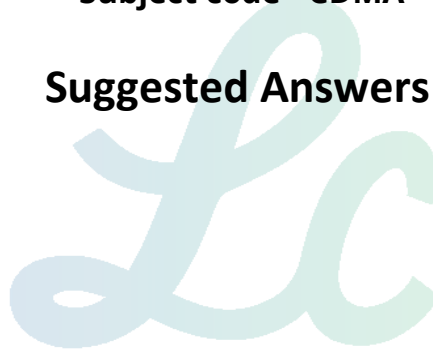


Paper – 2: Strategic Financial Management

NEW SYLLABUS

Subject code - CDMA

Suggested Answers



Disclaimer : The suggested answers given below are prepared as per the views and expertise of All India Rank Holding faculties of Learncab. The workings, notes and assumptions, if any stated, are purely based on the views of the respective faculties of LearnCab and students are encouraged to apply the same in the examination as a good practice. No assurance is given that the answer keys of the Institute of Chartered Accountants of India used for valuation are the same. However, the suggested answers are designed with utmost care in view of the upcoming examination. For the questions, please refer to the question paper



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Question 1(a)

(i) Stock value or conversion value of bond

$$12 \times 20 = \text{Rs. } 240$$

(ii) Percentage of the downside risk

$$\frac{\text{Rs. } 265 - \text{Rs. } 235}{\text{Rs. } 235} = 0.1277 \text{ or } 12.77\%$$

This ratio gives the percentage price decline experienced by the bond if the stock becomes worthless.

(iii) Conversion Premium

$$\frac{\text{Market Price} - \text{Conversion Value}}{\text{Conversion Value}} \times 100$$
$$\frac{\text{Rs. } 265 - \text{Rs. } 240}{\text{Rs. } 240} \times 100 = 10.42\%$$

(iv) Conversion Parity Price

$$\frac{\text{Bond Price}}{\text{No. of Shares on Conversion}}$$
$$\frac{\text{Rs. } 265}{20} = \text{Rs. } 13.25$$

This indicates that if the price of shares rises to Rs. 13.25 from Rs. 12 the investor will neither gain nor lose on buying the bond and exercising it. Observe that Rs. 1.25 (Rs. 13.25 – Rs. 12.00) is 10.42% of Rs. 12, the Conversion Premium.

Question 1(b)

The optional hedge ratio to minimize the variance of Hedger's position is given by:

$$H = \frac{\rho \cdot \sigma_S}{\sigma_F}$$

Where

σ_S = Standard deviation of ΔS

σ_F = Standard deviation of ΔF

ρ = coefficient of correlation between ΔS and ΔF H = Hedge Ratio

ΔS = change in Spot price.

ΔF = change in Future price.

Accordingly

$$H = \frac{0.75 \times 0.04}{0.06} = 0.5$$

No. of contract to be short = $10 \times 0.5 = 5$

Amount = $5000 \times \text{Rs. } 474 = \text{Rs. } 23,70,000$

Question 1(c):

Option - I

$$\$20 \times 5000 = \$ 1,00,000$$

$$\text{Repayment in 3 months time} = \$1,00,000 \times (1 + 0.10/4) = \$ 1,02,500$$

$$\text{3-months outright forward rate} = \text{Rs. } 59.90/ \text{Rs. } 60.30$$

$$\text{Repayment obligation in Rs. } (\$1,02,500 \times \text{Rs. } 60.30) = \text{Rs. } 61,80,75$$

Option -II

Overdraft (\$1,00,000 x Rs.60.55)	Rs. 60,55,000
Interest on Overdraft (Rs.60,55,000 x 0.14/4)	<u>Rs. 2,11,925</u>
	Rs. 62,66,925

Option I should be preferred as it has lower outflow.

