value system in which to operate; and it promotes strong employee identification with the company's vision, performance targets, and strategy. All this makes employees feel genuinely better about their jobs and work environment and the merits of what the company is trying to accomplish. Employees are stimulated to take on the challenge of realizing the company's vision, do their jobs competently and with enthusiasm, and collaborate with others as needed to bring the strategy to success.

Question 45

Davis and Lawrence have proposed three distinct phases to develop matrix structure. Explain. (RTP Nov'18)

Answer 45

For development of matrix structure, Davis and Lawrence have proposed three distinct phases:

- **Cross-functional task forces:** Temporary cross-functional task forces are initially used when a new product line is being introduced. A project manager is in charge as the key horizontal link.
- **Product/brand management:** If the cross-functional task forces become more permanent, the project manager becomes a product or brand manager and a second phase begins. In this arrangement, function is still the primary organizational structure, but product or brand managers act as the integrators of semi-permanent products or brands.
- **Mature matrix:** The third and final phase of matrix development involves a true dual- authority structure. Both the functional and product structures are permanent. All employees are connected to both a vertical functional superior and a horizontal product manager.

Question 46

Jupiter Electronics Ltd. is known for its ability to come out with path-breaking products. Though the work environment at Jupiter's is relaxed and casual, yet, there is a very strong commitment to deadlines. The employees believe in "work hard play hard" ethic. The organization has moved away from formal and hierarchical set up to a more results-driven approach. Employees are committed to strategies and work towards achieving them. They guard innovations, maintain confidentiality and secrecy in their working. They are closely related to values, practices, and norms of organizations. What aspects of an organization that are being discussed Explain? (RTP Nov'19, Old SM)

Answer 46

The scenario being referred to is culture in Jupiter Electronics. Strong culture promotes good strategy execution when there's fit and impels execution when there's negligible fit. A culture grounded in values, practices, and behavioral norms that match what is needed for good strategy execution helps energize people throughout the organization to do their jobs in a strategy-supportive manner. A culture built around such business principles as listening to customers, encouraging employees to take pride in their work, and giving employees a high degree of decision-making responsibility. This is very conducive to successful execution of a strategy of delivering superior customer service.

A strong strategy-supportive culture makes employees feel genuinely better about their jobs and work environment and the merits of what the company is trying to accomplish. Employees are stimulated to take on the challenge of realizing the organizational vision, do their jobs competently and with enthusiasm, and collaborate with others.

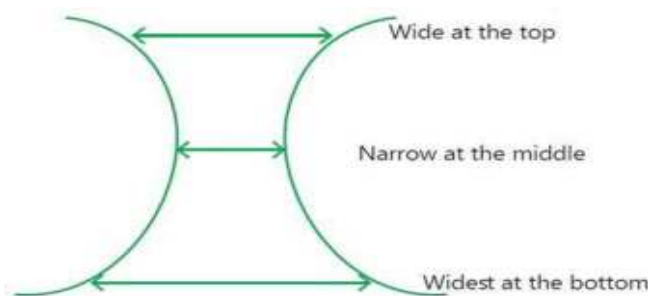
Question 47

Discuss the concept of Hourglass Structure (RTP Nov'19)

Answer 47

Information technology and communications have significantly altered the functioning of organizations. The role played by middle management is diminishing as the tasks performed by them are increasingly being replaced by the technological tools. Hourglass organization structure consists of three layers with constricted middle layer. The structure has a short and narrow middle-management level. Information technology links the top and bottom levels in the organization taking away many tasks that are performed by the middle level managers. A shrunken middle layer coordinates diverse lower level activities. Contrary to traditional middle level managers who are often specialist, the managers in the hourglass structure are generalists and perform wide variety of tasks. They would be handling cross-functional issues emanating such as those from marketing, finance or production.

Hourglass structure has obvious benefit of reduced costs. It also helps in enhancing responsiveness by simplifying decision making. Decision making authority is shifted close to the source of information so that it is faster.


Question 48

How the 'Strategic Business Unit (SBU), structure becomes imperative in an organization with increase in number, size and diversity of divisions? (RTP May '22)

Answer 48

SBU is a part of a large business organization that is treated separately for strategic management purposes. The concept of SBU is helpful in creating an SBU organizational structure. It is separate part of large business serving product markets with readily identifiable competitors. It is created by adding another level of management in a divisional structure after the divisions have been grouped under a divisional top management authority based on the common strategic interests.

Very large organisations, particularly those running into several products, or operating at distant geographical locations that are extremely diverse in terms of environmental factors, can be better managed by creating strategic business units. SBU structure becomes imperative in an organisation with increase in number, size and diversity. SBUs helps such organisations by:

- Establishing coordination between divisions having common strategic interest.
- Facilitate strategic management and control.
- Determine accountability at the level of distinct business units.
- Allow strategic planning to be done at the most relevant level within the total enterprise.
- Make the task of strategic review by top executives more objective and more effective.
- Help to allocate resources to areas with better opportunities.

Question 49

"A network structure is suited to unstable environment." Elucidate this statement. (RTP May '22)

Answer 49

Network structure is a newer and somewhat more radical organizational design. The network structure could be termed a "non-structure" as it virtually eliminates in-house business functions and outsource many of them. An organization organized in this manner is often called a virtual organization because it is composed of a series of project groups or collaborations linked by constantly changing non-hierarchical, cobweb-like networks.

The network structure becomes most useful when the environment of a firm is unstable and is expected to remain so. Under such conditions, there is usually a strong need for innovation and quick response.



Instead of having salaried employees, it may contract with people for a specific project or length of time. Long-term contracts with suppliers and distributors replace services that the company could provide for itself through vertical integration. The network structure provides organization with increased flexibility and adaptability to cope with rapid technological change and shifting pattern of international trade and competition.

Question 50

'A strategy-supportive culture promotes good strategy execution.' - Explain. (RTP Nov'22) (MTP 5 Marks Oct '23)

Answer 50

Strong cultures promote good strategy execution when there's fit and hurt execution when there's negligible fit. A culture grounded in values, practices, and behavioral norms that match what is needed for good strategy execution helps energize people throughout the organization to do their jobs in a strategy-supportive manner. A culture built around such business principles as listening to customers, encouraging employees to take pride in their work, and giving employees a high degree of decision-making responsibility. This is very conducive to successful execution of a strategy of delivering superior customer service.

