

**CURRENT 2 PAPERS LONG QUESTIONS
SOLVED
BY KAAAMI**

What is tick?

A tick is the minimum price movement of a contract. For example, the movement in US\$ / PKR rate from 60.1501 to 60.1505, means the rate has risen four ticks. Every tick movement in price has same money value. For example, sterling/us\$ contract standard size is sterling 62,500/-. The price is in us\$ and tick size is \$ 0.0001, which means each tick value is \$ 6.25. If a trader is holding a long position and price of future increases, then there's profit and fall in value represents loss. If trader is holding is short position, rise in future value represent a loss, fall in price profit. Like forward contracts, currency futures have also two-scenario: receipt of FCY and payment involving FCY.

My answer:-

The minimum movement in the price of a stock, financial asset e.g., bonds, debentures, securities etc., and in forex market is called a tick. The tick size may be different in the each of above said markets. For example, a tick size is \$0.01 in US stock market. At the same time, the tick size may be different in the forex market for example a change in the price of dollar in front of Rupee may go up for Rs. 0.01, such minimum change will be called a tick.

How Firm A can acquire a Private Limited Company

Private limited companies are one kind of joint stock companies which differs from the public limited companies. The shares of the private limited companies are not traded in the financial markets and they are not restricted to maintain such kind of statements maintained by the public limited companies under the Law. This scenario makes it difficult to judge the fair position and value of the Pvt Ltd company. The acquiring process becomes more complex but there exists some techniques discussed hereunder from which we can value the victim company.

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Income Based Approach

Present value method:

The present value approach is used to know the present value of future cash flows of the company's asset. The present value and discount rates may be different for each asset. The formula of the same is as under:-

$$\text{Value} = \text{CF}_t / (1+r)^t$$

where

n = Life of the asset

CF_t = Cash flow in period t

r = Discount rate reflecting the risky-ness of the estimated cash flows

Dividend Valuations method:

The dividend valuation method is also a primary tool to value the Pvt Ltd. company in question. The CAPM approach and the required rate of return approach may be used under this heading.

P/E method

The P/E approach is used to know the trend of the company earning. If the company have high P/E ratio, it means the company is consistently growing. The future expectations lying with the business and the shares are secured. While on the other side, low P/E ratio present the inverse of the situation narrated above. The formula of P/E ratio is as under:-

P/E ratio can be defined as = Price per share / EPS

Asset based approach:

Book value:-

The book value of the assets may be analyzed to find out the cost price of the assets accompanying with the company in question.

Replacement cost

We can evaluate what it would cost us to replace all of the assets of the company.

Break up value:-

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Breakup value represents the minimum price which should be accepted for the sale of a business. However, when a break up is considered in this way it must be remembered to include such items as

3. How can we hedge through currency option?

Currency option is a right of buyer to buy or sell (but not obligation) a fixed amount of underlying currency at fixed price (strike price) on a fixed expiry date. We should consider the following before using hedge with currency option:-

- i.** The extent of exposure and the currency involved – future receipt and payment to be determined.
- ii.** Consider the hedging tool – a call or put option will serve the purpose.
- iii.** Calculate the most suitable strike price out of several available.
- iv.** Option will be only exercised if it is in the money and buy or sell the currency at the strike price.
- v.** Alternatively, let the option lapse if it is out of money. Progress

4. Why option is exercised and when allowed to lapse

An option is a contract that confers a right to buy or sell a specific quantity of asset – but not the obligation, at agreed price on or before the specified future date. Options are available for commodities (like wheat, coffee, sugar, etc) and financial assets like currency or bank deposits.

Features of Options:

It is a contractual agreement.

The holder of option exercises his/her right only if it is in his/her favours.

Option writer is seller and must honor his side of contract. (Sell or buy at agreed price).

Options like futures are standardized transaction in terms of size & duration.

Options are Exchange traded

These agreements are easy to buy & sell

Options either are call options or put options.

The option purchase price is called option premium.

Call option gives its holder a right (not obligation) to buy underlying item at the specified price.

Put option gives its holder a right (not obligation) to sell underlying item at specified price.

Expiry date:

Each option has expiry date and the holder must exercise his/her right before this date otherwise, it will lapse.

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7. Define EOQ Model and its uses

Economic order quantity

EOQ The amount of orders that minimizes total **variable costs** required to order and hold **inventory**. In other words, economic order quantity is that size of quantity of the order which gives maximum economy in purchasing any material and ultimately contributes towards maintaining the material at the optimum level and minimum cost.

While setting economic order quantity, two types of cost should be taken into account:

1. **Ordering Cost:** This is the cost of placing an order with the supplier. Because of so many factors involved, it is quite difficult to quantify this cost. It mainly includes the cost of stationary, salaries of those engaged in receiving and inspection, salaries of those engaged in placing an order, etc.
2. **Cost of Carrying Stock:** This is the cost of holding the stock in storage.

