

UNIVERSITY OF BOLTON
SCHOOL OF BUSINESS AND CREATIVE
TECHNOLOGIES
BA ACCOUNTANCY
VIETNAM
SEMESTER 2 EXAMINATIONS 2009/2010
FINANCIAL MANAGEMENT
MODULE NO: ACC3015

Date: 15th October 2010

Time: 3 hours

INSTRUCTIONS TO CANDIDATES:

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

Answer **ALL** questions.

All questions carry equal marks.

Calculators may be used.

Discount tables are provided.

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

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QUESTIONS – Answer ALL FIVE questions

Question 1

Lexar & Co is planning to raise \$15 million of new finance for a major expansion of existing business and is considering a rights issue, a placing or an issue of bonds. The corporate objectives of Lexar & Co, as stated in its *Annual Report*, are to maximise the wealth of its shareholders and to achieve continuous growth in earnings per share. Recent financial information on Lexar & Co is as follows:

	2008	2007	2006	2005
Turnover (\$m)	28.0	24.0	19.1	16.8
Profit before interest and tax (\$m)	9.8	8.5	7.5	6.8
Earnings (\$m)	5.5	4.7	4.1	3.6
Dividends (\$m)	2.2	1.9	1.6	1.6
Ordinary shares (\$m)	5.5	5.5	5.5	5.5
Reserves (\$m)	13.7	10.4	7.6	5.1
8% Bonds, redeemable 2015 (\$m)	20	20	20	20
Share price (\$)	8.64	5.74	3.5	2.67

The par value of the shares of Lexar & Co is \$1.00 per share. The general level of inflation has averaged 4% per year in the period under consideration. The bonds of Lexar & Co are currently trading at their par value of \$100. The following values for the business sector of Lexar & Co are available:

Average return on capital employed	25%
Average return on shareholders' funds	20%
Average interest coverage ratio	20 times
Average debt/equity ratio (market value basis)	50%
Return predicted by the capital asset pricing model	14%

**Question 1 continued over
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Question 1 continued

Required

A. Evaluate the financial performance of Lexar & Co, and analyze and discuss the extent to which the company has achieved its stated corporate objectives of:

- i. Maximising the wealth of its shareholders;
- ii. Achieving continuous growth in earnings per share.

(10 marks)

B. If the new finance is raised via a rights issue at \$7.50 per share and the major expansion of business has not yet begun, calculate and comment on the effect of the rights issue on:

- i. the share price of Lexar & Co;
- ii. the earnings per share of the company; and
- iii. the debt/equity ratio.

(5 marks)

C. Analyze and discuss the relative merits of a rights issue, a placing, and an issue of bonds as ways of raising the finance for the expansion.

(5 marks)

TOTAL 20 MARKS

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Question 2

Presley plc is an importer/exporter of dairy equipment. It is based in the UK but trades with other countries around the world. It has a small subsidiary based in the USA. Presley plc is about to invoice a customer in the USA for US\$1,000,000 receivable in 3 months' time. Presley plc is considering 2 methods of hedging the exchange risk. These are:

Method 1: A money market hedge

Method 2: A 3-month forward exchange contract with the company's bank to sell US\$1,000,000.

The spot rate of exchange is US\$ 1.5834 to £1. The 3-month forward rate of exchange is US\$ 1.5688 to £1. The annual interest for borrowing in the USA is 3% and for investing in the UK is 5%.

Required

- A. Advise the treasurer on which of the 2 methods is the most financially advantageous for Presley plc. Include relevant calculations in your advice. **(8 marks)**
- B. Explain the causes of exchange rate fluctuations. **(4 marks)**
- C. Evaluate other methods available to hedge exchange rate risk. **(8 marks)**

TOTAL 20 MARKS

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Question 3

Bluetooth plc, which pays corporation tax at 33%, has the following capital Structure:

Ordinary Shares:

1,000,000 ordinary shares of nominal value 25c per share. The market value of the shares is 49c per share. A dividend of 7c per share has just been paid, and dividends are expected to grow by eight per cent per year for the foreseeable future.

Preference Shares:

250,000 preference shares of nominal value 50 c per share . The market value of the shares is 32 c per share and the annual net dividend of 7.5% per cent has just been paid.

Debentures:

\$100,000 of irredeemable debentures with a market price of \$92 per \$100 block. These debentures have a coupon rate of 10 % and the annual interest payment has just been made.

Required

- A. Calculate the weighted average after tax-cost of capital of Bluetooth plc
(12 marks)
- B. Critically evaluate any possible difficulties that may be experienced when calculating the Weighted Average Cost Of Capital.
(8 marks)

TOTAL 20 MARKS

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Question 4

Tiny Plc is considering purchasing a new machine to meet expected demand for a new product, Product DTZ.

The machine will cost \$300,000 and have a life of 4 years. At the end of its life the machinery will have a residual value of \$20,000.

Tiny Plc expects the demand for Product DTZ to be as follows:

Year	1	2	3	4
Demand in Units	35,000	45,000	30,000	20,000

The selling price for Product DTZ is expected to be \$15.00 per unit, and the variable cost of production is expected to be \$10.00 per unit.

Incremental annual fixed production overhead costs of £35,000 per year will be incurred.

Selling prices and costs are all current.

Selling Prices and Costs are expected to increase as follows:

Selling Price of Product DTZ	Increase per year	3%
Variable Cost of Production	Increase per year	3%
Fixed Production Overhead	Increase per year	5%

Other Relevant Information:

Tiny Plc has a real cost of capital of 9 %.

Tiny Plc pays corporation tax at a rate of 40%.

The company can claim capital allowances on a 25% reducing balance basis.

General inflation is expected to be 3 % per year.

Tiny plc has a target return on capital employed of 20%

Depreciation is charged on a straight line basis over the life of the asset (note a depreciation charge is not included in the Fixed Production Overhead)

**Question 4 continued over
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Question 4 continued

Required

- A. Calculate the net present value of the investment in the new machine.
(marks12)
- B. Evaluate the use of the Internal Rate of Return in appraising capital investments.
(Marks 8)

TOTAL 20 MARKS

Question 5

Evaluate your understanding of "Risk" and the processes and techniques that company's can embed in the organisation both to mitigate or capitalise on the impact of Risk.

TOTAL 20 MARKS

END OF QUESTIONS