

ANSWERS OF MODEL TEST PAPER 1
INTERMEDIATE: GROUP – II
PAPER – 6: FINANCIAL MANAGEMENT & STRATEGIC MANAGEMENT
PAPER 6A : FINANCIAL MANAGEMENT
PART I

1. I. (b) ₹ 35,55,556
- II. (c) ₹ 30,03,733
- III. (a) ₹ 8,83,200
- IV. (d) ₹ 4,83,200
- V. (a) 16.09%

Working Note

Particulars	(₹)
Total Sales	₹ 200 lakhs
Credit Sales (80%)	₹ 160 lakhs
Receivables for 40 days	₹ 80 lakhs
Receivables for 120 days	₹ 80 lakhs
Average collection period $[(40 \times 0.5) + (120 \times 0.5)]$	80 days
Average level of Receivables $(₹ 1,60,00,000 \times 80/360)$	₹ 35,55,556
Factoring Commission $(₹ 35,55,556 \times 2/100)$	₹ 71,111
Factoring Reserve $(₹ 35,55,556 \times 10/100)$	₹ 3,55,556
Amount available for advance $\{₹ 35,55,556 - (₹ 71,111 + ₹ 3,55,556)\}$	₹ 31,28,889
Factor will deduct his interest @ 18%: Interest = $\frac{₹ 31,28,889 \times 18 \times 80}{100 \times 360}$	₹ 1,25,156
Advance to be paid $(₹ 31,28,889 - ₹ 1,25,156)$	₹ 30,03,733

(i) Statement Showing Evaluation of Factoring Proposal

		₹
A.	Annual Cost of Factoring to the Company:	
	Factoring commission $(₹ 71,111 \times 360/80)$	3,20,000
	Interest charges $(₹ 1,25,156 \times 360/80)$	<u>5,63,200</u>
	Total	<u>8,83,200</u>
B.	Company's Savings on taking Factoring Service:	₹
	Cost of credit administration saved	2,40,000
	Bad Debts $(₹ 160,00,000 \times 1/100)$ avoided	<u>1,60,000</u>
	Total	<u>4,00,000</u>

C.	Net Cost to the company (A – B) (₹ 8,83,200 – ₹ 4,00,000)	<u>₹ 4,83,200</u>
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$$\text{Effective cost of factoring} = \frac{\text{₹ } 4,83,200}{\text{₹ } 30,03,733} \times 100 = 16.09\%$$

2. B. ₹ 3,20,513; ₹ 8.33

$$\frac{(\text{EBIT} - I)(1 - t) - D_p}{N_1} = \frac{(\text{EBIT} - I)(1 - t) - D_p}{N_2}$$

$$\frac{(x - 0)(1 - 0.35)}{25,000} = \frac{(x - 1,00,000)(1 - 0.35) - 60,000}{10,000}$$

$$x = \text{EBIT} = \text{₹ } 3,20,513$$

At EBIT of ₹ 3,20,513, EPS under both options will be the same i.e., ₹ 8.33 per share

3. D. 1.15

$$\text{FL} = \% \text{ change in NP} / \% \text{ change in EBIT} = 6.9/6 = 1.15$$

4. C. 3 years

These deposits may be accepted for a period of six months to three years.

PART II

1. (a)

Particulars	(₹' in lakhs)
Net Profit	54
Less: Preference dividend	24
Earnings for equity shareholders	30
Earnings per share	30/2 = ₹ 15

Let, the dividend per share be D to get share price of ₹ 120.

$$P = \frac{D + \frac{r}{K_e}(E - D)}{K_e}$$

Where,

P = Market price per share.

E = Earnings per share = ₹ 15

D = Dividend per share

R = Return earned on investment = 22%

K_e = Cost of equity capital = 15%

$$120 = \frac{D + \frac{0.22}{0.15}(15 - D)}{0.15}$$

$$\begin{aligned}
 18 &= \frac{0.15D + 3.3 - 0.22D}{0.15} \\
 0.07D &= 3.3 - 2.7 \\
 D &= 8.57 \\
 \text{D/P ratio} &= \frac{\text{DPS}}{\text{EPS}} \times 100 = \frac{8.57}{15} \times 100 = 57.13\%
 \end{aligned}$$

So, the required dividend pay-out ratio will be = 57.13%

(b) Value of AN Ltd. = $\frac{\text{NOI}}{K_0} = \frac{\text{₹ } 10,00,000}{20\%} = \text{₹ } 50,00,000$

(i) Return on Shares of Mr. R on AN Ltd.

