

Solved
Scanner Appendix

**CS Professional Programme Module - II
(New Syllabus)
(Solution of December - 2014)**

Paper - 5: Financial, Treasury and Forex Management

**Chapter - 1: Nature, Significance and Scope of Financial Management
2014 - Dec [4] (b)**

$$\begin{aligned} \text{EVA} &= (\text{Operating profit}) - (\text{Capital charge}) \\ \text{EVA} &= \text{NOPAT} - (\text{Cost of capital} \times \text{Capital}) \\ K_e &= R_f + (R_m - R_f) \times \beta \\ K_e &= 7 + (15 - 7) \times 0.9 \\ K_e &= 7 + (8 \times 0.9) \\ K_e &= 14.2\% \end{aligned}$$

(I) For year 2011- 12

Calculation of Capital Charge:

Particulars	Amount	Cost	Capital charge
Equity	10,00,000	0.142	1,42,000
Debt	5,00,000	0.10	50,000
	15,00,000		1,92,000

$$\text{EVA} = 2,00,000 - 1,92,000$$

$$\text{EVA} = ₹ 8,000.$$

(II) For year 2012 - 13

Calculation of Capital Charge:

Particulars	Amount	Cost	Capital charge
Equity	15,00,000	0.142	2,13,000
Debt	7,00,000	0.10	70,000
	22,00,000		2,83,000

$$\text{EVA} = 4,00,000 - 2,83,000$$

$$\text{EVA} = ₹ 1,17,000$$

(III) For year 2013-14**Calculation of capital charge**

Particulars	Amount	Cost	Capital charge
Equity	17,00,000	0.142	2,41,400
Debt	7,00,000	0.10	70,000
	<u>24,00,000</u>		<u>3,11,400</u>

$$\text{EVA} = 8,00,000 - 3,11,400$$

$$\text{EVA} = ₹ 4,88,600$$

Chapter - 2: Capital Budgeting**2014 - Dec [1] (b)**

There are various techniques that can be use to deal with risk in investment appraisal. Some of the techniques that are used in risk analysis are statistical and mathematical techniques. Statistical and mathematical techniques for risk analysis includes:

1. Probability Assignment
2. Expected Net Present Value
3. Standard Deviation
4. Coefficient of Variation
5. Probability Distribution Approach
6. Normal Probability Distribution.

2014 - Dec [2] (c)**Capital Budgeting**

- Capital budgeting refers to long-term planning for proposed capital outlays and their financing.
- Thus, it includes both raising or long-term funds as well as their utilisation. It may, thus, be defined as the “firm’s formal process for acquisition and investment of capital.”
- To be more precise, capital budgeting decision may be defined as “the firms’ decision to invest its current fund more efficiently in long-term activities in anticipation of an expected flow of future benefit over a series of years”.
- Capital budgeting decisions in most of the cases are irreversible

- Capital budgeting decision is surrounded by great number of uncertainties. These decisions require an overall assessment of future events which are uncertain.

Capital rationing

- 'Capital rationing' is the term usually coined to denote such a condition in which the business enterprises are not able to accept all the projects on account of external or internal fund constraints.
- In such a situation the business enterprises attempt to allocate the amount available in such a way so as to maximise the wealth of the shareholders.
- Capital rationing can be classified as hard capital rationing or soft capital rationing.
- Hard capital rationing is on account of external constraints while soft capital rationing problem is due to internal fund constraints.

Chapter - 3: Capital Structure

2014 - Dec [1] (d)

- By analyzing the relationship between earnings before interest and taxes (EBIT) and earnings per share (EPS), one can examine the effect of leverage.
- The use of EBIT – EPS analysis provides information to management regarding the projected EPS for different financial plans.
- Generally, management wants to maximise EPS if doing so also satisfies the primary goal of financial management i.e. maximisation of the owner's wealth.
- If the firm attempts to use excessive amounts of debt, shareholders may sell their shares and thus its price will fall. While the use of large amount of debt may result in higher EPS, it may also result in a reduction in the price of the firm's equity.
- The optimum financial structure for a firm (that is, the use of debt in relationship of equity and retained earnings as sources of financing) should be the one which maximises the price of the equity. Thus EBIT-EPS analysis is an effective method in analyzing the effect of leverage.