Question 1 (d)

$$\begin{aligned} \text{Yield for 9 months } (120\% \times 9/12) &= 90\% \\ \text{Market value of Investments as on 31.03.2011} &= \text{Rs. } 50,000/- + (\text{Rs. } 50,000 \times 90\%) = \text{Rs. } \\ 95,000 & \\ \text{Therefore, NAV as on 31.03.2011} &= (\text{Rs. } 95,000 - \text{Rs. } 5,000)/5,000 = \text{Rs. } \\ 18.00 & \end{aligned}$$

$$\text{Since dividend was reinvested by Mr. X, additional units acquired} = \frac{\text{Rs. } 5,000}{\text{Rs. } 18} = 277.78 \text{ unit}$$

$$\begin{aligned} \text{Therefore, units as on 31.03.2011} &= 5000 + 277.78 = 5277.78 \\ \text{Alternatively, units as on 31.03.2011} &= (\text{Rs. } 95000/\text{Rs. } 18) = 5277.78 \\ \text{Dividend as on 31.03.2012} &= 5277.78 \times \text{Rs. } 10 \times 0.2 = \text{Rs. } 10555.56 \\ \text{Let X be the NAV on 31.03.2012, then number of new units reinvested will be } & \text{Rs. } 10,555.56/X. \end{aligned}$$

Accordingly, 6,271.98 units shall consist of reinvested units and 5277.78 (as on 31.03.2011). Thus, by way of equation it can be shown as follows:

$$6271.98 = \frac{\text{Rs. } 10,555.56}{X} + 5277.78$$

$$\begin{aligned} \text{Therefore, NAV as on 31.03.2012} &= \text{Rs. } 10,555.56 / (6,271.98 - 5,277.78) = \text{Rs. } 10.62 \\ \text{NAV as on 31.03.2013} &= \text{Rs. } 50,000 (1 + 0.715 \times 33/12) / 6,271.98 = \text{Rs. } 23.65 \end{aligned}$$

Question 2(a)

Date	Sensex	Signs	Runs
1.10.07	2800		
3.10.07	2780	-	1
4.10.07	2795	+	1
5.10.07	2830	+	0
8.10.07	2760	-	1
9.10.07	2790	+	1
10.10.07	2880	+	0
11.10.07	2960	+	0
12.10.07	2990	+	0
15.10.07	3200	+	0
16.10.07	3300	+	0
17.10.07	3450	+	0
19.10.07	3360	-	1
22.10.07	3290	-	0
23.10.07	3360	+	1
24.10.07	3340	-	1
25.10.07	3290	-	0
29.10.07	3240	-	0
30.10.07	3140	-	0
31.10.07	3260	+	1

n1 11
n2 8
N 8

No of Positive changes = n1 = 11
No. of Negative changes = n2 = 08
N = Number of test runs = 8
(where direction is changed)

$$\mu = \frac{2n_1n_2}{n_1 + n_2} + 1$$

$$\mu = \frac{2(11)(8)}{11 + 8} + 1$$

$$\mu = 10.26$$

$$\sigma = \sqrt{\frac{2n_1n_2(2n_1n_2 - n_1 - n_2)}{(n_1 + n_2)^2(n_1 + n_2 - 1)}}$$

$$\sigma = \sqrt{\frac{2(11)(8)(2(11)(8) - 11 - 8)}{(11 + 8)^2(11 + 8 - 1)}}$$

$$\sigma = \sqrt{\frac{197(57)}{(19)^2(18)}} = 2.06$$

d.of. $n_1+n_2-1 = 11+8-1 = 18$

Testing of hypothesis

	$\mu - t \times \sigma$	$\mu + t \times \sigma$
Test at 5% level of significance with 18 d.o.f t = 2.101	=10.26 - 2.101 × 2.06 = 5.932	=10.26 + 2.101 × 2.06 = 14.588
Test at 10% level of significance with 18 d.o.f t = 1.734	=10.26 - 2.101 × 1.734 = 6.688	=10.26+2.101 × 1.734 = 13.832

