

**UNIVERSITY OF BOLTON**

**BOLTON BUSINESS SCHOOL**

**BA (HONS) ACCOUNTANCY PATHWAY BY**  
**DISTANCE LEARNING**

**KUALA LUMPUR INTAKE 18**

**SEMESTER 2 EXAMINATIONS 2008/2009**

**FINANCIAL MANAGEMENT**

**MODULE NO: ACC3015DL**

Date: 21<sup>st</sup> June 2009

Time: 3 hours

---

**INSTRUCTIONS TO CANDIDATES:**

There are **FOUR** questions on this paper.

Answer **ALL** questions.

All questions carry equal marks.

Candidates are advised that the examiners attach importance to legibility of writing and clarity of expression.

---

Bolton Business School  
 BA (Hons) Accountancy Pathway by Distance Learning  
 Kuala Lumpur Intake 18  
 Semester 2 Examinations 2008/2009  
 Financial Management  
 Module No. ACC3015DL

**Answer ALL questions**

**Q1**

Direct Frames is a listed company that plans to spend \$10m on expanding its existing business. It is intended that the money will be raised by issuing 9% loan notes redeemable in 10 years time. Current financial information is as follows:

**The Income statement for last year**

	\$000
Profit before interest and tax	7,000
Interest	<u>(500)</u>
Profit before tax	6,500
Tax	<u>(1,950)</u>
Profit for the period	<u>4,550</u>

**The Balance sheet for last year**

	\$000	\$000
Non-current assets		20,000
Current assets		<u>20,000</u>
Total assets		<u>40,000</u>

**Equity and liabilities**

Ordinary shares, par value \$1	5,000	
Retained earnings	<u>22,500</u>	
Total equity		27,500
10% loan notes	5,000	
9% preference shares	<u>2,500</u>	
Total non-current liabilities		7,500
Current liabilities		<u>5,000</u>
Total equity and liabilities		<u>40,000</u>

The current ex-div ordinary share price is \$4.50 per share. An ordinary dividend of 35¢ per share has just been paid and dividends are expected to increase by 4% per year for the foreseeable future. The current ex-div preference share price is 76.2¢. The loan notes are secured on the existing non-current assets of Direct Frames and are redeemable at par in 8 years time. They have a current ex interest market price of \$105 per \$100 loan note. Direct Frames pays tax on profits at an annual rate of 30%.

**Question 1 continued over  
PLEASE TURN THE PAGE...**

Bolton Business School  
BA (Hons) Accountancy Pathway by Distance Learning  
Kuala Lumpur Intake 18  
Semester 2 Examinations 2008/2009  
Financial Management  
Module No. ACC3015DL

**Question 1 continued**

The expansion of the business is expected to increase profit before interest and tax by 12% in the first year. Direct Frames has no overdraft.

**Average sector ratios:**

Financial gearing: 45% (prior charge capital is divided by equity capital book value)

Interest cover ratio: 12 times

**Required:**

- a) Calculate the current weighted average cost of capital of Direct Frames  
**(10 marks)**
- b) Briefly discuss the factors that may affect the weighted average cost of capital measure.  
**(3 marks)**
- c) Evaluate and comment on the effects, after one year, of the loan note issue and the expansion of business on the following ratios:
- (i) interest cover ratio
  - (ii) financial gearing
  - (iii) earnings per share

Assume that the dividend growth rate of 4% is unchanged

**(12 marks)**

**TOTAL 25 MARKS**

**Q2**

Kitchen Co plans to buy a new machine to meet expected demand for a new product, Product X. This machine will cost \$250,000 and last for 4 years, at the end of which time it will be sold for \$5,000. Kitchen Co expects demand for Product X to be as follows:

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
Demand (units)	35,000	40,000	50,000	25,000

**Question 2 continued over  
PLEASE TURN THE PAGE...**

Bolton Business School  
BA (Hons) Accountancy Pathway by Distance Learning  
Kuala Lumpur Intake 18  
Semester 2 Examinations 2008/2009  
Financial Management  
Module No. ACC3015DL

**Question 2 continued**

The selling price for Product X is expected to be \$12.00 per unit, and the variable cost of production is expected to be \$7.80 per unit. Incremental annual fixed production overheads of \$25,000 per year will be incurred. Selling price and costs are all in current terms.

Selling price and costs are expected to increase as follows:

	<b>Increase</b>
Selling price of Product X:	3% per year
Variable cost of production:	4% per year
Fixed production overheads:	6% per year

**Other information:**

Kitchen Co has a real cost of capital of 5.7% and pays tax at an annual rate of 30% one year in arrears. It can claim capital allowances on a 25% reducing balance basis. General inflation is expected to be 5% per year

Kitchen Co has a target return on capital employed of 20%. Depreciation is charged on a straight-line basis over the life of the asset.

