

**Part C- Essay Questions**

**Total marks for part C : 50**

**Answer three (03) questions including question number one**

01. i. Briefly explain in what respect is the objective of wealth maximization superior to the profit maximization objective. (3 Marks)
- ii. How does the modern financial manager differ from the traditional financial manager? (2 Marks)
- iii. a. "Cash flows of two years in absolute terms are incomparable". Discuss and give reasons in support of your answer  
b. Differentiate the "Compounding" and the "Discounting" (5 Marks)
- iv. a. "A higher rate of return on capital employed implies that the firm is managed efficiently". Is this true in every situation? Why or why not? (3 Marks)
- b. ABC Insurance company wants to calculate its weighted average cost of capital (WACC). The company's chief finance officer (CFO) has collected the following information.
- The company's long-term bonds currently offer a yield to maturity of 8 percent
  - The company's stock price is Rs.32 per share ( $P_0 = \text{Rs.}32$ )
  - The company recently paid a dividend of Rs.2 per share. ( $D_0 = \text{Rs.}2$ )
  - The dividend is expected to grow at a constant rate of 6 percent a year. ( $g = 6\%$ )
  - The company pays a 10 percent flotation cost whenever it issues new common stocks. ( $F = 10\%$ )
  - The company's target capital structure is 75 percent equity and 25 percent debt.
  - The company's tax rate is 40 percent.
  - The company anticipates issuing new common stock during the upcoming year.

**You are required to: Calculate the WACC**

**(7 Marks)**

**(Total Marks 20)**

04. i. Define the term "Capitalization"?

(2 Marks)

.....  
.....  
.....

ii. State five (5) factors which should be kept in the view while determining the capital structure of the company.

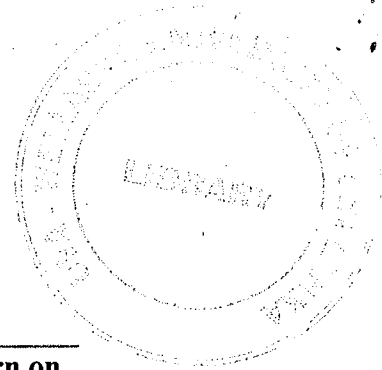
(5 Marks)

.....  
.....  
.....  
.....  
.....  
.....  
.....

05. A firm issues debentures of Rs.100,000 and realize Rs.98,000 after allowing 2% commission to brokers. The debenture carries an interest rate of 10%. The debentures are due for maturity at the end of the 10<sup>th</sup> year.

**You are required to:** calculate the cost of debt before tax and after tax.

(7 Marks)



02. i. You are given following information.

| State of economy | Probability of state | Return on A % | Return on B % |
|------------------|----------------------|---------------|---------------|
| Recession        | .20                  | -15           | 20            |
| Normal           | .50                  | 20            | 30            |
| Boom             | .30                  | 60            | 40            |

- a. What is the expected return for A? for B? (4 Marks)
- b. What is the Standard Deviation for A? for B? (4 Marks)
- c. Suppose you have Rs.20,000 total. If you put Rs. 15,000 in stock A and the remainder in Stock B, what will be the expected return and standard deviation of your portfolio? (4 Marks)

ii. Explain the fundamental relationship between risk and return in well functioning markets? (Marks 3)

(Total Marks 15)

03. i. a. What is meant by Working Capital management? (2 Marks)

b. Briefly explain factors that determine the working capital need of a firm (5 Marks)

ii. As a finance director you are required to find out the net working capital of Lanka Manufacturing Ltd. The company's cost structure as follows.

|               |            |
|---------------|------------|
|               | <u>Rs.</u> |
| Raw Materials | 20.00      |
| Direct labour | 5.00       |
| Overhead      | 15.00      |
| Total Cost    | 40.00      |
| Profit        | 10.00      |
| Selling Price | 50.00      |



Raw materials will be held in stock for **2 months**. Working process is approximated at a **half month** level of production and it comprises 75% total costs. Finished goods will remain in the warehouse for a period of **one month**. Suppliers for credit wait for a **one month**. Credit allowed to debtors is **two months**. The maximum cash is expected to be maintain Rs.25,000 and all sales are on credit basis.

Calculate the Working capital requirement.

(8 Marks)

(Total Marks 15)

04. i. What are the main characteristics of preference shares?

(2 Marks)

ii. Company debentures have a 10 percent coupon rate and a Rs.1000 face value. Interest is paid semi-annually and the debentures have 20 years to mature. If investors require a 12 percent yield, what is the bond's value?

(5 Marks)

iii. The Sahara Company has just paid a cash dividend of Rs.2 per share. Investors require a 16 percent return from investments such as this. If the dividend is expected to grow at a steady 8 percent per year,

a) What is the current value of the stock?

b) What will the stock be worth in five years?

c) What would the stock sell for today if the dividend was expected to grow at 20 percent per year for next three years and then settle down to 8 percent per year, indefinitely?

(8 Marks)

(Total Marks 15)