

Subjective Questions

Question No: 1 (Marks: 3)

How firms analyze their credit policies? Explain briefly.

Following factors to be considered:

- 1) Revenue effects: Granting credit period results in delayed revenue receipts. Offering discounts may or may not be Utilized by the customers. Firm may charges higher prices for longer period and may increase revenue.
- 2) Cost effect: Whether firm sells on cash or credit it has to pay for the cost of sale. Payment to firm's creditor rests on the cash to be received from debtors.
- 3) COST OF DEBT: When a firm extends credit to customers, it must finance the resulting receivable. Cost of short term borrowing is an important factor in the decision to grant credit to customers.
- 4) PROBABILITY OF DEFAULT: Chances of default or bad debt are always there
- 5) DISCOUNTS: When firm offers discount to customers, there is a cost when some customers choose to pay early to seek discounts.

Question No: 2 (Marks: 5)

How Economic Order Quantity (EOQ) Model is helpful in the reduction of total inventory costs?

Question No: 3 (Marks: 5)

Differentiate between Spot Rates and Forward Rates of currencies. Why forward rates are higher than spot rates?

Trading spot means that the settlement will be now – extended to two working days after the transaction is made. Buying or selling forward means that settlement will be made at an agreed future date.

Question No: 4 (Marks: 10)

A Firm sales 200,000 units per year of a particular Product, order size is for 5000 units and stock out is 3000 units. The stock out probability acceptance level is set to 5% and per unit stock out cost is Rs.7/-. Holding cost is estimated at Rs.3/- per unit. Being an inventory manager, determine stock out cost and amount of safety stock to be kept in hand.

STOCKOUT COST =

$$= AC / Q \times S \times Sc \times Ps$$

Where:

AC = Annual Consumption

Q = Order Quantity

S = Stock out in Unit

Sc = Stock out Unit Cost

Ps = Accepted Probability of Stock out

Plugging values, we get

$$= 200000 / 5000 \times 3000 \times 7 \times 0.05$$

$$= 42000$$

SAFETY STOCK LEVEL

Let X = Safety Stock

Then,

Stock out Cost = Carrying Cost x Safety Stock

$$= 42,000 = 2 * X$$

$$X = 42,000 / 2$$

$$= 21,000 \text{ UNITS}$$

Question No: 5 (Marks: 10)

Why firms do business internationally? Explain in detail.

Faster growth: Firms that have operate internationally tend to develop at a much quicker pace than those operating locally

Access to cheaper inputs: Operating internationally may enable the firm to source raw materials or labor at lower prices

Increased quality and efficiency: Exposure to foreign competition will encourage increased efficiency. Doing business in the international market allows firms to improve the quality of their product in order to gain a competitive advantage.

New market opportunities: International business presents firms with new market opportunities. These new markets provide more opportunities for expansion, growth, and income. A bigger market means more customers, increased revenue, a larger profit margin, and allows the business to realize economies of scale.

Diversification: As the firm diversifies its market, it becomes less vulnerable to changes in local demand. This reduces wild swings in a company's sales and profits.

Question No: 6 (Marks: 3)

Give at least three sources of synergies and explain each of them briefly.

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1. **Staff reductions** - As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff members from accounting, marketing and other departments.
2. **Economies of scale** - Yes, size matters. Whether it's purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. When placing larger orders, companies have a greater ability to negotiate prices with their suppliers.

3. **Acquiring new technology** - To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a smaller company with unique technologies, a large company can maintain or develop a competitive edge.

Question No: 7 (Marks: 5)

How would you expect the firm's cash balance to respond to the following changes?

- a) Interest rates increase.
- b) The volatility of daily cash flow decreases
- c) The transaction cost of buying or selling marketable securities goes up

Question No: 8 (Marks: 5)

The Inventory Manager of a firm has given the following data:

Consumption per Period = $S = 4000$ Units

Economic Order Quantity = $EOQ = 80$ Units

Lead Time = $L = 1$ Month

Stock out Acceptance Factor = $F = 1.10$

Requirement:

Determine the Economic Order Point for the firm.

$$EOP = SL + F \sqrt{S \times EOQ \times L}$$

Where

S= Consumption Per Period

L= Lead Time

F= Stock out Acceptance Factor

EOQ = Economic Order Quantity

S = 4000 Units

EOQ = 80 Units

L = 1 Month

F= 1.10 (This Represents The Stock out level of say, 10%)

$$EOP = SL + F \sqrt{S \times EOQ \times L}$$

$$= 4000 \times 1 + 1.10 \sqrt{4000 \times 80 \times 1}$$

$$= 4622.25 \text{ Units}$$

Question No: 9 (Marks: 5)

How a firm can create a money market hedge against transaction exposure, when the firm has to make a payment at some future date?

Money Market Hedge: A similar approach will be taken to create the hedge when a firm is expecting to pay in FCY in future. In this scenario, a hedge can be created by exchanging local currency for FCY now using spot rates and putting the currency on deposit until the future payment is to be made. The amount borrowed and the interest earned on the deposit should be equal to the FCY. If it is not the case then it will not be a clean hedge. The cash flows are fixed because the cost in local currency is the cost of buying FCY on spot rates that was put under a deposit. Mechanism:

Step 1: determine the FCY (assume US \$) amount to be put to a deposit that will grow exactly to equalize the future payment in dollars. You need to calculate this using the available spot rates and interest rate on dollar deposit.