2014 - Dec [2A] (Or) (i), (ii)

(i) Vertical capital structure

- In vertical capital structure, the base of the structure is formed by a small amount of equity share capital.
- This base serves as a foundation on which the super structure of preference share capital and debt is built .
- The incremental addition in the capital structure is mostly in the form of debt while quantum of retained earning is low and the dividend payout ratio is quite high.
- In such a structure cost of equity capital is usually higher than cost of debt.
- Thus, the financial risk of the firm increases and render the structure unstable.

Pyramid shaped capital structure

- A pyramid shaped capital structure has a large proportion consisting of equity capital and retained earnings which have been ploughed back into the firm over a considerably large period of time.
- In this case, the cost of share capital and the retained earnings of the firm is usually lower than the cost of debt.
- Pyramid shaped capital structure is indicative of risk averse conservative firms.

(ii)

Net Income (NI) Approach	Net Operating Income (NOI) Approach
Net Income Approach states that change in capital structure directly affects the value of the firm as increase in debt reduces cost of capital and increases value of firm.	As per this approach, the capital structure decision is not relevant and change in debt will not affect the total value of the firm.

In NI approach the cost of capital & consequently capital structure is dependent on degree of leverage.	Thus in NOI approach, cost of capital is independent of degree of leverage.
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2014 - Dec [3] (b)

(b) (i) Existing Case:

Sales = ₹ 17,50,000

EBIT = ₹ 4,50,000

Interest = ₹ 4,000

Preference Dividend = ₹ 10,000

Expansion plan require money = ₹ 1,75,000

Increase in EBIT due to expansion = ₹ 1,00,000

Particulars	Existing	Alt - 1	Alt - 2	Alt - 3
EBIT	= 4,50,000	5,50,000	5,50,000	5,50,000
(-) Interest	= (4,000)	(4,000)	(18,000)	(4,000)
EBT	= 4,46,000	5,46,000	5,32,000	5,46,000
(-) Tax	= <u>2,23,000</u>	<u>2,73,000</u>	<u>2,66,000</u>	<u>2,73,000</u>
EAT	2,23,000	2,73,000	2,66,000	2,73,000
(-) Pref. Dividend	(10,000)	(10,000)	(10,000)	(24,875)
Earnings available for shareholders	= 2,13,000	2,63,000	2,56,000	2,48,125
Shares	= 40,000	45,000	40,000	40,000
EPS	= <u>5.325</u>	<u>5.84</u>	<u>6.4</u>	<u>6.20</u>

(ii) Calculation of Indifference point:

EPS at option of equity = EPS at option of debt

$$\frac{(x - 4,000)(1 - 0.5) - 10,000}{(45,000)} = \frac{(x - 18,000)(1 - 0.5) - 10,000}{(40,000)}$$

$$\frac{0.5x - 2,000 - 10,000}{45,000} = \frac{0.5x - 9,000 - 10,000}{40,000}$$

$$\frac{0.5x - 12,000}{45,000} = \frac{0.5x - 19,000}{40,000}$$

$$\frac{0.5x - 12,000}{9} = \frac{0.5x - 19,000}{8}$$

$$\Rightarrow 4x - 96,000 = 4.5x - 1,71,000$$

$$0.5x = 75,000$$

$$x = 1,50,000$$

$$\text{EBIT} = ₹ 1,50,000$$

(iii) Calculation of Indifference point:

