THE OPEN UNIVERSITY OF SRI LANKA
COMMONWEALTH EXECUTIVE MASTER OF BUSINESS/PUBLIC ADMINSITRATION
FINAL EXAMINATION – March 2009
MCP 2610 – CORPORATE FINANCE
DURATION: THREE (03) HOURS

Date : 21.03.2009	**Time : 9.30 am – 12.30 pm**

Answer only five questions, including question numbers 02, 03 and 04
Calculators are allowed.

Q 01,

(a) What is the basic objective of corporate finance? Briefly discuss the major problems encountered by a financial manager in achieving this objective,

(b) " Role of a financial manager is not only raising funds". Discuss this statement.
(17 Marks)

Q 02,

(a) Why "Net Present Value" method is considered to be superior to other capital budgeting techniques? Discuss briefly using Internal Rate of Return and Pay-back Period methods,

(b) "Sri-Lanka Glass company", a plastic glass manufacturer, is considering a proposal of production of high quality plastic glasses. The required equipment for the proposal would cost Rs. 400,000 and the effective life time of this equipment is estimated to five years. The tax relevant rate of depreciation is 25 percent per year on written down value. The expected salvage value of this equipment is estimated to Rs.40,000. The glasses can be sold at Rs 16 each. Regardless of the level of production, the company will incur cash cost of Rs.100,000 each year if the project is under taken. The overhead costs allocated to this new production line would be Rs.20,000. The variable costs are estimated at Rs.8 per glass. The company estimates to sell 300,000 glasses per year; the tax rate is 35 percent. Should the new product be produced? Assume 20 percent cost of capital and additional working capital requirement of Rs. 200,000.

(c) (1) What is risk in capital budgeting? How can the risk be measured?

(11) A company is considering an investment in two mutually exclusive projects. Project "Kelani" which involves an initial investment of Rs. 500,000 and project "Mahawali" which has an initial investment of Rs.400,000. Company uses Certainty-equivalent approach to evaluate risk in capital budgeting. The current yield on risk-free investment is 16 percent. The expected net cash flows of these two project with their certainty equivalents are as follows

Year	Project Kelani Cash flow (in Rs,000)	Certainty Equivalent	Year	project Mahawali Cash flow (in Rs.000)	Certainty equivalent
1	150	0.8	1	180	0.9
2	170	0.6	2	200	0.7
3	200	0.5	3	220	0.4
4	160	0.5	4	170	0.2

(a) Which project should be acceptable to the company?

(b) Which project is riskier? Justify your answer

(22 Marks)

Q 03

(a) Briefly explain the major methods of financial statement analysis,

(b) " Ratio Analysis " is one of the most widely used technique by the financial analysts even with its major limitations. Discuss in short with appropriate examples.

(c) You are given the following information pertaining to the financial statement of "Abey" company Ltd, as at 31st December 2008. on the basis of the information supplied, you are required to prepare the Trading and Profit and Loss Account for the year ended and a Balance Sheet as on that date.

Net Current Assets	Rs. 200,000
Issued Share Capital	Rs. 600,000
Current Ratio	1.8 to 1
Quick Assets Ratio	1.35 to 1
Fixed Assets to Shareholders' Equity	80%
Gross Profit ratio to sales	25%
Net Profit to Issued Share Capital	20%
Stock Turnover	5 times
Debtors Period	36.5 days

On 31st December 2008 , the current assets consisted only stock, debtors, and bank balance ; liabilities consisted of share capital and current liabilities and assets consisted of fixed and current assets.

(d) Followings are the two Balance Sheets given to you related to a sole proprietorship

Balance Sheet as at 1st January 2008

		Rs			Rs.
Capital		150,000	Fixed Assets:		
			Land and buildings	100,000	
Long Term Liabilities			Furniture	10,000	
10% Loan		60,000			110,000
Current Liabilities			Current Assets		
Creditors	40,000		Stocks	80,000	
Bills Payables	10,000		Debtors	20,000	
		50,000	Bills Receivables	10,000	
			Cash/ bank balance	40,000	
					150,000
		260,000			260,000

Balance Sheet as at 31st December 2008

		Rs			RS
Capital Account			Fixed Assets:		
Balance at 1/1, 150,000			Land and buildings	135,000	
Add: Net Profit 60,000			Furniture	18,000	
Less: Drawings(20,000)		190,000			153,000
Long-term Liabilities			Investments		27,000
10% loan		40,000	Current Assets:		
Current Liabilities:			Stocks	60,000	
Creditors	20,000		Debtors	26,000	
Bills Payables	8,000		Bills Receivables	12,000	
Bank O/D	20,000	48,000			98,000
		278,000			278,000

You are provided with the following additional information:

1. Depreciation on furniture for the year was Rs. 4,000,
2. Rs 20,000 and Rs. 6,000 have been paid as loan installment and interest Respectively, during the year,
3. No investment income was credited to the P/L account for the year.