Step 2: in order to deposit dollars in interest bearing account, the company will buy dollars at spot rates.

Step 3: the company will borrow local currency for the period of hedge. These steps will ensure that the hedge created a definite cash flow regardless of exchange rate or interest rate fluctuations. The exchange rate has been fixed.

Question No: 10 (Marks: 5)

Describe in detail the major steps in short term financial planning process of a firm. Page78

The Financial Planning Process consists of the Following five Steps

1. Establishing and defining the client-planner relationship.
2. Gathering client data, including goals.
3. Analyzing and evaluating your financial status.
4. Developing and presenting financial planning recommendations and / or alternatives.
5. Implementing the financial planning recommendations.

Question No: 11 (Marks: 5)

Explain the process of re-organization of a firm in a financial distress.

Lecture # 37: PP Slide #16

Financial distress:

A situation in which available cash is insufficient to pay supplier, vendors, employees, banks and creditors is known as financial distress.

Assumptions:

- Company is incurring losses.
- Needs immediate capital injections.
- Assets and liabilities are out of line with market value.

Process:

- Revaluation of assets (Bring them to market value)

- Write of the debit balance on profit and loss account.
- To determine whether new capital / finances are needed?
 - if yes, through which source (Shares / Loans)

Question No: 12 (Marks: 3)

Explain the main features of a forward rate agreement.

Features of FRAs:

It is in between bank and client for fixing future interest rate on notional amount of loan. The loan is for an affirmed period starting on a particular time in future.

The size of the notional loan or deposit is decided between the bank and the client.

FRAs are cash settled.

On settlement date buyer and seller must settle the agreement.

The FRA rate for three months loan / deposit starting in a 6 months' time is normally expressed as 6v9 FRA.

The buyer of a FRA agrees to pay fixed interest rate on notional loan. At the same buyer will receive interest on notional loan at standard rate of interest. On the other side, seller of FRA agrees to pay interest on the notional amount at benchmark rate and receives interest at a fixed rate.

Question No: 13 (Marks: 3)

Differentiate between Management Buyout and Management Buy-In.

Lecture# 36 PP Slides

Management Buyouts

Buyout is defined as the purchase of a company or a controlling interest of a corporation's shares or product line or some business. A leveraged buyout is accomplished with borrowed money or by issuing more stock. Executives of the firm with the help of institutional financing buy the business from the current owner. Significant sources are pooled by the executives

Management Buy In (MBI):

Management Buy in (MBI) occurs when a manager or a management team from **outside** the company raises the necessary finance buys it and becomes the

company's new management. A management buy-in team often competes with other purchasers in the search for a suitable business. The executives from outside business acquire the business

Difference:

The difference to a management buy-out is in the position of the purchaser: in the case of a buy-out, they are already working for the company. In the case of a buy-in, however, the manager or management team is from another source.

Question No: 14 (Marks: 5)

Assume that a bookstore uses up cash at a steady rate of Rs.300,000 per year. The interest rate is 3% and each sale of securities costs Rs.20. Determine the optimal cash balance for the bookstore.

Optimal level of cash = $\sqrt{(2FT / I)}$

$$= \sqrt{[(2 \times 20 \times 300,000) / 0.03]}$$

$$= \sqrt{[12000000 / 0.03]}$$

$$= \sqrt{400000000}$$

$$= \text{Rs. } 20000$$

Question No: 15 (Marks: 5)

Firm A wants to acquire a private limited company operating in the same industry. What procedure would be followed by the Firm A to acquire the target company?

Question No: 16 (Marks: 5)

Why exchange rates of two currencies fluctuate? Explain briefly

Following are some factors for fluctuation:

Relative interest rates: One factor that affects exchange rates is the size of the differential between the real interest rates available to investors in the respective countries. The real interest rate is simply the nominal interest rate available to an investor in a high quality short-term investment subtracted by the country's inflation rate.

Trade imbalances: The size of any trade deficit between two countries will also affect those countries' currency exchange rates. This is because they result in an imbalance of currency reserves among the trading partners.

Political stability: If a country's government becomes unstable due to political gridlock, votes of no confidence, revolution or civil war, confidence can quickly be lost. People become less willing to accept paper currency in exchange for their goods and services, primarily because they're unsure whether they'll be able to pass the paper along to the next person.

Government involvement: The relative value of a country's currency is of great importance to its government. The value of a country's currency affects the wealth of its citizens, the competitiveness of domestically produced goods, the relative cost of the country's labor, and the country's ability to compete. As a result, governments often try to influence the relative value of their country's currencies in a number of different ways, including altering their monetary and fiscal policies, and by directly intervening in the currency markets.

Investors: Perhaps the most powerful factor that can influence exchange rates over short time frames is the role that speculators play. Investors typically have tremendous amounts of capital that they can use to either buy or sell any currency. Consequently, their actions can cause the value of such currency to fluctuate, sometimes quite significantly.

Question No: 17

Calculate spread using Miller-Orr Model. Page 96

The Miller-Orr model computes the spread between the minimum and maximum cash balance limits as:

Spread = $3(0.75 \times \text{transaction cost} \times \text{variance of daily cash flows} / \text{daily interest rate})^{1/3}$