EPS at option of equity = EPS at option of preference share

$$\frac{(x - 4,000)(1 - 0.5) - 10,000}{(45,000)} = \frac{(x - 4,000)(1 - 0.5) - 24,875}{(40,000)}$$

$$\frac{0.5x - 2,000 - 10,000}{45,000} = \frac{0.5x - 2,000 - 24,875}{40,000}$$

$$= \frac{0.5x - 12,000}{9} = \frac{0.5x - 26,875}{8}$$

$$4x - 96,000 = 4.5x - 2,41,875$$

$$x = 2,91,750$$

(c) An investor owns 10% of shares in Company A

Particulars	Company A	Company B
Profit before interest =	1,20,000	1,20,000
(-) Interest =	20,000	(-)
Profit before tax =	1,00,000	1,20,000
Number of shares =	1,00,000	2,00,000
EPS =	1	0.6
DPS =	1	0.6

Earning of investor = 10,000 shares \times ₹ 1 = ₹ 10,000

Investor will sell his 10% shares for (₹ 10,000 \times 15) = ₹ 1,50,000.

Buy 10% of the investment in Company B for (20,000 shares \times 7) = ₹ 1,40,000.

Balance money left = 1,50,000 - 1,40,000 = ₹ 10,000

Income in this case:

Income on investment in Company B (20,000 \times 0.6) = ₹ 12,000

Interest earned on balance funds (10,000 \times 10%) = ₹ 1,000

Total earnings ₹ 13,000

Thus, investor will be better off in switching his holding to Company B.

2014 - Dec [3A] (Or) (i)

In this case, Distance Sensor Ltd. has a market value of ₹ 35,00,000

Cost of equity = 20%

Company wants to buy back equity shares = ₹ 8,00,000

As per Modigliani and Merton Miller (MM), the value of a firm depends solely on its future earnings stream and hence its value is unaffected by its debt/equity mix. In short, they concluded that a firm's value stems from its assets, regardless of how those assets are financed. Thus, according to MM Hypothesis, a firm's stock price is not related to its mix of debt and equity financing. Thus in this case, the market value of the firm will be same and will not be changed.

2014 - Dec [4] (a)

Statement Showing the Comparative Analysis of Alternative Financial Plan

	Financial Plans	
	I	II
	Debt Issue	Equity Issue
	(₹)	(₹)
Earnings Before Interest and Taxes (EBIT)		
(₹ 5,00,000 + 15% of 16,00,000)	7,40,000	7,40,000

Less: Interest	<u>1,50,000</u>	<u>30,000</u>
Earnings Before Taxes (EBT)	5,90,000	7,10,000
Less: Taxes @ 50%	<u>2,95,000</u>	<u>3,55,000</u>
Earnings After Taxes	2,95,000	3,55,000
No. of shares	50,000	75,000
EPS (EAT/No. of shares)	5.9	4.73
Price-Earning Ratio	4 times	5 times
Market value of share (EPS P/E ratio)	5.90 x 4 = ₹ 23.60	4.73 x 5 = ₹ 23.65

Decision: Though there is a marginal difference in the market value of shares under alternative financial plans but in view of higher EPS (₹ 5.90) and debt equity ratio with in acceptable norm, i.e., 2.1; Financial Plan I may be accepted.

Chapter - 4: Cost of Capital

2014 - Dec [2A] (Or) (iii)

- It is apt to say that in real life, the component cost of debt and equity are jointly operational rather than independently determined.
- In the field of finance, the component costs of debt and equity tend to be jointly as opposed to independently determined.
- Higher levels of debt, for example, will usually increase the perceived level of risk for debt holders and equity holders alike and therefore, raise the interest rate charged by creditors and the rate of return requirement of stockholders.
- Thus cost of debt and cost of equity should not be determined independently. Both the cost of debt and equity should be determined on joint basis to have a true and fair cost of capital.

