

UNIVERSITY OF BOLTON

SCHOOL OF BUSINESS AND CREATIVE
TECHNOLOGIES

ACCOUNTANCY PATHWAY

SEMESTER 1 EXAMINATION 2010/2011

FINANCIAL MANAGEMENT

MODULE NO: ACC3015

Date: Tuesday 18 January 2011

Time: 10:00 am - 1:00 pm

INSTRUCTIONS TO CANDIDATES:

There are FOUR questions.

Answer ALL questions.

All questions carry equal marks.

Present value and Annuity tables are included at the back of this examination paper.

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

This examination carries 70% of the marks for this module.

Question 1 (25 marks)

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Piston is evaluating an investment proposal to manufacture Product ABC, which has performed well in test marketing trials conducted recently by the company's research and development division. The following information relating to this investment proposal has now been prepared.

Initial investment	£2 million
Selling price (current price terms)	£20 per unit
Expected selling price inflation	3% per year
Variable operating costs (current price terms)	£8 per unit
Fixed operating costs (current price terms)	£170,000 per year
Expected operating cost inflation	4% per year

The research and development division has prepared the following demand forecast as a result of its test marketing trials. The forecast reflects expected technological change and its effect on the anticipated life-cycle of Product ABC.

Year	1	2	3	4
Demand (units)	60,000	70,000	120,000	45,000

It is expected that all units of Product ABC produced will be sold, in line with the company's policy of keeping no inventory of finished goods. The machinery will be depreciated on a straight line basis over the four years and the residual value, at the end of four years, is expected to be £50,000, when production of Product ABC is planned to end. (Note there are no depreciation costs in the Operating Costs). For investment appraisal purposes, Piston uses a nominal money discount rate of 10% per year and a target return on capital employed of 30% per year. Capital allowances can be claimed on the investment on a straight-line basis over the life of the investment. Piston pays corporation tax at 30% per year.

Required:

(a) Calculate the following values for the investment proposal:

- (i) Net present value;
- (ii) Internal rate of return;
- (iii) Return on capital employed (accounting rate of return) based on average investment. (13 marks)

(b) Discuss your findings in each section of (a) above and advise whether the investment proposal is financially acceptable. (6 marks)

(c) Discuss the circumstances under which the weighted average cost of Capital can be used as an appropriate discount rate in investment appraisal. (6 marks)

(Total 25 marks)

Question 2 (25 marks)

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Edwards plc, a company listed on a major stock market, is looking at its cost of capital as it prepares to make a bid to buy a rival unlisted company, Danks Co. Both companies are in the same business sector. Financial information on Edwards plc and Danks Co is as follows:

	Edwards plc		Danks Co	
	£m	£m	£m	£m
Non-current assets		36		25
Current assets	7		7	
Current liabilities	3		4	
	<u> </u>		<u> </u>	
Net current assets		4		3
		<u> </u>		<u> </u>
Total assets less current liabilities		40		28
		<u> </u>		<u> </u>
Ordinary shares, par value 50p	15		5	
Retained earnings	10		3	
	<u> </u>		<u> </u>	
Total equity		25		8
7% bonds, redeemable at par in seven years' time		15		
9% bonds, redeemable at par in two years' time				20
		<u> </u>		<u> </u>
Total equity and non-current liabilities		40		28
		<u> </u>		<u> </u>
Other relevant financial information:				
Risk-free rate of return		4.0%		
Average return on the market		10.5%		
Taxation rate		30%		

Danks Co has a cost of equity of 12% per year and has maintained a dividend payout ratio of 45% for several years. The current earnings per share of the company is 80p per share and its earnings have grown at an average rate of 4.5% per year in recent years.

The ex div share price of Edwards plc is £4.20 per share and it has an equity beta of 1.2. The 7% bonds of the company are trading on an ex interest basis at £94.74 per £100 bond. The price/earnings ratio of Edwards plc is eight times.

The directors of Edwards plc believe a cash offer for the shares of Danks Co would have the best chance of success. It has been suggested that a cash offer could be financed by debt.

QUESTION CONTINUED ON THE NEXT PAGE

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QUESTION TWO CONTINUED

Required:

- (a) Calculate the weighted average cost of capital of Edwards plc on a market value weighted basis. (10 marks)
- (b) Calculate the total value of Danks Co, using the following valuation methods:
 - (i) Price/earnings ratio method, using the price/earnings ratio of Edwards plc; and
 - (ii) Dividend growth model. (6 marks)
- (c) Discuss the relationship between capital structure and weighted average cost of capital. (5 marks)
- (d) Comment on the suggestion that debt could be used to finance a cash offer for Danks Co. (4 marks)

(Total 25 marks)

Question 3 (25 Marks)

A multi national company may have more opportunities to lower the overall cost of capital than a “domestic based “business.

This is often due to their larger size and greater access to international money markets which allows them to exploit any temporary disequilibria, as well as receiving host government concessions.

Required:

Critically evaluate this statement when a multi national makes international financing decisions in terms of the optimal capital structure, whether to borrow and where from, and how much to borrow.

(Total 25 Marks)

Question 4 (25 Marks)

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Despite substantial evidence, drawn from different countries and different time periods that suggest the wealth of shareholders in a bidding company is unlikely to be increased as a result of taking over another company; takeovers and acquisitions remains an important part of the modern day business landscape.

a) Evaluate what a company should be looking for (in economic terms) when seeking to either acquire or merger with another company

(5 Marks)

b) Critically review four ways a takeover or merger may lead to an increase in wealth for the bidding company or the majority shareholder.

(10 Marks)

c) Critically review four reasons why a takeover or merger may fail to deliver an expected increase in wealth for the bidding company or majority shareholder.

(10 Marks)

(Total 25 Marks)

END OF QUESTIONS