A work environment where the culture matches the conditions for good strategy execution provides a system of informal rules and peer pressure regarding how to conduct business internally and how to go about doing one's job.

A strong strategy-supportive culture makes employees feel genuinely better about their jobs and work environment and the merits of what the company is trying to accomplish. Employees are stimulated to take on the challenge of realizing the organizational vision, do their jobs competently and with enthusiasm, and collaborate with others.

Question 51

"Samar Electronics Limited" is engaged in manufacturing and sale of consumer electronic goods globally. The company is rated 'best' in "customer satisfaction survey" for 5 years in a row. The spread of the current pandemic has affected the internal and external environment of the company adversely. Such adverse impact has negatively impacted the revenue of the company. In order to survive and retain the business, the company decided to outsource a major part of its organisational activities, like manufacturing, distribution channels, after sales service etc. Now the organisation's business functions are scattered worldwide with a small headquarter connected to independent business units digitally. What type of organisational structure is the company transitioning into? List the basic features of this new structure and the disadvantages that the company may face in future in this new structural arrangement. (RTP Nov'22)

Answer 51

Samar Electronics Limited transitioning into network structure. It is a newer and somewhat more radical organisational design. Its essential features are as follows:

1. It is termed as "non-structure" as it eliminates in house functions and outsources many of them.
2. An organisation organised in this manner is often called "virtual organisation" because it is composed of a series of project groups or collaborations linked by constantly changing nonhierarchical, cob-web like structures.
3. Network structures become most useful when the environment of a firm is unstable and is expected to remain so. Under such conditions, there is usually a strong need for innovation and quick response.
4. Instead of having salaried employees, it may contract with people for a specific project or length of time.
5. Long term contracts with suppliers and distributors replace services that company could provide for itself.

However, network structure does have following disadvantages that the company may face in future:

1. The availability of numerous potential partners can be a source of trouble.
2. Co-ordination among the functioning of business partners is perhaps, the biggest problem for the management in the networking structure.
3. Employees may lack the level of confidence necessary to participate actively in organisation sponsored



learning experiences.

Question 52

Anshuman was a CEO at a struggling company. Despite the challenges, he believed in the potential of his team and was determined to turn the company around. He started by communicating his vision to his employees. He encouraged them to think outside the box, take risks and be creative. He also invested in training programs to help employees develop new skills. He regularly recognized and rewarded employees for their hard work, which increased their job satisfaction and commitment. As a result, the company began to see positive changes. Identify and discuss the leadership style adopted by Anshuman? (RTP May 23)

Answer 52

Being a CEO of a struggling company, Anshuman has adopted Transformational leadership style. The style uses charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leaders offer excitement, vision, intellectual stimulation and personal satisfaction. They inspire involvement in a mission, giving followers a 'dream' or 'vision' of a higher calling so as to elicit more dramatic changes in organizational performance. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self - confidence, and also promote innovation throughout the organization.

Anshuman believed in the potential of his team. He started by communicating his vision to his employees. He encouraged them to think outside the box, take risks and be creative. He also invested in training programs to help employees develop new skills. He regularly recognized and rewarded employees for their hard work, which increased their job satisfaction and commitment.

Question 53

Write a short note on Matrix structure. (RTP Nov '23, PYP 5 Marks, Jan '21)

Answer 53

In matrix structure, functional and product forms are combined simultaneously at the same level of the organization. Employees have two superiors, a product / project manager and a functional manager. The "home" department - that is, engineering, manufacturing, or marketing - is usually functional and is reasonably permanent. People from these functional units are often assigned temporarily to one or more product units or projects.

The product units / projects are usually temporary and act like divisions in that they are differentiated on a product-market basis. The matrix structure may be very appropriate when organizations conclude that neither functional nor divisional forms, even when combined with horizontal linking mechanisms like strategic business units, are right for the implementation of their strategies. Matrix structure was developed to combine the stability of the functional structure with flexibility of the product form. It is very useful when the external environment (especially its technological and market aspects) is very complex and changeable.

A matrix structure is most complex of all designs because it depends upon both vertical and horizontal flows of authority and communication. It may result in higher overhead costs due to more management positions.

The matrix structure is often found in an organization when the following three conditions exist:

1. Ideas need to be cross-fertilized across projects or products;
2. Resources are scarce; and
3. Abilities to process information and to make decisions need to be improved.

Question 54

Write a short note on strategic change and explain the process of strategic change. (PYP 7 Marks, Nov'18)

Answer 54

The changes in the environmental forces often require businesses to make modifications in their existing strategies and bring out new strategies. Strategic change is a complex process that involves a corporate strategy focused on new markets, products, services and new ways of doing business.

Three steps for initiating strategic change are:

- (i) **Recognize the need for change** – The first step is to diagnose the which facets of the present corporate culture are strategy supportive and which are not.
- (ii) **Create a shared vision to manage change** – Objectives of both individuals and organization should coincide. There should be no conflict between them. This is possible only if the management and the organization members follow a shared vision.
- (iii) **Institutionalize the change** – This is an action stage which requires the implementation of the changed strategy. Creating and sustaining a different attitude towards change is essential to ensure that the firm does not slip back into old ways of doing things.

Kurt Lewin proposed three stages of the change process for moving the organization from the present to the future.

- (i) **Unfreezing the situation** – The process of unfreezing makes the individuals or organizations aware of the necessity for change and prepares them for it. The change should not come as a surprise to the members of the organization. Sudden and unannounced change would be socially destructive and morale lowering,
- (ii) **Changing to new situation** – once unfreezing is complete and members of the organization recognize the need for change, then their behavior patterns need to be redefined as:
 - i. **Compliance** – enforcing reward and punishment strategy for good or bad behavior
 - ii. **Identification** – members are psychologically impressed to identify themselves with some given role models whose behavior they would like to adopt.
 - iii. **Internalization** - involves some internal changing of the individual's thought process. They are given the freedom to learn and adopt new behavior.
- (iii) **Refreezing** – occurs when the new behavior becomes a normal way of life. The new behavior must replace the former behavior completely for successful and permanent change. This can be achieved by continuously reinforcing the newly acquired behavior.