2014 - Dec [3A] (Or) (iv)

$$\text{Return of security/Ke} = R_F + \beta (R_m - R_F)$$

Where,

R_F = Risk free rate of return

R_m = Return on market portfolio

β = Beta of security

$$K_e = 4 + 1.5 (3.5)$$

$$K_e = 9.25\%$$

$$K_d = I (1 - \text{tax})$$

$$K_d = 7 (1 - 0.35)$$

$$K_d = 4.55\%$$

$$W_d = 0.33$$

$$W_e = 0.67$$

Calculation of WACC:

Particulars	Weight	Cost	Cost
Equity	0.67	9.25	6.17
Debt	0.33	4.55	1.52
			<u>7.69</u>

$$\text{WACC} = 7.69\%$$

Chapter - 5: Financial Services**2014 - Dec [5] (a)**

- ⇒ Merchant banker means any person engaged in the business of issue management by making arrangements regarding selling, buying and subscribing to securities or acting as manager/consultant/advisor in relation to issue management.
- ⇒ Merchant bankers constitute an important segment of capital market intermediaries.
- ⇒ Following are the activities, undertaken by the merchant bankers:
 - Managing of public issue
 - Managing international issues in form of ADRs, GDRs and Euro bonds.
 - Private placement of securities
 - Underwriting
 - Stock breaking
 - Advisory services related to diverse issues such as mergers & acquisitions.
- ⇒ The activities of Merchant Bankers are regulated by SEBI (Merchant Bankers) Rules 1992 and SEBI (Merchant Bankers) Regulations, 1992.

2014 - Dec [6] (b)

Credit rating refers to the process of rating any instrument with regards to its ability and credit worthiness of repayment. Credit rating is thus an opinion of credit rating agency (CRA) generated on the basis of assessment and analysis. Some of the limitations of credit rating includes:

- Rating is done on the present and the past historic data of the company and this is only a static study. Prediction of the company's health through rating is momentary and anything can happen after assignment of rating symbols to the company.
- The companies having lower grade rating do not advertise or use the rating while raising funds from the public.
- Rating Company might conceal material information from the investigating team of the credit rating company. In such cases quality of rating suffers and renders the rating unreliable.
- Credit Rating is no guarantee for soundness of company.
- Time factor affects' rating, sometimes, misleading conclusions are derived. For example, company in a particular industry might be temporarily in adverse condition but it is given a low rating. This adversely affects the company's interest.
- Rating done by the two different credit rating agencies for the same instrument of the same issuer company in many cases would not be identical. Such differences are likely to occur because of value judgement differences on qualitative aspects of the analysis in two different agencies.

Chapter - 6: Project Planning

2014 - Dec [1] (c)

- Venture capital is the capital contributed in new, highly risky projects promoted by qualified entrepreneurs with high reward expectations. It is either in the form of equity or combination of equity and debt, generally through equity alone.
- This type of capital is provided by risk-oriented people to such group of entrepreneurs who have talent & skill but lack funds.

- Venture capital industry strives to provide the technocrats with basis to build the business alongwith substantial growth and face long gestation period.
- Venture capitalist prefers to invest in “entrepreneurial businesses”. This does not necessarily mean small or new businesses. Rather, it is more about the investment’s aspirations and potential for growth, rather than by current size.
- Those businesses which are aiming to grow rapidly to a significant size are being funded by the venture capitalists.
- Venture capital investors are only interested in companies with high growth prospects, which are managed by ambitious teams who are capable of turning their business plan into reality.

2014 - Dec [2] (b)

	Basis	Operating Lease	Finance Lease
1	Meaning	Under operating lease, all risk and rewards are not transferred.	That form of lease wherein all risk incidental to ownership and benefits arising therefrom are transferred.
2	Term period	It is entered for comparatively shorter period.	It is a long term arrangement.
3	Termination of agreement / Revocability clause	Generally gives an option to terminate the lease.	Such an arrangement is irrevocable (cannot be cancelled) during the primary lease period which is generally full economic life of asset under lease.
4	Repairs and Maintenance expenses	The lessor agrees to bear insurance, maintenance and repair cost.	Repairs, maintenance and other administrative expense are borne by the lessee himself.