N lies between these limits. Hence, the market exhibits weak form of efficiency

Question 2(b)

- (a) Calculation of maximum price per share at which PQR Ltd. can offer to pay for XYZ Ltd.'s share

Market Value (10,00,000 x Rs. 24)	Rs. 2,40,00,000
Synergy Gain	Rs. 80,00,000
Saving of Overpayment	Rs. 30,00,000
	Rs. 3,50,00,000
Maximum Price (Rs. 3,50,00,000/10,00,000)	Rs. 35

- (b) Calculation of minimum price per share at which the management of XYZ Ltd.'s will be willing to offer their controlling interest

Value of XYZ Ltd.'s Management Holding (40% of 10,00,000 x Rs. 24)	Rs. 96,00,000
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Add: PV of loss of remuneration to top management	Rs. 30,00,000
	Rs. 1,26,00,000
No. of Shares	4,00,000
Minimum Price (Rs. 1,26,00,000/4,00,000)	Rs. 31.50

Question 2(c)

Differences between a startup and entrepreneurship Startups are different from entrepreneurship. The major differences between them have been discussed in the following paragraphs:

- (i) Start up is a part of entrepreneurship. Entrepreneurship is a broader concept and it includes a startup firm.
- (ii) The main aim of startup is to build a concern, conceptualize the idea which it has developed into a reality and build a product or service. On the other hand, the major objective of an already established entrepreneurship concern is to attain opportunities with regard to the resources they currently control.
- (iii) A startup generally does not have a major financial motive whereas an established entrepreneurship concern mainly operates on financial motive.

Priorities and challenges which startups in India are facing

The priority is on bringing more and more smaller firms into existence. So, the focus is on need based, instead of opportunity based entrepreneurship. Moreover, the trend is to encourage self - employment rather than large, scalable concerns.

The main challenge with the startup firms is getting the right talent. And, paucity of skilled workforce can hinder the chances of a startup organization's growth and development. Further, startups had to comply with numerous regulations which escalates it's cost. It leads to further delaying the chances of a breakeven or even earning some amount of profit.

Question 3(a)

(i) Beta of the Portfolio

Security	Market Price	No. of Shares	Value	β	Value x β
A	29.40	400	11760	0.59	6938.40
B	318.70	800	254960	1.32	336547.20
C	660.20	150	99030	0.87	86156.10
D	5.20	300	1560	0.35	546.00
E	281.90	400	112760	1.16	130801.60
F	275.40	750	206550	1.24	256122.00
G	514.60	300	154380	1.05	162099.00

H	170.50	900	153450	0.76	116622.00
			994450		1095832.30

$$\text{Portfolio Beta} = \frac{10,95,832.30}{9,94,450} = 1.102$$

(ii) Theoretical Value of Future Contract Expiring in May and June

$$F = Se^{rt}$$

$$F_{\text{May}} = 8500 \times e^{0.20 \times (2/12)} = 8500 \times e^{0.0333}$$

$e^{0.0333}$ shall be computed using Interpolation Formula as follows:

$e^{0.03}$	= 1.03045
$e^{0.04}$	= 1.04081
$e^{0.01}$	= 0.01036
$e^{0.0033}$	= 0.00342
$e^{0.0067}$	= 0.00694

$$e^{0.0333} = 1.03045 + 0.00342 = 1.03387 \text{ or } 1.04081 - 0.00694 = 1.03387$$

According the price of the May Contract

$$8500 \times 1.03387 = \text{Rs. } 8788$$

Price of the June Contract

$$F_{\text{May}} = 8500 \times e^{0.20 \times (3/12)} = 8500 \times e^{0.05} = 8500 \times 1.05127 = 8935.80$$

(i) No. of NIFTY Contracts required to sell to hedge until June

$$\frac{\text{Value of Position to be hedged} \times \beta}{\text{Value of Future Contract}}$$