Change process is not a one-time application but a continuous process due to dynamism and ever-changing environment.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

The candidates were not comfortable with the concept and accordingly they were neither able to explain the change nor provide process of strategic change.

Question 55

What is strategic control? Kindly explain the statement that "premise control is a tool for systematic and continuous monitoring of the environment". (PYP 5 Marks, Nov'20)

Answer 55

Strategic Control

Strategic control is the process of evaluating formulated and implemented strategy. It is directed towards identifying changes in the internal and external environments of the organization and making necessary adjustments accordingly.

Strategic Control focuses on the dual questions of whether: (1) the strategy is being implemented as planned; and (2) the results produced by the strategy are those intended.

Yes, Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built. It primarily **involves monitoring two types of factors:**

- (i) Environmental factors such as economic (inflation, liquidity, interest rates), technology, social and legal-regulatory.
- (ii) Industry factors such as competitors, suppliers, substitutes.

It is neither feasible nor desirable to control all types of premises in the same manner. Different premises may require different amount of control. Thus, managers are required to select those premises that



are likely to change and would severely impact the functioning of the organization and its strategy.

Question 56

Sonya Private Limited is an automobile company. For the past few years, it has been observed that the progress of the company has become stagnant. When scrutinized, it was found that the planning department was performing fairly well but the plans could not be implemented due to improper use of resources, undesirable tendencies of workers and non-conformance to norms and standards. You are hired as a Strategic Manager. Suggest the elements of process of control to overcome the problem. (PYP 5 Marks, Jan'21)

Answer 56

Sonya Private Limited deteriorating performance due to poor implementation of plans that is improper use of resources, undesirable tendencies of the workers, and non-conformance to norms and standards, all point towards weak controls in the organization. Implementation of plans cannot assure results unless strong and sufficient controls are put in place. The management of the company should focus diligently on developing controls especially in the identified problem areas.

The process of control has the following elements:

- (a) Objectives of the business system which could be operationalized into measurable and controllable standards.
- (b) A mechanism for monitoring and measuring the performance of the system.
- (c) A mechanism (i) for comparing the actual results with reference to the standards (ii) for detecting deviations from standards and (iii) for learning new insights on standards themselves.
- (d) A mechanism for feeding back corrective and adaptive information and instructions to the system, for effecting the desired changes to set right the system to keep it on course.

Above elements of control would ensure a proper check on improper use of resources, undesirable tendencies of the workers, and non-conformance to norms and standards and ensure a result oriented implementation of plans.

Question 57

"Strategy formulation and strategy implementation are intertwined and linked with each other." Elucidate this statement with suitable arguments. (PYP 5 Marks May'22)

Answer 57

The strategy formulation and strategy implementation are intertwined and linked with each other. Two types of linkages exist between these two phases of strategic management. The forward linkages deal with the impact of strategy formulation on strategy implementation while the backward linkages are concerned with the impact in the opposite direction.

Forward Linkages: The different elements in strategy formulation starting with objective setting through environmental and organizational appraisal, strategic alternatives and choice to the strategic plan determine the course that an organization adopts for itself. With the formulation of new strategies, or reformulation of existing strategies, many changes have to be affected within the organization. For instance, the organizational structure has to undergo a change in the light of the requirements of the modified or new strategy. The style of leadership has to be adapted to the needs of the modified or new strategies. In this way, the formulation of strategies has forward linkages with their implementation.

Backward Linkages: Just as implementation is determined by the formulation of strategies, the formulation process is also affected by factors related with implementation. While dealing with strategic choice, remember that past strategic actions also determine the choice of strategy. Organizations tend to adopt those strategies which can be implemented with the help of the present structure of resources combined with some additional efforts. Such incremental changes, over a period of time, take the organization from where it is to where it wishes to be.



It is to be noted that while strategy formulation is primarily an entrepreneurial activity, based on strategic decision-making, the implementation of strategy is mainly an administrative task based on strategic as well as operational decision-making.

Question 58

XYZ Ltd. is an automobile company that offers diversified products for all customer segments. Due to COVID-19, the changes took place in the economy forced the company to change its strategy. Being the CEO of the company, what stages will you follow for developing and executing the new strategy? (PYP 5 Marks May'22)

Answer 58

Today, India has become the outsourcing hub for many of the global automobile manufacturers. The auto industry comprises of four segments which are passenger vehicles, commercial vehicles, three wheelers and two wheelers. XYZ Ltd. is an automobile company that offers diversified products for all customer segments. The company has already in existence, so it has its own vision, mission and a strategy to execute for achieving its vision. While developing and executing the strategy, XYZ Ltd. might have followed the five-stage managerial process as given below:

1. Developing a strategic vision.
2. Environmental and organizational analysis.
3. Formulation of strategy.
4. Implementing and executing the strategy.
5. Strategic evaluation and control.

But due to COVID-19, the automobile industry has faced the lockdown situation. Changes in the economy forced the XYZ Ltd. to change its existing strategy and prepare the new strategy. The changes in the environmental forces due to COVID-19 requires XYZ Ltd. to make modifications in their existing strategies and bring out new strategies. For initiating strategic change, three steps can be followed by the CEO of the company which are as under:

- (i) **Recognize the need for change:** This is the first step to diagnose facets of the corporate culture that are strategy supportive or not. This has already identified by the XYZ Ltd.
- (ii) **Create a shared vision to manage change:** Objectives and vision of both individuals and organization should coincide. The CEO of XYZ Ltd. need to constantly and consistently communicate the vision not only to inform but also to overcome resistance.
- (iii) **Institutionalize the change:** Creating and sustaining a different attitude towards change is essential to ensure that the XYZ Ltd. does not slip back into old ways of thinking or doing things. All these changes should be set up as a practice to be followed by the company and be able to transfer from one level to another as a well settled practice.

