

Solutions – Financial Policy & Corporate Strategy and Risk Management

Question 1

1. (A)
2. (B)
3. (C)
4. (D)

Question 2

NPV for bond refunding

	₹
PV of annual cash flow savings (W.N. 2)	
(3,49,600 × PVIFA 8%,25) i.e. 10.675	37,31,980
Less: Initial investment (W.N. 1)	<u>29,20,000</u>
NPV	<u>8,11,980</u>

Recommendation: Refunding of bonds is recommended as NPV is positive.

Working Notes:

(1) Initial investment:

(a) Call premium

Before tax $(1,140 - 1,000) \times 30,000$	42,00,000	
Less tax @ 40%	<u>16,80,000</u>	
After tax cost of call prem.		25,20,000

(b) Floatation cost

4,00,000

(c) Overlapping interest

Before tax $(0.14 \times 2/12 \times 3 \text{ crores})$	7,00,000	
Less tax @ 40%	<u>2,80,000</u>	4,20,000

(d) Tax saving on unamortised discount on old bond $25/30 \times 9,00,000 \times 0.4$

(3,00,000)

(e) Tax savings from unamortised floatation

Cost of old bond $25/30 \times 3,60,000 \times 0.4$		<u>(1,20,000)</u>
		<u>29,20,000</u>

(2) Annual cash flow savings:

(a) Old bond

(i)	Interest cost $(0.14 \times 3 \text{ crores})$	42,00,000	
	Less tax @ 40%	<u>16,80,000</u>	25,20,000
(ii)	Tax savings from amortisation of discount $9,00,000/30 \times 0.4$		(12,000)
(iii)	Tax savings from amortisation of floatation cost $3,60,000/30 \times 0.4$		<u>(4,800)</u>
	Annual after tax cost payment under old Bond (A)		<u>25,03,200</u>

(b) New bond

(i)	Interest cost before tax $(0.12 \times 3 \text{ crores})$	36,00,000	
-----	---	-----------	--

Less tax @ 40%	<u>14,40,000</u>	
After tax interest		21,60,000
(ii) Tax savings from amortisation of floatation cost $(0.4 \times 4,00,000/25)$		<u>(6,400)</u>
Annual after tax payment under new Bond (B)		<u>21,53,600</u>
Annual Cash Flow Saving (A) – (B)		<u>3,49,600</u>

Question 4

1. (B)
2. (B)
3. (C)
4. (A)
5. (A)