The shop owner was hospitalized during 2nd half of the year 2008,and the shop was managed by the paid manager. The owner suspects his manager for cash misappropriation assuming that there cannot be a bank overdraft of Rs 20,000 at the end of year 2008 since the business has maid a net profit of Rs 60,000 for the year. Give your opinion to the shop owner on this matter.

(22 Marks)

Q 04.

(a) Discuss the advantages of leasing. What are its limitations?

(b) Differentiate leasing and hire-purchase,

(c) The managing director of General Electronic Company Ltd, is evaluating the company's policy regarding computers, which are now being leased on a yearly basis on rental amounting to Rs.1,000,000 per year. The computers can be bought for 5,000,000. the purchase would be financed by 16 percent loan repayable in 4 equal annual installments.
On account of rapid technological progress in the computer industry, it is suggested that a 4-year economic life should be used, instead of the 10 years physical life. It is estimated that the computers would be sold for Rs.2,000,000 at the end of 4 years. The company uses the straight line method of depreciation. Corporate tax rate is 50 percent.
Comment on whether the equipment should be bought or leased?

(22 Marks)

Q 05

(a) What is meant by the term "leverage" What its type? With what type of risk is each leverage generally associated? Why is increasing leverage also indicative of increasing risk?

(b) A firm's sales, variable costs and fixed cost amounted to Rs. 6,000,000, Rs.3,000,000,and Rs.500,000 respectively. It has borrowed Rs. 3,000,000 at 10percent and its capitals totals to Rs.4,000,000.
    (a) What is firm's ROI,
    (b) What are the operating, financial, and combined leverages of the firm?

(c) Beta limited is considering three financial plans. The key information as follows:
    (a) Total funds to be raised Rs.200,000
    (b) Financing plans:

Plan	Equity(%)	Debt(%)	Preference(%)
A	100	-------	-------
B	50	50	-------
C	50	-------	50

(c) Cost of debt 8 percent; cost of preference shares 8 percent,
(d) Tax rate, 35 percent,
(e) Equity shares of the face value of Rs.10 each will be issued at a premium of Rs. 10 per share,
(f) Expected EBIT, Rs. 80,000
Determine earning per share (EPS) and financial break-even point for each plans.

(d) Company A and B are in the same risk class, and are identical in every respect expect that company A uses debt, while company B does not. The levered firm has Rs.500,000 debentures, carrying 12percent interest rate. Both firms earn 25 percent operating profits on their total assets of Rs.2,000,000. tax rate is 40 percent and capitalization rate of 18 percent for an all-equity company.

(a) Compute the value of firms A and B using the Net Income (NI) approach,
(b) Compute the value of firms A and B using the Net Operating Income (NOI) approach.

(e) Briefly discuss criticisms against MM theory.

(17 Marks)

Q 06

(a) What are hybrid financial Instruments?

(b) What is conversion feature? What is conversion ratio?

(c) Colombo Manufactures has current earnings of Rs. 6 per shares with 500,000 shares outstanding. It is planning to issue 40,000 shares of 9 percent, Rs. 100 par value convertible preference shares at par. The preference share is convertible into 2 ordinary shares for each preference share held. The current market price of ordinary shares is Rs. 42 per share.

(a) Compute the conversion value of preference shares,
(b) Compute the conversion premium.

(d) What is a warrant? How does it differ from convertible securities?

(e) Explain briefly (1) Theoretical value, (2) Market value, and (3) premium of a Warrant.