(A) Total portfolio

$$\frac{994450 \times 1.102}{8850 \times 25} = 4.953 \text{ say 5 contracts}$$

$$8850 \times 25$$

(B) 50% of Portfolio

$$\frac{994450 \times 0.50 \times 1.102}{8850 \times 25} = 2.47 \text{ say 3 contracts}$$

$$8850 \times 25$$

(C) 120% of Portfolio

$$\frac{994450 \times 1.20 \times 1.102}{8850 \times 25} = 5.94 \text{ say 6 contracts}$$

$$8850 \times 25$$

Question 3(b)

In order to find out the NAV, the cash balance at the end of the year is calculated as follows-

Particulars	Rs.
Cash balance in the beginning (Rs. 100 lakhs – Rs. 98 lakhs)	2,00,000
Dividend Received	12,00,000

Interest on 7% Govt. Securities	56,000
Interest on 9% Debentures	45,000
Interest on 10% Debentures	50,000
	<u>15,51,000</u>
(-) Operating expenses	5,00,000
Net cash balance at the end	10,51,000
Calculation of NAV	Rs.
Cash Balance	10,51,000
7% Govt. Securities (at par)	8,00,000
50,000 equity shares @ Rs. 175 each	87,50,000
9% Debentures (Unlisted) at cost	5,00,000
10% Debentures @90%	4,50,000
Total Assets	<u>1,15,51,000</u>
No. of Units	<u>10,00,000</u>
NAV per Unit	<u>Rs. 11.55</u>

Calculation of NAV, if dividend of Rs. 0.80 is paid –

Net Assets (Rs. 1,15,51,000 – Rs. 8,00,000) Rs. 1,07,51,000

No. of Units 10,00,000

NAV per unit Rs. 10.75

Question 3(c)

EITHER

Inter Bank Participation Certificate (IBPC): The Inter Bank Participation Certificates are short term instruments to even out the short-term liquidity within the Banking system particularly when there are imbalances affecting the maturity mix of assets in Banking Book.

The primary objective is to provide some degree of flexibility in the credit portfolio of banks. It can be issued by schedule commercial bank and can be subscribed by any commercial bank.

The IBPC is issued against an underlying advance, classified standard and the aggregate amount of participation in any account time issue. During the currency of the participation, the aggregate amount of participation should be covered by the outstanding balance in account.

There are two types of participation certificates, with risk to the lender and without risk to the lender. Under 'with risk participation', the issuing bank will reduce the amount of participation from the advances outstanding and participating bank will show the participation as part of its advances. Banks are permitted to issue IBPC under 'with risk' nomenclature classified under Health Code-I status and the aggregate amount of such participation in any account should not exceed 40% of outstanding amount at the time of issue. The interest rate on IBPC is freely determined in the market. The certificates are neither transferable nor prematurely redeemable by the issuing bank.

Under without risk participation, the issuing bank will show the participation as borrowing from banks and participating bank will show it as advances to bank.

The scheme is beneficial both to the issuing and participating banks. The issuing bank can secure funds against advances without actually diluting its asset-mix. A bank having the highest loans to total asset ratio and liquidity bind can square the situation by issuing IBPCs. To the lender, it provides an opportunity to deploy the short-term surplus funds in a secured and profitable manner. The IBPC with risk can also be used for capital adequacy management. This is simple system as compared to consortium tie up.

OR

Although there are number of Islamic Finance products, but some of common products/instruments are as follows:

Mudaraba: The Mudaraba is a kind of profit-sharing arrangement wherein one party provides 100% of the capital involved and other party provides specialized knowledge and entrusted with exclusive responsibility of working. In case there is profit it shared among them in the pre-decided ratio and if there is loss only financier will be borne the same.

Musharaka: It is a kind of joint business venture wherein all parties provide the capital in the business in agreed ratio and also have right to participate in the business. While the loss is strictly shared in the ratio of their capital contribution, the profit is shared as per pre-agreed ratio.