Particulars	Amount (₹)
Value of the company	50,00,000
Market value of debt (50% x ₹ 50,00,000)	25,00,000
Market value of shares (50% x ₹ 50,00,000)	25,00,000
Particulars	Amount (₹)
Net operating income	10,00,000
Interest on debt (10% x ₹ 25,00,000)	2,50,000
Earnings available to shareholders	7,50,000
Return on 8% shares (8% x ₹ 7,50,000)	60,000

(ii) Implied required rate of return on equity of AN Ltd. = $\frac{\text{₹ } 7,50,000}{\text{₹ } 25,00,000} = 30\%$

(c) ANVY Ltd

Balance Sheet as on 31st March, 2023

Liabilities	₹	Assets	₹
Equity share capital	2,00,000	Fixed assets	1,40,000
Current debt	60,000	Cash (balancing figure)	1,00,000
Long term debt	<u>60,000</u>	Inventory	<u>80,000</u>
	<u>3,20,000</u>		<u>3,20,000</u>

Working Notes

- Total debt = 0.60 x Equity share capital = 0.60 x ₹ 2,00,000 = ₹ 1,20,000
Further, Current debt to total debt = 0.50. So, current debt = 0.50 x ₹ 1,20,000 = ₹ 60,000,
Long term debt = ₹ 1,20,000 - ₹ 60,000 = ₹ 60,000
- Fixed assets = 0.70 x Equity share Capital = 0.70 x ₹ 2,00,000 = ₹ 1,40,000
- Total assets to turnover = 2.5 Times: Inventory turnover = 10 Times

Hence, Inventory /Total assets = 2.5/10=1/4, Total assets = ₹ 3,20,000

Therefore Inventory = ₹ 3,20,000/4 = ₹ 80,000

2. (a) Cash inflows after tax (CFAT)

Particular	₹
Current production (units per week)	5,000 units
New capacity (units per week)	15,000 units
Demand (units per week)	10,000 units
Increase in sales (units per week) A.	5,000 units
Contribution per unit (₹ 30,000 x 0.10) B.	3,000
Increase in contribution A x B x 56	84 crores
Less: Additional fixed cost	10 crores
Increase in profit	74 crores
Less: Tax @ 40%	29.6 crores
Profit after tax	44.4 crores

Tax shield due to depreciation

Year	Depreciation (₹ in Crore)	Tax Shield (₹ in Crore)	PV Factor @ 20%	Total Present Value (₹ in Crore)
1	25.00	10	0.83	8.33
2	18.75	7.5	0.69	5.18
3	14.06	5.62	0.58	3.26
4	10.55	4.22	0.48	2.03
5	7.91	3.16	0.40	1.27
Total				20.07

Tax shield on capital loss = (23.73-20.00) x 30% = ₹ 1.12 crores

Net Present Value (NPV)

Particulars	Year	Cash Flow (₹ in Crores)	PVAF @ 20%	Present Value (₹ in Crores)
Initial Investment	0	(100)	1	(100)
Working capital	0	(3)	1	(3)
Profit after tax	1-5	44.4	2.99	132.76
Salvage value	5	20	0.40	8.00
Tax shield on Depreciation	1-5			20.07
Tax shield on capital loss	5	1.12	0.40	0.45
Release of Working Capital	5	3	0.40	1.20
NPV				59.47

The company is advised to replace the old machine since the NPV of the new machine is positive.

- (b) **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.

3. (a) **Working Note:**

Let the rate of Interest on debenture be x

$$\therefore \text{Rate of Interest on loan} = 1.4x$$

$$\begin{aligned}\therefore k_d \text{ on debentures} &= \frac{\text{Int} (1-t) + \frac{RV - NP}{n}}{\frac{RV + NP}{2}} \\ &= \frac{100x(1-0.30) + \frac{100-98}{4}}{\frac{100+98}{2}} \\ &= \frac{70x+0.5}{99}\end{aligned}$$

$$\therefore K_d \text{ on bank loan} = 1.4 \times (1 - 0.30) = 0.98x$$

$$K_e = \frac{EPS}{MPS} = \frac{1}{MPS/EPS} = \frac{1}{PE} = \frac{1}{4} = 0.25$$

$$K_e = 0.25$$

Computation of WACC

Capital	Amount	Weights	Cost	Product
Equity	20,00,000	0.2	0.25	0.05
Reserves	30,00,000	0.3	0.25	0.075
Debentures	30,00,000	0.3	$(70x+0.5)/99$	$(21x+0.15)/99$
Bank Loan	20,00,000	0.2	0.98x	0.196x
	1,00,00,000	1		$0.125+0.196x + \frac{21x+0.15}{99}$