(17 Marks)

Table 1

Present Value of $1

$$PV = \frac{1}{(1+i)^n}$$

Periods	3%	4%	5%	6%	7%	8%	10%	12%	14%	16%	18%	20%	22%	24%	25%	26%	28%	30%	40%
1	.9709	.9615	.9524	.9434	.9346	.9259	.9091	.8929	.8772	.8621	.8475	.8333	.8197	.8065	.8000	.7937	.7813	.7692	.7143
2	.9426	.9246	.9070	.8900	.8734	.8573	.8264	.7972	.7695	.7432	.7182	.6944	.6719	.6504	.6400	.6299	.6104	.5917	.5102
3	.9151	.8890	.8638	.8396	.8163	.7938	.7513	.7118	.6750	.6407	.6086	.5787	.5507	.5245	.5120	.4999	.4768	.4552	.3644
4	.8885	.8548	.8227	.7921	.7629	.7350	.6830	.6355	.5921	.5523	.5158	.4823	.4514	.4230	.4096	.3968	.3725	.3501	.2603
5	.8626	.8219	.7835	.7473	.7130	.6806	.6209	.5674	.5194	.4761	.4371	.4019	.3700	.3411	.3277	.3149	.2910	.2693	.1859
6	.8375	.7903	.7462	.7050	.6663	.6302	.5645	.5066	.4556	.4104	.3704	.3349	.3033	.2751	.2621	.2499	.2274	.2072	.1328
7	.8131	.7599	.7107	.6651	.6227	.5835	.5132	.4523	.3996	.3538	.3139	.2791	.2486	.2218	.2097	.1983	.1776	.1594	.0949
8	.7894	.7307	.6768	.6274	.5820	.5403	.4665	.4039	.3506	.3050	.2660	.2326	.2038	.1789	.1678	.1574	.1388	.1226	.0678
9	.7664	.7026	.6446	.5919	.5439	.5002	.4241	.3606	.3075	.2630	.2255	.1938	.1670	.1443	.1342	.1249	.1084	.0943	.0484
10	.7441	.6756	.6139	.5584	.5083	.4632	.3855	.3220	.2697	.2267	.1911	.1615	.1369	.1164	.1074	.0992	.0847	.0725	.0346
11	.7224	.6496	.5847	.5268	.4751	.4289	.3505	.2875	.2366	.1954	.1619	.1346	.1122	.0938	.0859	.0787	.0662	.0558	.0247
12	.7014	.6246	.5568	.4970	.4440	.3971	.3186	.2567	.2076	.1685	.1372	.1122	.0920	.0757	.0687	.0625	.0517	.0429	.0176
13	.6810	.6006	.5303	.4688	.4150	.3677	.2897	.2292	.1821	.1452	.1163	.0935	.0754	.0610	.0550	.0496	.0404	.0330	.0126
14	.6611	.5775	.5051	.4423	.3878	.3405	.2633	.2046	.1597	.1252	.0985	.0779	.0618	.0492	.0440	.0393	.0316	.0254	.0090
15	.6419	.5553	.4810	.4173	.3624	.3152	.2394	.1827	.1401	.1079	.0835	.0649	.0507	.0397	.0352	.0312	.0247	.0195	.0064
16	.6232	.5339	.4581	.3936	.3387	.2919	.2176	.1631	.1229	.0930	.0708	.0541	.0415	.0320	.0281	.0248	.0193	.0150	.0046
17	.6050	.5134	.4363	.3714	.3166	.2703	.1978	.1456	.1078	.0802	.0600	.0451	.0340	.0258	.0225	.0197	.0150	.0116	.0033
18	.5874	.4936	.4155	.3503	.2959	.2502	.1799	.1300	.0946	.0691	.0508	.0376	.0279	.0208	.0180	.0156	.0118	.0089	.0023
19	.5703	.4746	.3957	.3305	.2765	.2317	.1635	.1161	.0829	.0596	.0431	.0313	.0229	.0168	.0144	.0124	.0092	.0068	.0017
20	.5537	.4564	.3769	.3118	.2584	.2145	.1486	.1037	.0728	.0514	.0365	.0261	.0187	.0135	.0115	.0098	.0072	.0053	.0012
21	.5375	.4388	.3589	.2942	.2415	.1987	.1351	.0926	.0638	.0443	.0309	.0217	.0154	.0109	.0092	.0078	.0056	.0040	.0009
22	.5219	.4220	.3418	.2775	.2257	.1839	.1228	.0826	.0560	.0382	.0262	.0181	.0126	.0088	.0074	.0062	.0044	.0031	.0006
23	.5067	.4057	.3256	.2618	.2109	.1703	.1117	.0738	.0491	.0329	.0222	.0151	.0103	.0071	.0059	.0049	.0034	.0024	.0004
24	.4919	.3901	.3101	.2470	.1971	.1577	.1015	.0659	.0431	.0284	.0188	.0126	.0085	.0057	.0047	.0039	.0027	.0018	.0003
25	.4776	.3751	.2953	.2330	.1842	.1460	.0923	.0588	.0378	.0245	.0160	.0105	.0069	.0046	.0038	.0031	.0021	.0014	.0002
26	.4637	.3607	.2812	.2198	.1722	.1352	.0839	.0525	.0331	.0211	.0135	.0087	.0057	.0037	.0030	.0025	.0016	.0011	.0002
27	.4502	.3468	.2678	.2074	.1609	.1252	.0763	.0469	.0291	.0182	.0115	.0073	.0047	.0030	.0024	.0019	.0013	.0008	.0001
28	.4371	.3335	.2551	.1956	.1504	.1159	.0693	.0419	.0255	.0157	.0097	.0061	.0038	.0024	.0019	.0015	.0010	.0006	.0001
29	.4243	.3207	.2429	.1846	.1406	.1073	.0630	.0374	.0224	.0135	.0082	.0051	.0031	.0020	.0015	.0012	.0008	.0005	.0001
30	.4120	.3083	.2314	.1741	.1314	.0994	.0573	.0334	.0196	.0116	.0070	.0042	.0026	.0016	.0012	.0010	.0006	.0004	.0000
40	.3066	.2083	.1420	.0972	.0668	.0460	.0221	.0107	.0053	.0026	.0013	.0007	.0004	.0002	.0001	.0001	.0001	.0000	.0000