Sukuk: It is one of the most popular Islamic financial products. It is a kind of 'Debt Certificate' representing ownership in business or assets and through this instrument company borrows the money. Although it appears to be conventional debt instruments but is differs in following aspects:

- To have share in profit of assets.
- To have share in the underlying assets on realization of assets

Ijara: It is a kind of lease financing arrangement wherein one party transfer the asset to other partly for some specific time for specific fee which includes capital cost of assets and profit margin of the lessor. In this arrangement, the responsibility for maintenance of the leased items remains with the lessor.

Murabaha: Also, known as cost plus contract it is a kind of trade credit or loans and mainly helps exporters and importer in meeting their funding requirements. The main feature of this arrangement is that profit margin of the financier is known to the buyer. In this a arrangement financier buys thee assets and sells to the client (buyer) and buyer pays to the financier in installments consisting of following two elements:

- Cost of asset financed.
- Financier's profit on acquisition of asset.

Istisna: It is a kind of funding arrangements for long term construction contracts wherein client pays some initial amount and balance amount is payable is repaid in installments. The whole project is funded by the financier and completion of project it is delivered to the client.

Salam: It is analogues to forward contract in the conventional finance. Though cash is received by the seller immediately on sale but goods as per pre-decided quality, quantity and time shall

only be delivered in future. This sale shall be at the discounted price so that financier could make some profit out of the deal. However, it is important to note that Salam is prohibited in commodities such a gold, silver and other type of monetary assets.

Question 4(a)

Interest and Commission due from Sleepless = Rs. 50 crore (0.10+0.002) = Rs. 5.10 crore

Net Sum Due to Sleepless in each of Scenarios

Scenario 1

Year	PLR	Sum due to Sleepless	Net Sum Due (Rs. Crore)		(Rs. Crore)
1	10.25	50 (10.25 + 0.8)%= 5.525	5.10 – 5.525 = - 0.425	0.909	-0.38633
2	10.5	50 (10.50 + 0.8)%= 5.650	5.10 – 5.650 = - 0.550	0.826	-0.4543
3	10.75	50 (10.75 + 0.8)%= 5.775	5.10 – 5.775 = - 0.675	0.751	-0.50693
4	11	50 (11.00 + 0.8)%= 5.900	5.10 – 5.900 = - 0.800	0.683	-0.5464
					<u>-1.89395</u>

Scenario 2

Year	PLR	Sum due to Sleepless	Net Sum Due (Rs. Crore)		(Rs. Crore)
1	8.75	50 (8.75 + 0.8)%= 4.775	5.10 – 4.775 = 0.325	0.909	0.295425
2	8.85	50 (8.85 + 0.8)%= 4.825	5.10 – 4.825 = 0.275	0.826	0.22715
3	8.85	50 (8.85 + 0.8)%= 4.825	5.10 – 4.825 = 0.275	0.751	0.206525
4	8.85	50 (8.85 + 0.8)%= 4.825	5.10 – 4.825 = 0.275	0.683	0.187825
					<u>0.916925</u>

Scenario 3

Year	PLR	Sum due to Sleepless	Net Sum Due (Rs. Crore)		(Rs. Crore)
1	7.20	50 (7.20 + 0.8)% = 4.00	5.10 – 4.00 = 1.10	0.909	0.9999
2	7.40	50 (7.40 + 0.8)% = 4.10	5.10 – 4.10 = 1.00	0.826	0.826
3	7.60	50 (7.60 + 0.8)% = 4.20	5.10 – 4.20 = 0.90	0.751	0.6759
4	7.70	50 (7.70 + 0.8)% = 4.25	5.10 – 4.25 = 0.85	0.683	0.58055
					<u>3.08235</u>

Decision: Since the NPV of the proposal is positive in Scenario 2 (Best Case) and Scenario 3 (Most likely Case) the proposal of swap can be accepted. However, if management of No Bank

is of strong opinion that PLR are likely to be more than 10% in the years to come then it can reconsider its decision.