Question 59

Which of the following statements are 'correct' and which are 'incorrect'? Give reasons, in brief, for your answer:

Corporate culture is always identical in all business organisations (PYP 2 Marks, May'18)

Answer 59

Incorrect: Every company has its own organisational culture. Each has its own business philosophy and principles, its own ways of approaching to the problems and making decisions, its own work climate, work ethics, etc. Therefore, corporate culture is not identical in all organisations. Organisations over a period of time inherit and percolate down its own specific work ethos and approaches.

Question 60

Which of the following statements are correct and which are incorrect? Give reasons in brief for your

answer Structure has no impact on the strategy of the organization. (PYP 2 Marks, Nov'18)

Answer 60

Incorrect: Structures are designed to facilitate the strategic pursuit of a firm and, therefore, follows strategy. Without a strategy or reason for being, it will be difficult to design an effective structure. Strategic developments may require allocation of resources and there may be a need for adapting the organization's structure to handle new activities as well as training personnel and devising appropriate systems.

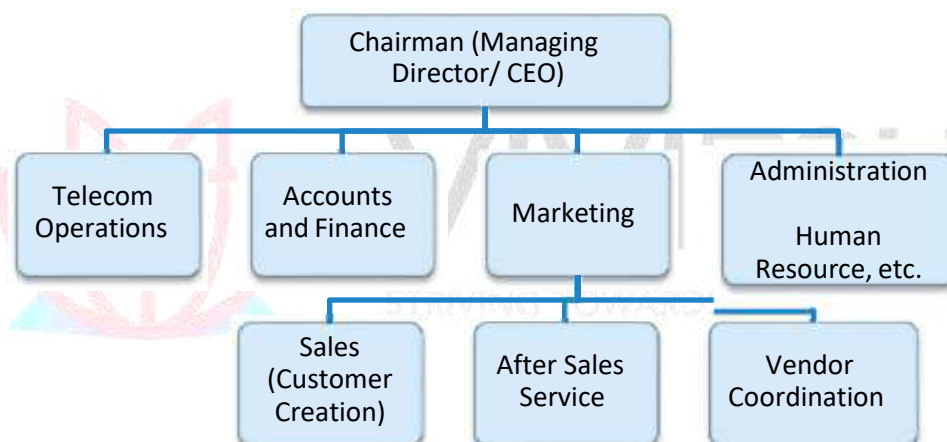
Question 61

Manoj started his telecom business in 2010. Over next five years, he gradually hired fifty people for various activities such as to keep his accounts, administration, sell his products in the market, create more customers, provide after sales service, coordinate with vendors. Draw the organization structure Manor should implement in his organization and name it. (PYP 5 Marks, Nov'18, Old & New SM)

Answer 61

Manor has started a telecom business. Accounts, Administration, Marketing (customer creation, after sales service, vendor coordination) are the functional areas that are desired in the organisational structure. Further there is inherent need to have a department for the management of telecom services/ operations.

Thus, the **functional structure in the telecom business** of Manor can be as follows:



EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

The performance of the candidates was average. It appears that the examinees were not able to understand the question. Some of the examinees have either explained structure diagram or have provided name of structure.

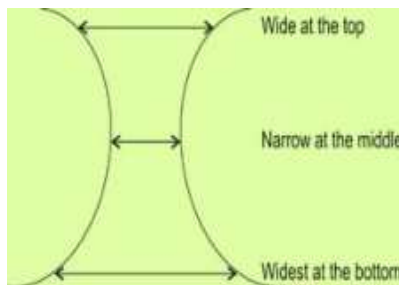
Question 62

What is an Hourglass structure? How is it beneficial for an organization? (PYP 3 Marks, May'19, Old & New SM)

Answer 62

In the recent year's information technology and communications have significantly altered the functioning of organizations. The role played by middle management is diminishing as the tasks performed by them are increasingly being replaced by the technological tools. Hourglass organization structure consists of three layers in an organization structure with constricted middle layer. The structure has a short and narrow middle management level.

Information technology links the top and bottom levels in the organization taking away many tasks that are performed by the middle level managers. A shrunken middle layer coordinates diverse lower level activities.



Hourglass Organization Structure

Hourglass structure has obvious benefit of reduced costs. It also helps in enhancing responsiveness by simplifying decision making. Decision making authority is shifted close to the source of information so that it is faster. However, with the reduced size of middle management, the promotion opportunities for the lower levels diminish significantly.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Overall performance of the examinees was good in both the alternatives related to hourglass structure and difference between strategy formulation and strategy implementation.

Question 63

Draw 'Divisional Structure' with the help of a diagram. Also, give advantages and disadvantages of this structure in brief. (PYP 5 Marks, Nov'20, Old & New SM)

Answer 63

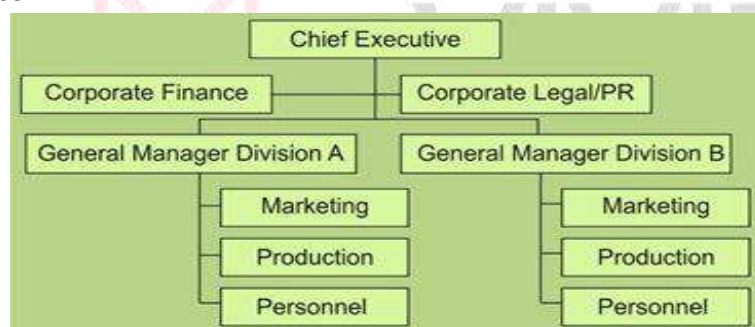


Figure: Divisional Structure

Advantages of divisional structure

- **Accountability is clear:** Divisional managers can be held responsible for sales and profit levels. Because a divisional structure is based on extensive delegation of authority, managers and employees can easily see the results of their good or bad performances and thus their morale is high.
- **Other advantages:** It creates career development opportunities for managers, allows local control of local situations, leads to a competitive climate within an organization, and allows new businesses and products to be added easily.

Disadvantages of divisional structure

- **Higher cost:** Owing to following reasons: (i). requires qualified functional specialist at different divisions and needed centrally (at headquarters); (ii). It requires an elaborate, headquarters – driven control system.
- **Conflicts between divisional managers:** Certain regions, products, or customers may sometimes receive special treatment, and it may be difficult to maintain consistent, company-wide practices.