$$WACC = 16\%$$

$$\therefore 0.125+0.196x + \frac{21x+0.15}{99} = 0.16$$

$$\therefore 12.375+19.404x+21x+0.15 = (0.16)(99)$$

$$\therefore 40.404x = 15.84 - 12.525$$

$$\therefore 40.404x = 3.315$$

$$\therefore x = \frac{3.315}{40.404}$$

$$\therefore x = 8.20\%$$

(i) Rate of interest on debenture = $x = 8.20\%$

(ii) Rate of interest on Bank loan = $1.4x = (1.4)(8.20\%) = 11.48\%$.

- (b)** 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,

K_e = Cost of equity

D = Expected dividend (also written as D_1)

P_0 = Market price of equity (ex- dividend)

4. (a) Limitations of Profit Maximisation objective of financial management.

- (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.

- (b) Some common methods of venture capital financing are as follows:
- (i) **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.
 - (ii) **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.
- (c) **Optimum Capital Structure:** The capital structure is said to be optimum when the firm has selected such a combination of equity and debt so that the wealth of firm is maximum. At this capital structure, the cost of capital is minimum and the market price per share i.e. value of the firm is maximum.

OR

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 an 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”**.

ANSWERS OF MODEL TEST PAPER 1
PAPER 6B: STRATEGIC MANAGEMENT

PART I

- | | | | | | | | | | | |
|--------|-----|-----|------|-----|-------|-----|------|-----|-----|-----|
| 1. (A) | (i) | (a) | (ii) | (b) | (iii) | (c) | (iv) | (b) | (v) | (c) |
| (B) | (i) | (c) | (ii) | (b) | (iii) | (b) | | | | |

PART II

1. (a) Swati operates at the functional level of management, specifically as the marketing manager at a software company. Functional managers like Swati oversee specific departments or functions within an organization, such as marketing, finance, or operations. Their primary responsibilities include implementing corporate strategies and policies within their area of expertise and ensuring that daily operations are conducted efficiently and effectively.

In Swati's case, as a marketing manager, her role involves developing and executing marketing strategies for the company's products. This includes leading a team of marketing professionals, collaborating with product development and sales teams, and analyzing market trends and customer feedback to refine strategies. By working closely with these teams, Swati ensures that the company's products are effectively promoted in the market and that marketing efforts align with overall business goals.

Functional managers like Swati play a critical role in the organization by bridging the gap between corporate strategy and daily operations. They are responsible for translating high-level strategic goals into actionable plans for their departments and ensuring that these plans are executed effectively. Additionally, they are often key decision-makers within their areas of responsibility, making strategic choices that impact on the company's success. Overall, Swati's role as a marketing manager exemplifies the importance of functional managers in driving the success of their organizations.

- (b) The PESTLE framework can help ABC Corp assess the external factors affecting its decision to expand into a new country by considering the following aspects:

- **Political Factors:** These include the stability of the government, government policies on foreign investment, trade agreements, and regulatory frameworks. By analyzing these factors, ABC Corp can assess the political risks associated with entering the new market.
- **Economic Factors:** Economic factors such as GDP growth rate, inflation rate, exchange rates, and economic stability can impact ABC Corp's decision. By analyzing these factors, the company can

understand the economic environment of the new market and its potential impact on business operations.

- **Social Factors:** Social factors such as cultural norms, demographics, and lifestyle trends can influence consumer behavior and demand for ABC Corp's products. Understanding these factors can help the company tailor its marketing strategies to the new market.
- **Technological Factors:** Technological factors such as infrastructure, technological advancements, and the level of technology adoption in the new market can impact ABC Corp's operations. By assessing these factors, the company can determine the technological requirements for entering the new market.
- **Legal Factors:** Legal factors such as laws and regulations related to foreign investment, intellectual property rights, and labor laws can impact ABC Corp's decision. By analyzing these factors, the company can ensure compliance with legal requirements in the new market.
- **Environmental Factors:** Environmental factors such as climate change, environmental regulations, and sustainability practices can impact ABC Corp's operations and reputation. By considering these factors, the company can assess the environmental risks and opportunities in the new market.

Overall, the PESTLE framework can provide ABC Corp with a comprehensive analysis of the external factors that could impact its decision to expand into a new country, helping the company make informed and strategic decisions.