**Required:**

- a) Calculate the net present value of the investment in the new machine  
(12 marks)
- b) Calculate the before tax return on capital employed (accounting rate of return) based on the average investment and comment on your findings.  
(6 marks)
- c) Critically evaluate the use of the Internal rate of return in appraising capital investments.  
(7 marks)

**TOTAL 25 MARKS**

**PLEASE TURN THE PAGE...**

Bolton Business School  
BA (Hons) Accountancy Pathway by Distance Learning  
Kuala Lumpur Intake 18  
Semester 2 Examinations 2008/2009  
Financial Management  
Module No. ACC3015DL

**Q3**

Lipton Co is a UK based company which has the following expected transactions:

One month: Expected receipt of \$240,000  
One month: Expected payment of \$140,000  
Three months: Expected receipts of \$300,000

The finance manager has collected the following information:

Spot rate (\$ per £): 1.7820 + or – 0.0002  
One month forward rate (\$ per £): 1.7829 + or – 0.0003  
Three months forward rate (\$ per £): 1.7846 + or – 0.0004

Money market rates for Lipton Co:

	<b>Borrowing</b>	<b>Deposit</b>
On year sterling interest rate	4.9%	4.6%
One year dollar interest rate	5.4%	5.1%

Assume that it is now April 1<sup>st</sup>.

**Required:**

- a) Discuss the differences between transaction risk, translation risk and economic risk. **(6 marks)**
- b) Calculate the expected sterling receipts in one month and in three months using the forward market. **(6 marks)**
- c) Calculate the expected sterling receipts in three months using a money-market hedge and recommend whether a forward market hedge or money-market hedge should be used **(8 marks)**
- d) Discuss how sterling currency futures contracts could be used to hedge the three-month dollar receipt. **(5 marks)**

**TOTAL 25 MARKS**

**PLEASE TURN THE PAGE...**

Bolton Business School  
BA (Hons) Accountancy Pathway by Distance Learning  
Kuala Lumpur Intake 18  
Semester 2 Examinations 2008/2009  
Financial Management  
Module No. ACC3015DL

**Q4**

Rainbow plc is considering the immediate purchase of some, or all, of the share capital of one of two firms: Indigo Ltd and Violet Ltd. Both Indigo and Violet have 1 million ordinary shares issued and neither company has any debt capital outstanding.

Both firms are expected to pay a dividend in one years time, Indigo's expected dividend amounting to 30¢ per share and Violet's being 27¢ per share. Dividends will be paid annually and are expected to increase over time. Indigo's dividends are expected to display perpetual growth at a compound rate of 6% per year. Violet's dividend will grow at the high annual compound rate of 33 $\frac{1}{3}$ % until a dividend of 64¢ is reached in year 4. Thereafter Violet's dividend will remain constant.

If Rainbow plc is able to purchase all the equity capital of either firm then the reduced competition would enable Rainbow to save some advertising and administration costs which would amount to \$225,000 per year indefinitely and, in year 2, to sell some office space for \$800,000. These benefits and savings would only occur if a complete takeover were to be carried out. Rainbow would change some operations of any company completely taken over. The details are as follows:

- (i) Indigo: no dividend would be paid until year 3. Year 3 dividend would be 25¢ per share and dividends would grow at 10% per year indefinitely.
- (ii) Violet: no change in total dividends in years 1 to 4, but after year 4, dividend growth would be 25% per year compound until year 7. Thereafter annual dividends would remain constant at year 7 amount per share

An appropriate discount rate for the risk inherent in all cash flows is 15%.

**Required:**

- (a) Calculate the valuation per share for a minority investment in each of the two firms, Indigo and Violet, that would provide the investor with a 15% return (ignore tax).  

**(5 marks)**
- (b) Calculate the maximum amount per share that Rainbow should consider paying for each company in the event of a complete takeover (ignore tax).  

**(11 marks)**

**Question 4 continued over  
PLEASE TURN THE PAGE...**

Bolton Business School  
BA (Hons) Accountancy Pathway by Distance Learning  
Kuala Lumpur Intake 18  
Semester 2 Examinations 2008/2009  
Financial Management  
Module No. ACC3015DL

**Question 4 continued**

(c) Critically evaluate the above approach, and recommend the other factors that should be considered if the proposed investments took place.

**(9 marks)**

**END OF QUESTIONS**