Question 64

Moonlight Private Limited deals in multi-products and multi-businesses. It has its own set of competitors. It seems impractical for the company to provide separate strategic planning treatment to each one of its product or businesses. As a strategic manager, suggest the type of structure best suitable



for Moonlight Private Limited and state its benefits. (PYP 5 Marks, Jan'21, Old & New SM)

Answer 64

It is advisable for Moonlight Private Limited to follow the strategic business unit (SBU) structure.

Moonlight Private Limited has a multi-product and multi-business structure where, each of these businesses has its own set of competitors. In the given case, Strategic Business Unit (SBU) structure would best suit the interests of the company.

SBU is a part of a large business organization that is treated separately for strategic management purposes. It is separate part of large business serving product markets with readily identifiable competitors. It is created by adding another level of management in a divisional structure after the divisions have been grouped under a divisional top management authority based on the common strategic interests.

Very large organizations, particularly those running into several products, or operating at distant geographical locations that are extremely diverse in terms of environmental factors, can be better managed by creating strategic business units, just as is the case for Moonlight Private Limited. SBU structure becomes imperative in an organization with increase in number, size and diversity.

Benefits of SBUs:

1. Establishing coordination between divisions having common strategic interest.
2. Facilitate strategic management and control.
3. Determine accountability at the level of distinct business units.
4. Allow strategic planning to be done at the most relevant level within the total enterprise.
5. Make the task of strategic review by top executives more objective and more effective.
6. Help to allocate resources to areas with better opportunities.

Thus, an SBU structure with its set of advantages would be most suitable for the company with the given diverse businesses having separate identifiable competitors, but a common organizational goal.

Question 65

A Chennai based fast moving consumer goods (FMCG) major CDE Ltd. recently announced restructuring its business. The company indicated that the business would be split into mainly four different streams- FMCG, E-commerce, Retail, and Research & Development. The company management has decided that these four units will operate as separate businesses. The top corporate officer shall delegate responsibility for day-to-day operations and business unit strategy to the concerned managers. Identify the organization structure that CDE Ltd. has planned to implement. Discuss any four attributes and the benefits the firm may derive by using this organization structure. (PYP 5 Marks Dec '21)

Answer 65

CDE Ltd. has planned to implement Strategic Business Unit (SBU) structure. Very large organisations, particularly those running into several products, or operating at distant geographical locations that are extremely diverse in terms of environmental factors, can be better managed by creating strategic business units. SBU structure becomes imperative in an organisation with increase in number, size and diversity.

The attributes of an SBU and the benefits a firm may derive by using the SBU Structure are as follows:

- ◆ A scientific method of grouping the businesses of a multi – business corporation which helps the firm in strategic planning.
- ◆ An improvement over the territorial grouping of businesses and strategic planning based on territorial units.
- ◆ Strategic planning for SBU is distinct from rest of businesses. Products/ businesses within an SBU receive same strategic planning treatment and priorities.
- ◆ Each SBU will have its own distinct set of competitors and its own distinct strategy.
- ◆ The CEO of SBU will be responsible for strategic planning for SBU and its profit performance.
- ◆ Products/businesses that are related from the stand point of function are assembled together as a distinct SBU.
- ◆ Unrelated products/ businesses in any group are separated into separate SBUs.



- ◆ Grouping the businesses on SBU lines helps in strategic planning by removing the vagueness and confusion.
- ◆ Each SBU is a separate business and will be distinct from one another on the basis of mission, objectives etc.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Majority of the examinees identified the correct organization structure but failed to provide proper explanation. Hence, the performance was below average.

Question 66

Due to reoccurrence of various variants of Corona virus, LMN Ltd. is facing unstable environment and it has started unbundling and disintegrating its activities. It also started relying on outside vendors for performing these activities. Identify the organisation structure LMN Ltd. is shifting to. Under what circumstances this structure becomes useful? (PYP 5 Marks May'22)

Answer 66

LMN Ltd. is shifting into network structure. It is a newer and somewhat more radical organizational design. The network structure could be termed a "non-structure" as it virtually eliminates in-house business functions and outsource many of them. An organization organized in this manner is often called a virtual organization because it is composed of a series of project groups or collaborations linked by constantly changing non-hierarchical, cobweb-like networks.

The network structure becomes most useful when the environment of a firm is unstable and is expected to remain so. Under such conditions, there is usually a strong need for innovation and quick response. Instead of having salaried employees, it may contract with people for a specific project or length of time. Long-term contracts with suppliers and distributors replace services that the company could provide for itself through vertical integration. The network structure provides organization with increased flexibility and adaptability to cope with rapid technological change and shifting pattern of international trade and competition.

Question 67

Write short note on Strategic Business Unit (SBU). (PYP 5 Marks Nov 22)

Answer 67

SBU is a part of a large business organization that is treated separately for strategic management purposes. It is separate part of large business serving product markets with readily identifiable competitors. It is created by adding another level of management in a divisional structure after the divisions have been grouped under a divisional top management authority based on the common strategic interests.

Very large organizations, particularly those running into several products, or operating at distant geographical locations that are extremely diverse in terms of environmental factors, can be better managed by creating strategic business units. SBU structure becomes imperative in an organization with increase in number, size and diversity.

The three most important characteristics of a SBU are:

- It is a single business or a collection of related businesses which offer scope for independent planning and which might feasibly standalone from the rest of the organization.
- It has its own set of competitors.
- It has a manager who has responsibility for strategic planning and profit performance, and who has control of profit-influencing factors.

Benefits of SBUs:

1. Establishing coordination between divisions having common strategic interest.
2. Facilitate strategic management and control.



3. Determine accountability at the level of distinct business units.
4. Allow strategic planning to be done at the most relevant level within the total enterprise.
5. Make the task of strategic review by top executives more objective and more effective.
6. Help to allocate resources to areas with better opportunities.

Thus, an SBU structure with its set of advantages would be most suitable for the company with the given diverse businesses having separate identifiable competitors, but a common organizational goal.