2014 - Dec [5] (c)

During inflationary conditions the project cost is affected in magnitude of parameters. Cost of project on various heads i.e. labour wage, raw material, fixed assets, equipments, plant and machinery, building material, remuneration of managerial personnels undergo a shift change. Moreover, the financial institution and banks revise their rate of lending and their financing cost further escalate during inflationary conditions. Under such conditions, the appraisal of the project should be done keeping in view the following guidelines:

- (i) Make provisions for delay in project implementation, escalation in project cost as per the forecasted rate of inflation in the economy particularly on all heads of cost.
- (ii) Sources of finance should be carefully scrutinized with reference to revised rate of interest.
- (iii) Profitability and cash flow projections should be revised.
- (iv) Explain fully the criteria followed in adjusting the inflationary pressures.
- (v) It is also important to examine the financial viability of the project at the revised rates.

2014 - Dec [6] (c)

Operating Lease:

- An operating lease can be defined as any lease other than a finance lease.
- Operating lease does not result in a substantial transfer of the risks and rewards of ownership from the lessor to the lessee.
- It is entered for comparatively shorter period as compared to economic life of the equipment.
- Generally operating lease gives an option to terminate the lease.
- In case of operating lease. The lessor agrees to bear insurance, maintenance and repair cost.

Chapter - 8: Working Capital**2014 - Dec [2] (a)**

- Balance sheet of a company does not provide a true picture of the current assets of the company.
- Balance sheet of a company provides the information of a company of a particular date. The position at the end of a day is a static position which is not representative of the entire year.
- Another point is that an industry might have seasonal peaks or troughs of working capital requirement. For example, agro based industry like fruit processing unit would need to stock more raw material during the peak season when the crop has been harvested than during the lean season. In such cases, different norms have to be applied for peak season and non peak season for holding of current assets for judging the reasonability of their holding.
- There may be a case where high level of current assets is nothing but a fiction when company seek to realize the current assets. It may happen that the inventory carried by the firm may consist of obsolete items, packing materials, finished goods which have been rejected by buyers.
- On the other hand, the current liabilities are more ascertainable and less fictions. The payment of these liabilities, if not possible from the operating cycle, has to be arranged from long term sources of funds which results in a mismatch that is not conducive to financial health of the firm.
- Thus it is apt to say that the balance sheet does not provide exact picture of the current assets of a firm.

2014 - Dec [3] (a)**Evaluation of factoring proposal****Saving on account of factoring:**

Saving / Reduction in Bad debts

(6,00,000 × 1%)	=	6,000
+ Saving in other cost	=	<u>4,000</u>
(48,000/12)		<u>10,000</u>

Cost of factoring:

Commission $\left(1,00,00,000 \times 72\% \times \frac{1}{12}\right) \times 5\%$	=	30,000
+ Fees $(6,00,000 \times 80\% \times 1\%)$	=	<u>4,800</u>
Total cost		34,800
Net cost of factoring -		
34,800 - 10,000	=	<u>24,800</u> -(A)

Evaluation of Bank proposal

No saving (as was applicable in factoring proposal)	=	10,000
+ Interest $\left(72,00,000 \times \frac{1}{12} \times 80\% \times 15\%\right) \times \frac{1}{12}$	=	6,000
+ Processing charges $(6,00,000 \times 1\%)$	=	<u>6,000</u>
Net cost of Bank proposal		<u>22,000</u> -(B)

Comparing (A) and (B), it is better to go in for bank proposal.

2014 - Dec [5] (b)

(i) Requirements of working capital is dependant on number of factors. Some of the factors which determine the requirement of working capital are:

1. **Nature of business:** The kind of business in which the company is engaged determine the requirement of working capital. A company engaged in manufacturing items require more amount of working capital than a company which provides services on cash payment.
2. **Production cycle:** Production cycle also determine the amount of working capital. Production cycle is the total time taken from the procurement of the raw material till the realisation of sale proceeds. Longer the production cycle higher will be the requirement of working capital.
3. **Dividend policy:** Dividend policy of a company affect the working capital requirement. A change in dividend policy of a company requires a change in the working capital policy also. A company that desires to pay a higher dividend needs more working capital and *vice-versa*.