Question 4(b)

Receipts using a forward contract = $1,00,000/0.02127$	= Rs. 47,01,457
Receipts using currency futures	
The number of contracts needed is $(1,00,000/0.02118)/4,72,000 = 10$	
Initial margin payable is $10 \times \text{Rs. } 15,000 = \text{Rs. } 1,50,000$	
On September 1 Close at 0.02133	
Receipts = $\text{US\$}1,00,000/0.02133$	= 46,88,233
Variation Margin = $[(0.02134 - 0.02118) \times 10 \times 472000/-]/0.02133$	
OR $(0.00016 \times 10 \times 472000)/.02133 = 755.2/0.02133$	<u>=35,406</u>
	47,23,639
Less: Interest Cost – $1,50,000 \times 0.08 \times 3/12$	=Rs. 3,000
Net Receipts	<u>=Rs. 47,20,639</u>

Receipts under different methods of hedging

Forward contract Rs. 47,01,457

Futures Rs. 47,20,639

No hedge

US\$ 1,00,000/0.02133 Rs. 46,88,233

The most advantageous option would have been to hedge with futures.

Question 5(a)

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 declared

$$100 = \frac{1}{1+0.10} \times (15 + P_1)$$

$$100 = \frac{15 + P_1}{1.10}$$

$$110 = 15 + P_1$$

$$P_1 = 110 - 15 = \underline{95}$$

The market price of the equity share at the end of the year would be Rs. 95

(ii) If the dividend is not declared:

$$100 = \frac{1}{1+0.10} \times (0 + P_1)$$

$$100 = \frac{P_1}{1.10}$$

$$P_1 = 110$$

The Market price of the equity share at the end of the year would be Rs. 110.

- (iii) In case the firm pays dividend of Rs. 15 per share out of total profits of Rs. 6,00,000 and plans to make new investment of Rs. 12,00,000, the number of shares to be issued may be found as follows:

Total Earnings	Rs. 6,00,000
- Dividends paid	<u>Rs. 1,50,000</u>
Retained earnings	Rs. 4,50,000
Total funds required	<u>Rs. 12,00,000</u>
Fresh funds to be raised	<u>Rs. 7,50,000</u>
Market price of the share	Rs. 95

Number of shares to be issued (Rs. 7,50,000 / Rs.95)

$$7,894.74$$

or, the firm would issue 7895 shares at the rate of Rs. 95

Question 4 (c)

FCCBs are important source of raising funds from abroad. Their salient features are –

1. FCCB is a bond denominated in a foreign currency issued by an Indian company which can be converted into shares of the Indian Company denominated in Indian Rupees.
2. Prior permission of the Department of Economic Affairs, Government of India, Ministry of Finance is required for their issue
3. There will be a domestic and a foreign custodian bank involved in the issue
4. FCCB shall be issued subject to all applicable Laws relating to issue of capital by a company.
5. Tax on FCCB shall be as per provisions of Indian Taxation Laws and Tax will be deducted at source.
6. Conversion of bond to FCCB will not give rise to any capital gains tax in India.

Question 5(b)

Decision Tree showing pay off

Year 0	Year 1	Abandonment Pay off
Rs. 100	130	0
	60	80-60 = 20

First of all, we shall calculate probability of high demand (P) using risk neutral method as follows:

$$8\% = p \times 30\% + (1-p) \times (-40\%)$$

$$0.08 = 0.30p - 0.40 + 0.40p$$

$$p = \frac{0.48}{0.70} = 0.686$$

The value of abandonment option will be computed as follows:

Expected Payoff at Year 1

$$= p \times 0 + [(1-p) \times 20]$$

$$= 0.686 \times 0 + [0.314 \times 20]$$

$$= \text{Rs. } 6.28 \text{ crore}$$

Since expected pay off at year 1 is 6.28 crore. Present value of expected pay off will be:

$$\frac{6.28}{1.08} = 5.81 \text{ crore.}$$

$$1.08$$

Thus, the value of abandonment option (Put Option) is Rs. 5.80 crore.