Question 68

Ramesh and Suresh own software development firms ACS Ltd. and BDS Ltd. Ramesh and Suresh pitch their business in international markets and win international contracts. Ramesh has fifty software engineers in his team. Suresh, on the other hand, leads a team of forty software engineers. Every project has a specific and fixed timeline. Individual projects are assigned to project heads by Ramesh and Suresh. Ramesh adheres to strict rules and procedures. He met with the project heads to get an update but exchanged ideas occasionally. He set a weekly target of forty hours to complete the assigned goal or task. The group that met the deadline and completed the task received a 10% bonus. The group that was unable to meet the deadline was penalized. The group that did not meet the deadline was penalized with unpaid extra working hours to complete the task. Suresh, unlike Ramesh, did not priorities a structured approach to work. Suresh inspired the project managers by making them feel like leaders rather than just participants. Suresh's empowering attitude helped to align individual goals with group goals. Ramesh established routines to maximize his team efficiency. Suresh, on the other hand, used positive reinforcement to maximize his team efficiency.

- (a) Identify the leadership style employed by Ramesh and Suresh.
- (b) What are the conditions/situations that make such leadership styles more appropriate?
- (c) Discuss the characteristics of the leadership styles. (PYP 5 Marks May '23)

Answer 68

- (i) Ramesh adopted transactional leadership style, while Suresh adopted transformational leadership style.
- (ii) Transactional leadership style can be appropriate in settled and static environment, in growing or mature industries and in organizations that are performing well.

Transformational leadership style may be appropriate in turbulent environment, in industries at the very start or end of their life cycles, in poorly performing organizations when there is a need to inspire a company to embrace major changes.

- (iii) Transactional leadership style uses the authority of its office to exchange rewards such as pay, status symbols etc. Transactional leaders prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement and non-achievement. Transactional leaders focus mainly to build on existing culture and enhance current practices.

Transformational leadership style uses charisma and enthusiasm to inspire people to exert them for the good of organization. Transformational leaders inspire employees by offering excitement, vision, intellectual stimulation and personal satisfaction.

Question 69

You have been appointed as head of the Strategic Business Unit (SBU) of a large multiproduct company. Explain the leadership roles, you have to play as a Manager in pushing for good strategy execution. (PYP 5 Marks May '23)

Answer 69

A head of the strategic business unit (SBU) has many different leadership roles to play: visionary, chief entrepreneur and strategist, chief administrator, culture builder, resource acquirer and allocator, capabilities builder, process integrator, crisis solver, spokesperson, negotiator, motivator, arbitrator,



policy maker, policy enforcer, and head cheerleader. Managers have five leadership roles to play in pushing for good strategy execution:

1. Staying on top of what is happening, closely monitoring progress, working through issues and obstacles.
2. Promoting a culture that mobilizes and energizes organizational members to execute strategy and perform at a high level.
3. Keeping the organization responsive to changing conditions, alert for new opportunities and remain ahead of rivals in developing competitively valuable competencies and capabilities.
4. Ethical leadership and insisting that the organization conduct its affairs like a model corporate citizen.
5. Pushing corrective actions to improve strategy execution and overall strategic performance.

MULTIPLE CHOICE QUESTIONS

1. The purpose of strategy evaluation is to:

- (a) increase the budget annually
- (b) alert management to problems or potential problems
- (c) make budget changes
- (d) evaluate employees' performance **(MTP-Oct '19,1 Mark)**

Ans: (b)

2. In evaluating strategies, which one of Rumelt's criteria for evaluating strategies, refers to the need for strategists to examine sets of trends?

- (a) Consistency
- (b) Consonance
- (c) Feasibility
- (d) Advantage **(MTP-March '19, 1 Mark)**

Ans: (b)

3. Which of the following is not a phase in Kurt Lewin's Model of Change?

- (a) Changing
- (b) Deep freezing
- (c) Refreezing
- (d) Unfreezing **(MTP-April '19, 1 Mark)**

Ans: (c)

**4. The following are part of Richard Rumelt's criteria for strategy audit, except:
Adaptation**

- (a) Consistency
- (b) Consonance
- (c) Feasibility **(MTP-April '19, 1 Mark)**

Ans: (a)

5. Which of the following would be chosen by the core strategist to implement operational control?

- (a) Premise Control
- (b) Special Alert Control
- (c) Implementation Control

(d) Budgetary Control **(1 Mark Oct 20, New SM)**



Ans: (d)

6. As the head of an MNC, you have been asked to bring in radical changes in your organization through BPR. Which of these is the thrust area you would focus on reducing:

- (a) Total cycle time
- (b) Total order time
- (c) Total inventory time
- (d) None **(2 Marks March '21)**

Ans: (a)

7. Which one is NOT a type of strategic control?

- (a) Operational control
- (b) Strategic surveillance
- (c) Special alert control
- (d) Premise control **(1 Mark April 21, New SM)**

Ans: (a)

8. Systematic and continuous monitoring of the business environment to verify the accuracy of assumptions on which strategy is built is achieved by?

- (a) Premise Control
- (b) Special Alert Control
- (c) Implementation Control
- (d) Strategic Surveillance **(2 Marks Oct 21)**

Ans: (a)

9. Anshul joined a telecom company after his MBA and started working as market research analyst. His job included analyzing industry factors like competitors, suppliers and substitutes. Which of the strategic controls is he working on?

- (a) Strategic Surveillance
- (b) Special Alert Control
- (c) Premise Control
- (d) Benchmarking **(2 Marks April 22)**

Ans: (c)

10. After an earnest attempt to bring in a strategic change in your organization, you the operational head of XYZ Ltd, succeeded but still your organization couldn't achieve the desired competitive position in the market. Out of the following what could be the reason?

- (a) Strategy Formulation
- (b) Strategy Model
- (c) Strategy Implementation
- (d) Strategy Decision **(2 Marks) (Oct'22 & March '23)**

Ans: (c)

11. You being the core strategist of your company, entrusted with bringing about strategic change in your company, how will you initiate "unfreezing of the situation"?