4. **Size:** Requirement of working capital depends on the size of the company. The amount needed may be relatively large per unit of output for a small company subject to higher overhead costs, less favourable buying terms and higher interest rates.
5. **Growth & diversification:** A company that has a diversification programme require more working capital. As a company grows, it is logical to expect that a larger amount of working capital is required. The composition of working capital in a growing company also shifts with economic circumstances and corporate practices.
6. **Sales policies:** Working capital needs also vary with sales policy.
7. **Operating Efficiency:** The operating efficiency of the management is also an important determinant of the level of working capital.

Chapter - 9: Security Analysis and Portfolio Management

2014 - Dec [2] (d)

Security market line:

- (a) Security Market Line or SML in short depicts the linear relationship which exists between expected return and beta (systematic risk).
- (b) The importance of security market line (SML) is that it helps us to determine whether or not the securities are correctly priced.

Capital Market Line (CML)

- (a) CML is given by -

$$R_p = R_f + \left(\frac{R_M - R_f}{\sigma_M} \right) \sigma_p$$

- (b) Risk premium of diversified portfolio depends upon σ_p .

Capital Market Line

- ⇒ CML, abbreviation for Capital Market Line describes the relationship between expected rate of return and total risk for efficient portfolio.
- ⇒ CML has applicability for portfolios which are efficient as against SML which is applicable for all sorts of portfolios.

2014 - Dec [3A] (Or) (ii)

Expected rate of return = $R_F + \beta (R_m - R_i)$

Where,

R_F = Risk -free rate of return

R_m = Return on market portfolio

β = Beta of security

Expected rate of return = $5 + 1.15 (14 - 5)$
= 15.35%

In this case, return on stock of Zebra Ltd. is 1.35% more than the return of market.

Chapter - 10: Derivatives and Commodity Exchanges - An Overview**2014 - Dec [5] (d)**

Main participants involved in derivatives market are as follows:

1. Hedgers
 2. Speculators
 3. Arbitrageurs
- (a) **Hedgers:** Hedgers are the one who try to avoid or mitigate the risk element in price of asset.
- (b) **Speculators:** Speculators try to gain advantage by speculating the anticipated trends in prices of assets.
- (c) **Arbitrageurs:** Arbitrageurs book profits on the basis of differences that exists between different markets & location.

2014 - Dec [6] (a), (d)**(a) Credit derivatives**

- Credit derivatives are a part of derivatives market.
- Credit derivatives are financial contracts that provide insurance against credit-related losses.
- These contracts give investors, debt issuers and banks new techniques for managing credit risk that complement the loan sales and asset securitization methods. The general credit risk is indicated by the happening of certain events, called credit events, which include bankruptcy, failure to pay, restructuring etc. There is a party trying to transfer credit risk, called protection seller.

- A credit derivative being a derivative does not require either of the parties, the protection seller or protection buyer to actually hold the reference asset. When a credit event takes place, there are two ways of settlement – cash and physical. Cash settlement means the reference asset will be valued and the difference between its and fair value will be paid by the protection seller. Physical settlement means the protection seller will acquire the defaulted asset, for its par value.

(d) Commodities markets

Commodity market is an important constituent of the financial markets of any country. It is the market where a wide range of products, viz., precious metals, base metals, crude oil, energy and soft commodities like palm oil, coffee etc. are traded. It is important to develop a vibrant, active and liquid commodity market. This would help investors hedge their commodity risk, take speculative positions in commodities and exploit arbitrage opportunities in the market.

The various benefits associated with commodity trading are:

- High liquidity
- Higher risk adjusted return
- Low risk
- Low volatility
- Diversified portfolios can be created.