It includes the following:

- (a) cost of operating the stores, (salaries, rent, stationary)
- (b) the incidence of insurance cost;
- (c) interest on the capital locked up in store;
- (d) Deterioration and wastage of material.

Economic order quantity is a level of quantity of ordering where all the costs are minimized and it is the most economical to place the order. Economic order quantity minimizes the total cost and it is used especially for re-stock purpose in the business.

8. Define benefits of short cash cycle

Cash Conversion Cycle, also known as the asset conversion cycle, net operating cycle, working capital cycle or just cash cycle, is used in the financial analysis of a business.

A short cash conversion cycle indicates good working capital management. Conversely, a long cash conversion cycle suggests that capital is tied up while the business waits for customers to pay. It is possible for a business to have a negative cash conversion cycle, i.e. receiving customer payments before having to pay suppliers. Examples are typically companies that employ Just in Time practices such as Dell, and companies that buy on extended credit terms and sell for cash, such as Tesco. The longer the production process, the more cash the firm must keep tied up in inventories. Similarly, the longer it takes customers to pay their bills, the higher the value of accounts receivable. On the other hand, if a firm can delay paying for its own materials, it may reduce the amount of cash it needs. In other words, accounts payable reduce net working capital.

Difference B/W growth stock and income stock (3 marks)

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growth stocks are

- higher risk
- often cheaper in price
- often from emerging countries
- are concerned with capital growth not dividend income
- are companies that have not reached their full potential

Income stock is a stock with a history of paying consistently high dividends.

Growth stock is stock of a company which is MORE

2) Described the steps in credit management (3 marks)

The following section will shed light on credit control policy and its components.

- a) Terms of sale
- b) Credit analysis
- c) Collection policy

Terms of sale refer to the conditions on which the company will sell its good to the customers on cash or credit. The most important issues under these terms are the credit period and the discount level and discount period. In order to induce the debtors to settle their invoices at the earliest the company offers a discount or reduction in the invoice amount. That discount is predominantly based on receiving the payment within a very short period of time compared with normal credit period. For example, the normal terms representing the period and discount are described as “3/10, net 45”. This means that the credit period is 10 days. The credit period is the length of time that is allowed to debtors to pay off their bills. It will vary business to business and firm to firm. Normally this period is between 30 to 60 days, however, 90 days credit is not very un-common. Credit period count runs from the invoice date but can be the point of delivery of goods. Length of credit period is influenced by several factors but the most important is the buyer’s operating cycle and inventory period. Before moving ahead, let’s take up operating cycle concept.

2 – Accounts receivable period – the time to recover the sales.

In our example, March 01 to April 15 – 45 days period is termed as accounts receivable period. It should be noted that by extending credit to buyer, we finance a portion of buyer’s operating cycle and shorten buyer’s cash cycle. And if seller’s credit extension period exceeds the buyer’s inventory period, then seller is not only financing the buyer’s inventory purchases but also a part of the receivable as well. On the other side if seller’s credit extension period exceeds the buyer’s operating cycle, then seller is effectively financing the buyer’s need beyond the purchase and sale of seller’s merchandise. The other factors that influence the credit period decisions are:

3)steps involved in merger and acquisition (5 marks)

1. The first step is to determine the target sector and the company in which we wants to merge or acquire.

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2. After targeting, ascertain basic information, e.g. skills of staff, expertise, payroll, structure, and apportionment terms; benefit plans etc., of the company in question.
3. Analyze historic sales, trends, products, strength, market share and market reputation.
4. Obtain technical expertise to run the target company for future development, research, and growth.
5. Establish prevailing financial situation as well as the past information.
6. Obtain details of the liquidity of the company i.e. details of bank accounts, collaterals against loans, details of agreements like leases, forward rates, etc.
7. Hire the legal and financial consultants to finalize the details proposed scheme of merger
8. If the object company's rules permits continuation the business by amalgamation (transfer), if not, then suitable amendments should be made in the company act.
9. Notify the stock exchange about the offer of the merger made and approved by regional stock exchange.
10. The proposed scheme of merger should be submitted to the Board of Director of each company for their approval.
11. The scheme, once approved by the Board of Directors, should be placed before shareholders at a general meeting for their approval. It is not a legal necessity, but the company in practice gets the scheme approved by its shareholders before they file an application for the sanction of the court.
12. Transfer of Assets and Liabilities, issuance of Shares, etc.
Finally, the companies can implement the scheme by transferring assets and liabilities by issuing of shares and given any other consideration to the members of the amalgamating company, as per the scheme of merger.

4) How a hedge could be established with currency option (5 marks)

Currency option is a right of buyer to buy or sell (but not obligation) a fixed amount of underlying currency at fixed price (strike price) on a fixed expiry date. We should consider the following before using hedge with currency option:-

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