- (c) To help the small manufacturing company navigate its digital transformation successfully, we would recommend the following strategy:
1. **Begin at the top:** The leadership team should be united and committed to the digital transformation. They should communicate a clear vision for the future of the company and lead by example.
 2. **Ensure that the change is necessary and desired:** Before implementing any changes, the company should assess its current state and identify areas where digital transformation can add value. It's important to involve employees in this process to ensure their buy-in.
 3. **Reduce disruption:** Employee perceptions of change can vary, so it's important to minimize disruption. This can be done by communicating early and often about the changes, providing training and support for employees, and empowering change agents within the organization.

4. **Encourage communication:** Create channels for employees to ask questions and provide feedback. Encourage collaboration between departments to share ideas and innovations. Effective communication can help alleviate fears and keep everyone aligned.
5. **Recognize that change is the norm:** Digital transformation is not a one-time project but an ongoing process. The company should be prepared to adapt to new technologies and market conditions continuously.

By following these best practices, the small manufacturing company can successfully navigate its digital transformation and position itself for future growth and success.

2. (a) The retail company can develop a strategic approach that is both proactive and reactive to address the challenge of increasing competition from online retailers. To achieve this, the company can:

- **Proactive Strategy:** The company can proactively analyze market trends and customer preferences to identify opportunities for growth. For example, it can invest in market research to understand what customers value in a retail experience and tailor its offerings to meet those needs. This proactive approach can help the company stay ahead of competitors and attract new customers.
- **Reactive Strategy:** In addition to proactive measures, the company should also be prepared to react to changes in the market environment. For example, if a competitor launches a new online shopping platform, the company should quickly assess the impact on its business and develop a response. This reactive strategy can help the company adapt to changing market conditions and maintain its competitiveness.

By combining proactive and reactive strategies, the retail company can develop a comprehensive approach to addressing the challenge of increasing competition from online retailers. This approach will allow the company to capitalize on opportunities for growth while also mitigating risks and responding to threats in the market.

- (b) To target tech-savvy consumers for the new smartphone model, the tech company can develop a marketing strategy based on customer behavior. Consumer behaviour may be influenced by a number of things. These elements can be categorised into the following conceptual domains:

- **External Influences:** Utilize online platforms and tech forums to generate buzz around the new smartphone. Partner with tech influencers and bloggers to review the product and create awareness among tech-savvy consumers.
- **Internal Influences:** Appeal to the desire for innovation and advanced features among tech-savvy consumers. Highlight the

unique selling points of the new smartphone, such as its cutting-edge technology, performance, and design.

- **Decision Making:** Recognize that tech-savvy consumers are early adopters who value functionality and performance. Provide detailed specifications and comparisons with other smartphones to help them make an informed decision.
- **Post-decision Processes:** Offer excellent customer service and support to address any technical issues or concerns. Encourage customers to provide feedback and reviews to build credibility and trust among tech-savvy consumers.

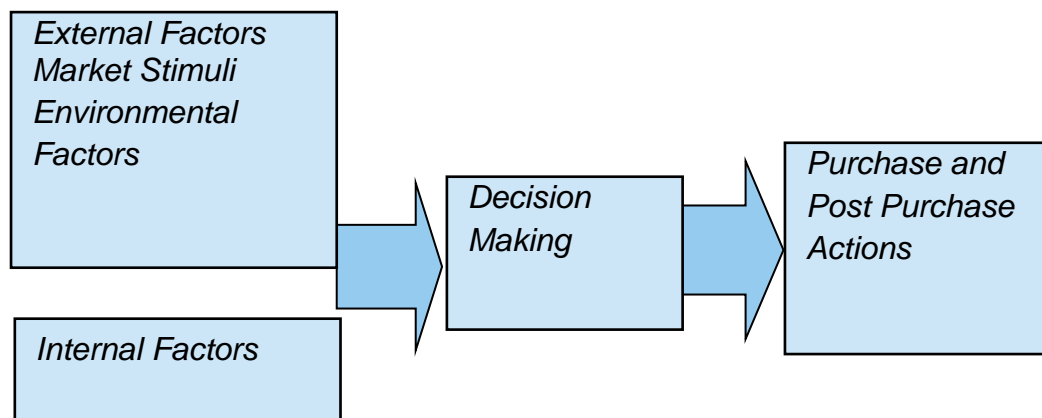


Figure: Process of consumer behaviour

By understanding the behavior of tech-savvy consumers and aligning the marketing strategy with their preferences, the tech company can effectively promote the new smartphone and attract this demographic.