Table 2

Present Value of Ordinary Annuity of $1

$$PV_A = \frac{1}{i}\left[1 - \frac{1}{(1+i)^n}\right]$$

Periods	3%	4%	5%	6%	7%	8%	10%	12%	14%	16%	18%	20%	22%	24%	25%	26%	28%	30%	40%
1	.9709	.9615	.9524	.9434	.9346	.9259	.9091	.8929	.8772	.8621	.8475	.8333	.8197	.8065	.8000	.7937	.7813	.7692	.7143
2	1.9135	1.8861	1.8594	1.8334	1.8080	1.7833	1.7355	1.6901	1.6467	1.6052	1.5656	1.5278	1.4915	1.4568	1.4400	1.4235	1.3916	1.3609	1.2245
3	2.8286	2.7751	2.7232	2.6730	2.6243	2.5771	2.4869	2.4018	2.3216	2.2459	2.1743	2.1065	2.0422	1.9813	1.9520	1.9234	1.8684	1.8161	1.5889
4	3.7171	3.6299	3.5460	3.4651	3.3872	3.3121	3.1699	3.0373	2.9137	2.7982	2.6901	2.5887	2.4936	2.4043	2.3616	2.3202	2.2410	2.1662	1.8492
5	4.5797	4.4518	4.3295	4.2124	4.1002	3.9927	3.7908	3.6048	3.4331	3.2743	3.1272	2.9906	2.8636	2.7454	2.6893	2.6351	2.5320	2.4356	2.0352
6	5.4172	5.2421	5.0757	4.9173	4.7665	4.6229	4.3553	4.1114	3.8887	3.6847	3.4976	3.3255	3.1669	3.0205	2.9514	2.8850	2.7594	2.6427	2.1680
7	6.2303	6.0021	5.7864	5.5824	5.3893	5.2064	4.8684	4.5638	4.2883	4.0386	3.8115	3.6046	3.4155	3.2423	3.1611	3.0833	2.9370	2.8021	2.2628
8	7.0197	6.7327	6.4632	6.2098	5.9713	5.7466	5.3349	4.9676	4.6389	4.3436	4.0776	3.8372	3.6193	3.4212	3.3289	3.2407	3.0758	2.9247	2.3306
9	7.7861	7.4353	7.1078	6.8017	6.5152	6.2469	5.7590	5.3282	4.9464	4.6065	4.3030	4.0310	3.7863	3.5655	3.4631	3.3657	3.1842	3.0190	2.3790
10	8.5302	8.1109	7.7217	7.3601	7.0236	6.7101	6.1446	5.6502	5.2161	4.8332	4.4941	4.1925	3.9232	3.6819	3.5705	3.4648	3.2689	3.0915	2.4136
11	9.2526	8.7605	8.3064	7.8869	7.4987	7.1390	6.4951	5.9377	5.4527	5.0286	4.6560	4.3271	4.0354	3.7757	3.6564	3.5435	3.3351	3.1473	2.4383
12	9.9540	9.3851	8.8633	8.3838	7.9427	7.5361	6.8137	6.1944	5.6603	5.1971	4.7932	4.4392	4.1274	3.8514	3.7251	3.6059	3.3868	3.1903	2.4559
13	10.6350	9.9856	9.3936	8.8527	8.3577	7.9038	7.1034	6.4235	5.8424	5.3423	4.9095	4.5327	4.2028	3.9124	3.7801	3.6555	3.4272	3.2233	2.4685
14	11.2961	10.5631	9.8986	9.2950	8.7455	8.2442	7.3667	6.6282	6.0021	5.4675	5.0081	4.6106	4.2646	3.9616	3.8241	3.6949	3.4587	3.2487	2.4775
15	11.9379	11.1184	10.3797	9.7122	9.1079	8.5595	7.6061	6.8109	6.1422	5.5755	5.0916	4.6755	4.3152	4.0013	3.8593	3.7261	3.4834	3.2682	2.4839
