

CORRECTION- DIVIDEND

EXTRA PRACTICAL QUESTION(EPO)

QUESTION NO.1 JC Ltd. is planning an equity issue in current year. It has an earning per share (EPS) of Rs20 and proposes to pay 60% dividend at the current year end. With a P/E ratio 6.25, it wants to offer the issue at market price. The flotation cost is expected to be 4% of the issue price.

Required: Determine the required rate of return for equity share (K_e) before the issue and after the issue ?

Solution:

Workings

- $P_0 = \text{EPS} \times \text{P/E} = 20 \times 6.25 = 125$
- $r = \text{Rate of Return on Retained Earnings} = 1/6.25 = 16\%$ [Note: Assumed $r = k_e$]
- Retention ratio (b) = $1 - \text{Dividend Payout Ratio} = 1 - 0.60 = 0.40$
- Growth rate (g) = $br = 0.40 \times 0.16 = 0.064$
- $D_0 = \text{EPS} \times \text{Dividend Payout} = 20 \times 60\% = 12$; • $D_1 = D_0(1 + g) = 12(1 + 0.064) = 12.768$

Cost of Equity before issue : $K_e = \frac{D_1}{P_0} + g = \frac{12.768}{125} + 0.064 = 0.1021 + 0.064 = 0.1661$ or 16.61%

Cost of Equity after issue : $K_e = \frac{D_1}{P_0} + g = \frac{12.768}{120} + 0.064 = 0.1064 + 0.064 = 0.1704$ or 17.04%

Note: Assuming DPS given in question relates to year 0.

DEBTOR'S MANAGEMENT

CORRECTION

QUESTION NO.1B XYZ Corporation is considering relaxing its present credit policy and is in the process of evaluating two proposed policies. Currently, the firm has annual credit sales of ₹ 50 lakhs and accounts receivable turnover ratio of 4 times a year. The current level of loss due to bad debts is ₹ 1,50,000. The firm is required to give a return of 25% on the investment in new accounts receivables. The company's variable costs are 70% of the selling price. Given the following information, which is the better option?

	<u>Policy</u>	<u>Present</u>	<u>Option I</u>
Option II			
Annual credit sales	50,00,000	60,00,000	67,50,000
Accounts receivable turnover ratio	4 times	3 times	2.4 times
Bad debt losses	1,50,000	3,00,000	4,50,000

Solution:

XYZ CORPORATION Evaluation of Credit Policies
(Amount in ₹)

	<u>Present</u> <u>Policy</u>	<u>Policy</u> <u>Option I</u>	<u>Policy</u> <u>Option II</u>
Benefit			
Annual credit sales	50,00,000	60,00,000	67,50,000
Less: Variable Cost @ 70 %	<u>35,00,000</u>	<u>42,00,000</u>	<u>47,25,000</u>
Contribution	15,00,000	18,00,000	20,25,000
Less: Bad Debt	<u>1,50,000</u>	<u>3,00,000</u>	<u>4,50,000</u>
Benefit (A)	<u>13,50,000</u>	<u>15,00,000</u>	<u>15,75,000</u>

Cost Of Funds Blocked In Receivables

Annual credit sales	50,00,000	60,00,000	67,50,000
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Accounts receivable turnover	4 times	3 times	2.4 times
Average collection period [1/Turnover Ratio x 12]	3 months	4 months	5 months
Variable Cost Involved in sales	35,00,000	42,00,000	47,25,000
Average Receivables at cost	35,00,000	42,00,000	47,25,000
	x 3/12	x 4/12	x 5/12
	8,75,000	14,00,000	19,68,750
Cost @ 25% (B)	218750	350000	492187.5
Net Benefit (A-B)	11,31250	11,50,000	10,82,812.5

Recommendation: The Proposed Policy I should be adopted since the net benefits under this policy are higher as compared to other policies.