- (a) Promoting new ideas throughout the organization
- (b) Promoting compliance throughout the organization
- (c) Promoting change in process throughout the organization



- (d) None of the above (MTP 2 Marks Oct'22, RTP May'20)

Ans: (a)

12. When there is impact of strategy implementation on strategy formulation it can be referred as?

- (a) Backward Linkages
- (b) Forward Linkages
- (c) Vertical Linkages
- (d) Horizontal Linkages (1 Mark April 22, Nov'21, Oct'22)

13. Technique to cope up with sudden change in Government, natural calamities, terrorist attacks, industrial disasters etc. is called

- (a) Special Alert Control
- (b) Strategic Surveillance
- (c) Premise Control
- (d) Implementation Control (1 Mark March '23)

Ans: (a)

14. As the head of an MNC, you have been asked to bring in radical changes in your organisation through BPR. Which of these is the thrust area you would focus on reducing:

- (a) Total cycle time
- (b) Total order time
- (c) Total inventory time
- (d) None (2 Marks April '23)

Ans: (a)

15. _____ leadership style may be appropriate in turbulent environment.

- (a) Transactional
- (b) Transformational
- (c) Autocratic
- (d) None of these (MTP-Oct '19, 1 Mark, New SM)

Ans: (b)

16. What type of organizational structure do most small businesses follow?

- (a) Divisional structure
- (b) Functional structure
- (c) Hour Glass structure
- (d) Matrix structure (MTP-March '19, 1 Mark)

Ans: (d)

17. Who is a transformational leader?

- (a) Someone who is involved in organizational change.
- (b) A leader, who provides new ways of carrying out management.
- (c) A leader who inspires the workers to new levels by offering them a vision of a better future.
- (d) A leader who tries to transform their staff by giving them rewards for what they do.

(MTP-April '19, 1 Mark)

Ans: (c)

18. Individual investors are reliant on upon the organization's managers to



- (a) Maximize short-term returns in the form of dividends.
- (b) Add value to their investments in a way that the stockholders could not accomplish on their own.
- (c) Achieve risk reduction at a lower cost than stockholders could obtain on their own.
- (d) Diversify the stockholder's investments in order to reduce risk. **(Mar '19, 1 Mark)**

Ans: (b)

19. Which of the following is more radical organisation design and is also called as non-structure which virtually eliminates in-house business functions and outsources many of them?

- (a) Network structure
- (b) Strategic business unit
- (c) Hourglass structure
- (d) Simple structure **(MTP 1 Mark May 20)**

Ans: (b)

20. A corporation organized in network structure is often called

- (a) Virtual organization
- (b) Hierarchical organization
- (c) Structured organization
- (d) Simple organization **(MTP 1 Mark March '21)**

Ans: (a)

21. J&P, a western wear brand has contracted Pee Kaw marketing firm from Singapore, product design team working as an outsource company from Mexico and Humans branding company taking care of its people's operations. What kind of structure is this?

- (a) Hourglass Structure
- (b) Outsourcing
- (c) Network Structure
- (d) Tree Branch Structure **(MTP 2 Marks March '22)**

Ans: (c)

22. Swabhaav, a social media marketing firm introduced an AI based management tool that has the capabilities of managing teams across functions all while being creative. What is the most likely organisational structure post this implementation?

- (a) Divisional
- (b) Matrix
- (c) Hourglass
- (d) Network **(MTP 2 Marks Sep'22)**

Ans: (c)

23. Maadhyam, a hearing aid manufacturer recently introduced an AI based management tool that has the capabilities of managing teams across functions. What could be their new organisational structure post this implementation?

- (a) Divisional Structure
- (b) Matrix Structure
- (c) Hourglass Structure
- (d) Network Structure **(MTP 2 Mark Oct'22)**

Ans: (c)



24. Corporate culture refers to:

- (a) Company's values and beliefs
- (b) Company's business principles
- (c) Internal work environment
- (d) All the above **(MTP 1 Mark Oct'22)**

Ans: (d)

25. A strategic business unit is a grouping of businesses.

- (a) unrelated
- (b) differentiated
- (c) related
- (d) None of these. **(MTP 1 Mark April 22)**

Ans: (c)

26. Abhishek a freelancer writes promotional materials. He decided to collaborate without requiring physical presence of employee, and hired virtual assistants to transcribe voice mail, update his website, and design PowerPoint graphics. What kind of structure is he using for his business?

- (a) Functional structure
- (b) Divisional structure
- (c) Network structure
- (d) Multi-divisional structure **(MTP 2 Marks April '23)**

Ans: (c)

27. Davis and Lawrence have proposed three distinct phases for development of matrix structure. These phases are (1) Cross-functional task forces (2) Product/brand management and (3) ____ .

- (a) Market/external management
- (b) Functional matrix
- (c) Mature matrix
- (d) Internal management **(MTP 2 Marks April 21)**

Ans: (c)

28. Shreya, the owner of Kalakaari boutiques, wanted to reduce uncertainty of their business strategy for which she gathered a lot of information from peers, groups, industry reports and experts. But it did not give her comfort to take up new strategies. What tool can help her in this regard?

- (a) Risk Analysis
- (b) BCG Analysis
- (c) ADL Matrix
- (d) Scenario Analysis **(MTP 2 Marks Oct 21)**

Ans: (d)

29. Which is true for Hourglass Organization Structure?

- (a) Wide at the bottom and widest at the top.
- (b) Middle level managers are generalist and perform wide variety of tasks
- (c) Decision making is slow
- (d) Difficult to keep motivation level high among lower-level staff **(MTP 1 Mark Sep '23)**

Ans: (b)

30. TechNo Solutions, a dynamic tech company, is considering a shift in its organizational structure to



enhance efficiency. The management team is evaluating various strategies and decided to virtually eliminate in-house business functions. Which of the following organizational structures is TechNo Solutions shifting towards?