3. (a) To study the market position of rival companies in the energy drink segment, the strategic manager can use **strategic group mapping**. This tool helps identify strategic groups, which consist of rival firms with similar competitive approaches and positions in the market. The procedure for implementing strategic group mapping effectively is as follows:
 1. **Identify the competitive characteristics** that differentiate firms in the industry typical variables that 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).
 2. **Plot the firms on a two-variable map** using pairs of these differentiating characteristics.

3. **Assign firms that fall in about the same strategy space** to the same strategic group.
4. **Draw circles around each strategic group** making the circles proportional to the size of the group's respective share of total industry sales revenues.

By following these steps, the strategic manager can gain valuable insights into the competitive landscape of the energy drink segment and identify potential positioning strategies for the new line of energy drinks targeted at health-conscious consumers.

(b) A workable action plan for turnaround of the textile mill 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 after analyzing strengths and weaknesses in the areas of competitive position.
- **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.

4. (a) Strategic performance measures are essential for organizations for several reasons:

- ♦ **Goal Alignment:** Strategic performance measures help organizations align their strategies with their goals and objectives, ensuring that they are on track to achieve their desired outcomes.
- ♦ **Resource Allocation:** Strategic performance measures provide organizations with the information they need to make informed decisions about resource allocation, enabling them to prioritize their

efforts and allocate resources to the areas that will have the greatest impact on their performance.

- ◆ **Continuous Improvement:** Strategic performance measures provide organizations with a framework for continuous improvement, enabling them to track their progress and make adjustments to improve their performance over time.
- ◆ **External Accountability:** Strategic performance measures help organizations demonstrate accountability to stakeholders, including shareholders, customers, and regulatory bodies, by providing a clear and transparent picture of their performance.

(b) Mendelow's Matrix can be used effectively to analyze and manage stakeholders through a grid-based approach by the following steps:

1. **Identify Stakeholders:** Begin by identifying all relevant stakeholders for your project or organization. This includes individuals, groups, or organizations that may be impacted by or have an impact on your activities.
2. **Assess Power and Interest:** For each stakeholder, assess their power to influence your project or organization and their level of interest in its success. Power can be assessed based on factors such as authority, resources, and expertise, while interest can be gauged by their level of involvement, expectations, and potential benefits or risks.
3. **Plot Stakeholders on the Grid:** Create a grid with Power on one axis and Interest on the other. Plot each stakeholder on the grid based on your assessment. Stakeholders with high power and high interest are placed in the "Key Players" quadrant, those with high power but low interest are in the "Keep Satisfied" quadrant, those with low power but high interest are in the "Keep Informed" quadrant, and those with low power and low interest are in the "Low Priority" quadrant.



4. **Develop Strategies for each Quadrant:** Based on the placement of stakeholders in the grid, develop specific strategies for managing each quadrant:
 - **Key Players:** Fully engage with these stakeholders, seek their input, and keep them informed. They are crucial for the success of your project, so their needs and expectations should be a top priority.
 - **Keep Satisfied:** These stakeholders have significant power but may not be as interested in your project. Keep them satisfied by providing regular updates and addressing any concerns they may have to prevent them from becoming detractors.
 - **Keep Informed:** While these stakeholders may not have much power, they are highly interested in your project. Keep them informed to ensure they remain supportive and to leverage their insights and feedback.
 - **Low Priority:** These stakeholders have low power and interest. Monitor them for any changes but allocate minimal resources to managing their expectations.
5. **Monitor and Adapt:** Continuously monitor the power and interest of stakeholders and adjust your strategies accordingly. Stakeholders may move between quadrants based on changing circumstances, so it's important to remain flexible and responsive.

By using Mendelow's Matrix as a grid-based tool, you can effectively analyze and manage stakeholders by tailoring your engagement strategies to their specific needs and expectations, ultimately increasing the likelihood of project success.

OR

The following are the principal points of distinction between concentric diversification and conglomerate diversification:

- (i) Concentric diversification occurs when a firm adds related products or markets. On the other hand, conglomerate diversification occurs when a firm diversifies into areas that are unrelated to its current line of business.
- (ii) In concentric diversification, the new business is linked to the existing businesses through process, technology or marketing. In conglomerate diversification, no such linkages exist; the new business/product is disjointed from the existing businesses/products.
- (iii) The most common reasons for pursuing concentric diversification are that opportunities in a firm's existing line of business are available. However, common reasons for pursuing a conglomerate growth strategy are that opportunities in a firm's current line of business are limited or opportunities outside are highly lucrative.