16	12.5611	11.6523	10.8378	10.1059	9.4466	8.8514	7.8237	6.9740	6.2651	5.6685	5.1624	4.7296	4.3567	4.0333	3.8874	3.7509	3.5026	3.2832	2.4885
17	13.1661	12.1657	11.2741	10.4773	9.7632	9.1216	8.0216	7.1196	6.3729	5.7487	5.2223	4.7746	4.3908	4.0591	3.9099	3.7705	3.5177	3.2948	2.4918
18	13.7535	12.6593	11.6896	10.8276	10.0591	9.3719	8.2014	7.2497	6.4674	5.8178	5.2732	4.8122	4.4187	4.0799	3.9279	3.7861	3.5294	3.3037	2.4941
19	14.3238	13.1339	12.0853	11.1581	10.3356	9.6036	8.3649	7.3658	6.5504	5.8775	5.3162	4.8435	4.4415	4.0967	3.9424	3.7985	3.5386	3.3105	2.4958
20	14.8775	13.5903	12.4622	11.4699	10.5940	9.8181	8.5136	7.4694	6.6231	5.9288	5.3527	4.8696	4.4603	4.1103	3.9539	3.8083	3.5458	3.3158	2.4970
21	15.4150	14.0292	12.8212	11.7641	10.8355	10.0168	8.6487	7.5620	6.6870	5.9731	5.3837	4.8913	4.4756	4.1212	3.9631	3.8161	3.5514	3.3198	2.4979
22	15.9369	14.4511	13.1630	12.0416	11.0612	10.2007	8.7715	7.6446	6.7429	6.0113	5.4099	4.9094	4.4882	4.1300	3.9705	3.8223	3.5558	3.3230	2.4985
23	16.4436	14.8568	13.4886	12.3034	11.2722	10.3711	8.8832	7.7184	6.7921	6.0442	5.4321	4.9245	4.4985	4.1371	3.9764	3.8273	3.5592	3.3254	2.4989
24	16.9355	15.2470	13.7986	12.5504	11.4693	10.5288	8.9847	7.7843	6.8351	6.0726	5.4509	4.9371	4.5070	4.1428	3.9811	3.8312	3.5619	3.3272	2.4992
25	17.4131	15.6221	14.0939	12.7834	11.6536	10.6748	9.0770	7.8431	6.8729	6.0971	5.4669	4.9476	4.5139	4.1474	3.9849	3.8342	3.5640	3.3286	2.4994
26	17.8768	15.9828	14.3752	13.0032	11.8258	10.8100	9.1609	7.8957	6.9061	6.1182	5.4804	4.9563	4.5196	4.1511	3.9879	3.8367	3.5656	3.3297	2.4996
27	18.3270	16.3296	14.6430	13.2105	11.9867	10.9352	9.2372	7.9426	6.9352	6.1364	5.4919	4.9636	4.5243	4.1542	3.9903	3.8387	3.5669	3.3305	2.4997
28	18.7641	16.6631	14.8981	13.4062	12.1371	11.0511	9.3066	7.9844	6.9607	6.1520	5.5016	4.9697	4.5281	4.1566	3.9923	3.8402	3.5679	3.3312	2.4998
29	19.1885	16.9837	15.1411	13.5907	12.2777	11.1584	9.3696	8.0218	6.9830	6.1656	5.5098	4.9747	4.5312	4.1585	3.9938	3.8414	3.5687	3.3317	2.4999
30	19.6004	17.2920	15.3725	13.7648	12.4090	11.2578	9.4269	8.0552	7.0027	6.1772	5.5168	4.9789	4.5338	4.1601	3.9950	3.8424	3.5693	3.3321	2.4999
40	23.1148	19.7928	17.1591	15.0463	13.3317	11.9246	9.7791	8.2438	7.1050	6.2335	5.5482	4.9966	4.5439	4.1659	3.9995	3.8458	3.5712	3.3332	2.5000