Chapter - 11: Treasury Management

2014 - Dec [1] (a)

- (a) Treasury management is the efficient management of liquidity and the financial risk in the business.
- (b) The objective of treasury management is planning, organising and controlling cash assets to achieve the financial goals which may be to maximise the return on available cash or minimise the interest cost or mobilise cash for different activities / transactions.
- (c) Treasury management has both macro & micro aspects.

Macro Level: At the macro level, the inflows & outflows of cash, credit and other financial instruments are the functions of the government and the business sectors. These inflows are arranged by them as borrowings from the public. Reserve Bank of India manages the macro treasury management of the country through issue of currency notes, maintenance of currency chests, distribution of coins & rupee notes on behalf of government.

Micro Level: At micro level, the finance manager aims at optimising the value of his assets. He tries to maximise the wealth of stakeholders of the micro unit. He seeks to increase his operational profits.

2014 - Dec [2A] (Or) (iv)

Objectives of treasury management includes:

- **Availability of funds in right quantity:** The treasury manager arranges funds for the unit. It is the duty of the treasury manager to ensure that the funds have been arranged in required quantity.
- **Availability of funds at right time:** Timely availability of funds smoothens the operations of the firm. The treasury manager ensures that requisite funds for day-to-day working of the firm should be available in time.
- **Deployment of Funds in right quantity:** By deployment of funds, we mean earmarking of funds for various expense heads, parking of short-term funds and investing surplus funds.
- **Deployment of funds at right time:** Another objective of treasury management is to deploy the funds at right time. Timely deployment of funds is a well planned activity requiring intra-organisation coordination and liaison with banks and financial institutions apart from forex dealers.
- **Profiting from availability and deployment:** Modern day treasury manager has another objective, which is to profit from sourcing and deployment of funds.

Chapter - 12 : Forex Management**2014 - Dec [3A] (Or) (iii)**

Options I: Let Sunshine Ltd. borrow funds @ 12% p.a. with quarterly rest
Given that:

$$1 ₹ = ¥ 2.46$$

$$x ₹ = ¥ 2,460 \text{ lakh}$$

$$\Rightarrow x = \frac{2,460 \text{ lakh}}{2.46} = 1,000 \text{ lakh}$$

$$\text{Add: Int @ 12\% for 3 month} = 1,000 \times \frac{12}{100} \times \frac{3}{12} = 30 \text{ lakh}$$

$$= ₹ 1,030 \text{ lakh.}$$

Option II: Let Sunshine Ltd. borrow from India based Tokyo branch:

Amount borrowed: ¥ 2,460 lakh

Add:

Interest @ 2%

$$\left(2,460 \text{ lakh} \times \frac{2}{100} \times \frac{90}{365} \right) \quad \text{¥ 12.13 lakh}$$

$$2472.13 \text{ lakh}$$

Given that,

$$\text{After 90 days} \quad 1 ₹ = ¥ 2.5$$

$$x ₹ = ¥ 2,472.13/2.5$$

$$x = 988.852 \quad \text{----- (1)}$$

But along with this interest expense, there exist another requirement of India based Tokyo branch which calls for opening of an irrevocable letter of credit.

Commission charges for letter of credit being 4% per 12 months

$$\text{So, } ₹ 100 = ¥ 246$$

$$₹ x = ¥ 2,460 \text{ lakh}$$

$$x = \frac{2,460 \text{ lakh}}{246} \times 100 = 1,000 \text{ lakh}$$

$$\text{Commission @ 4\% p.a. on 1,000 lakh} = 1,000 \text{ lakh} \times \frac{4}{100} \times \frac{3}{12} = 10 \text{ lakh}$$

Add: Interest on 10 lakh @ 12% for 3 month = .3 lakh
= 10.3 lakh

----- (2)

Adding (1) + (2)

i.e. 988.852 + 10.3 = ₹ 999.152 lakh

Thus, option II proves out to be better than option I and hence the offer from foreign branch should be accepted.

Shuchita Prakashan (P) Ltd.

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FOR NOTES

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FOR NOTES

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