Question 5 (c)

The interface of strategic management and financial policy will be clearly understood if we appreciate the fact that the starting point of an organization is money and the end point of that organization is also money. No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base.

Sources of finance and capital structure are the most important dimensions of a strategic plan. The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and / or preference shares for mobilizing ownership capital. Along with the mobilization of funds, policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital. There are some norms for debt equity ratio. However, this ratio in its ideal form varies from industry to industry. It also depends on the planning mode of the organization under study.

Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions. A planner has to frame policies for regulating investments in fixed assets and for restraining of current assets. Investment proposals mooted by different business units may be addition of a new product, increasing the level of operation of an existing product and cost reduction and efficient utilization of resources through a new approach and or closer monitoring of the different critical activities.

Now, given these three types of proposals a planner should evaluate each one of them by making within group comparison in the light of capital budgeting exercise.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the firm.

It may be noted from the above discussions that financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. These policies being related to external awareness about the firm, specially the awareness of the investors about the firm, in respect of its internal performance. There is always a process of evaluation active in the minds

Question6(a)

$$\begin{aligned}
 ER &= R_f + \beta (R_m - R_f) \\
 &= 8 + 1.5 (12 - 8) \\
 &= 8 + 1.5 (4) \\
 &= 8 + 6 \\
 &= 14\% \text{ or } 0.14
 \end{aligned}$$

Applying Dividend Growth Model for the calculation of per share equilibrium price:

$$\begin{aligned}
 ER &= \frac{D_1}{P_0} + g \\
 0.14 &= \frac{3 (1.10)}{P_0} + 0.10 \\
 0.14 - 0.10 &= \frac{3.30}{P_0} \\
 0.04 P_0 &= 3.30
 \end{aligned}$$

$$P_0 = \frac{3.30}{0.04} = \text{Rs. } 82.50$$

Per share equilibrium price will be Rs. 82.50.

Question 6 (b)

Identify: Foreign currency is an asset. Amount \$ 3,50,000.

Create: \$ Liability.

Borrow: In \$. The borrowing rate is 9% per annum or 2.25% per quarter.

Amount to be borrowed: $3,50,000 / 1.0225 = \$ 3,42,298.29$

Convert: Sell \$ and buy £. The relevant rate is the Ask rate, namely, 1.5905 per £, (Note: This is an indirect quote). Amount of £s received on conversion is 2,15,214.27 ($3,42,298.29 / 1.5905$).

Invest: £ 2,15,214.27 will be invested at 5% for 3 months and get £ 2,17,904.45

Settle: The liability of \$3,42,298.29 at interest of 2.25 per cent quarter matures to \$3,50,000 receivable from customer.

Using forward rate, amount receivable is $= 3,50,000 / 1.6140 = £2,16,852.54$

Amount received through money market hedge = £2,17,904.45

Gain = $2,17,904.45 - 2,16,852.54 = £1,051.91$

So, money market hedge is beneficial for the exporter

Question 6(c)

Clearing house is an exchange-associated body charged with the function of ensuring (guaranteeing) the financial integrity of each trade. Orders are cleared by means of the clearinghouse acting as the buyer to all sellers and the seller to all buyers. Clearing houses provide a range of services related to the guarantee of contracts, clearance and settlement of trades, and management of risk for their members and associated exchanges.

Role of Clearing Houses

- It ensures adherence to the system and procedures for smooth trading.
 - It minimizes credit risks by being a counter party to all trades.
 - It involves daily accounting of all gains or losses.
 - It ensures delivery of payment for assets on the maturity dates for all outstanding contracts.
- It monitors the maintenance of speculation margins.

of the current and future stake holders of the company. As a result, preference and patronage for the company depends significantly on the financial policy framework. And hence attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself.

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