- (a) Network Structure
- (b) Matrix structure
- (c) Hourglass Structure
- (d) SBU Structure (MTP 2 Marks Oct '23)

Ans: (a)

31. Which of the following does not form part of Richard Tumult's criteria for strategy audit?

- (a) Adaptation.
- (b) Consistency.
- (c) Consonance.
- (d) Feasibility. (RTP May'19)

Ans: (a)

32. Which of the following is not a phase in Kurt Lewin's Model of Change?

- (a) Changing.
- (b) Deep freezing.
- (c) Refreezing.
- (d) Unfreezing. (May'19)

Ans: (b)

33. In the questions given below select the best answer out of options (a), (b), (c), or (d):

After an earnest attempt to bring in a strategic change in your organization, you the operational head of XYZ Ltd, succeeded but still your organization couldn't achieve the desired competitive position in the market. Out of the following what could be the reason?

- (a) Strategy Formulation
- (b) Strategy Model
- (c) Strategy Implementation
- (d) Strategy Decision (May'20)

Ans: (c)

34. In the questions given below select the best answer out of options (A), (B), (C), or (D):

Strategy evaluation is difficult on account of following trends, except:

- (a) There is dramatic increase in the environment's complexity.
- (b) It is difficult to predict future.
- (c) Firms have unlimited resources.
- (d) Obsolescence is rapid. (Nov'19)

Ans: (c)

35. Training company operates a network of accounting training centers throughout Europe, the US and Australia. The business intends to enter developing markets in order to drive growth and has now decided to enter India which is 7,500 kilometers from the Training Co.'s UK headquarters. The Board has suggested that it will require externally focused management information to move into India. Which of the following is an external factor(s) that the Board should consider while implementing its strategy?

- (a) Key local rivals and their strengths and weaknesses
- (b) Courses are suitable for this market
- (c) Timing of the courses (Public holidays, religious festivals, etc. to be avoided)



- (d) All of the above (Nov'20)

Ans: (d)

36. GetWellSoon Limited is a health provider and has only large edge of town hospitals. It is considering setting-up additional small city centre clinics capable of treating less-serious day cases. Which of the following will fall under "Strategy Implementation"?

- (1) Acquiring and fitting out clinics
- (2) Hiring and/or transferring staff
- (3) Publicity, so that patients know where and when to go
- (4) Liaison with general practitioners and the main hospitals

(a) Only (d)

(b) (b) & (d)

(c) (a), (b) & (d)

(d) (a), (b), (c) & (d) (Nov'20)

Ans: (d)

37. The tool for analyzing and comparing the best practices being used by established players in each segment, is known as:

- (a) Benchmarking
- (b) Strategic Analysis
- (c) Strategic Decision making
- (d) BPR

Ans: (a)

38. What is the first step in the comprehensive strategic-management model?

- (a) Developing vision and mission statements
- (b) Performing external audits
- (c) Measuring and evaluating performance
- (d) Establishing long-term objectives (MTP-Oct '19, 1 Mark)

Ans: (a)

39. During what stage of strategic management are a firm's specific internal strengths and weaknesses determined?

- (a) Formulation
- (b) Implementation
- (c) Evaluation
- (d) Feedback (MTP 1 Mark March 19)

Ans: (a)

40. Gennex industries are analyzing the technological forces for the firm which may provide it opportunities and threats for which of the following stage/s of strategic management process?

- (a) Strategy formulation
- (b) Strategy implementation
- (c) Strategy evaluation
- (d) All of the above (MTP 1 Mark May 20)

Ans: (d)

41. What is the first step in the comprehensive strategic-management model?

- (a) Developing vision and mission statements
- (b) Performing external audits



- (c) Measuring and evaluating performance
- (d) Establishing long-term objectives **(MTP 1 Mark April 21)**

Ans: (a)

42. Developing vision and mission, identifying an organization's external opportunities and threats, and determining internal strengths and weaknesses are:

- (a) SBU planning
- (b) Strategy formulation
- (c) Strategy implementation
- (d) Business process reengineering **(MTP 2 Marks March '21)**

Ans: (b)

43. The strategic management process is:

- (a) a solution that guarantees prevention of organizational failure.
- (b) concerned with a resources, capabilities, and competencies, but not the conditions in its external environment.
- (c) not to be used in the not-for-profit organizations.
- (d) full set of commitments, decisions, and actions related to the firm. **(RTP May'19)**

Ans: (d)

44. In which phase of strategic management are annual objectives especially important?

- (a) Formulation
- (b) Control
- (c) Evaluation
- (d) Implementation **(May'20)**

Ans:(d)

45. Which of the following situation will most likely suit a transformational leader?

- (a) An organization that is in trouble.
- (b) A growing organization.
- (c) An organization in a stable environment.
- (d) An organization at maturity stage of product life cycle. **(RTP May'19)**

Ans:(a)

46. In the questions given below select the best answer out of options (a), (b), (c), or (d): In strategic management, there are two main styles of leadership. These are transformational and:

- (a) Transparent
- (b) Transitional
- (c) Translational
- (d) Transactional **(RTP May'20)**

Ans: (d)

47. In the questions given below select the best answer out of options (A), (B), (C), or (D): Which of the following is not true for SBUs?

- (a) It is relevant for multi-product, multi-business enterprises.
- (b) It provides for more control at enterprise level with centralised strategic planning.
- (c) A SBU has its own set of competitors.
- (d) SBUs can be created for units at distant geographical locations. **(RTP Nov'19)**

Ans: (b)



48. Maadhyam, a hearing aid manufacturer recently introduced an AI based management tool that has the capabilities of managing teams across functions. What could be their new organisational structure post this implementation?

- (a) Divisional Structure
- (b) Matrix Structure
- (c) Hourglass Structure
- (d) Network Structure **(RTP May '22)**

Ans: (c)

49. Which of the following is more radical organisation design and is also called as non- structure which virtually eliminates in house business functions and outsources many of them?

- (a) Network Structure
- (b) Strategic Business Unit
- (c) Hourglass Structure
- (d) Divisional Structure **(RTP Nov'22)**

Ans: (a)

50. In which type of organization are Strategic Business Units (SBUs) commonly found?

- (a) Sole proprietorships
- (b) One-business organizations
- (c) Non-profit organizations
- (d) Multi-business organizations **(RTP Nov'23)**

Ans: (d)

