

UNIVERSITY OF BOLTON

**SCHOOL OF BUSINESS AND CREATIVE
TECHNOLOGIES**

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

HONG KONG – CED (INTAKES 37 & 39)

SEMESTER 1 EXAMINATIONS 2010/2011

FINANCIAL MANAGEMENT

MODULE NO: ACC3015

Date: 4th December 2010

Time: 3 hours

INSTRUCTIONS TO CANDIDATES:

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

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.

School of Business and Creative Technologies
 BA (Hons) Accountancy by Distance Learning
 Hong Kong – CED (Intakes 37 & 39)
 Semester 1 Examinations 2010/2011
 Financial Management
 Module No. ACC3015

Answer ALL questions

Question 1

Red Star Co 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 Red Star Co and are redeemable at par in 8 years time. They have a current ex interest market price of \$105 per \$100 loan note. Red Star Co pays tax on profits at an annual rate of 30%

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

Average sector ratios:

Financial gearing: 45% (prior charge capital divided by equity capital on a book value basis)

Interest cover ratio: 12 times

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

School of Business and Creative Technologies
BA (Hons) Accountancy by Distance Learning
Hong Kong – CED (Intakes 37 & 39)
Semester 1 Examinations 2010/2011
Financial Management
Module No. ACC3015

Question 1 continued

Required:

- a) Calculate the current weighted average cost of capital of Red Star Co.
(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

School of Business and Creative Technologies
 BA (Hons) Accountancy by Distance Learning
 Hong Kong – CED (Intakes 37 & 39)
 Semester 1 Examinations 2010/2011
 Financial Management
 Module No. ACC3015

Question 2

Saint & 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. Saint & Co expects demand for Product X to be as follows:

Year	1	2	3	4
Demand (units)	35,000	40,000	50,000	25,000

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:

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

Other information:

Saint & 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

Saint & 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...

School of Business and Creative Technologies
 BA (Hons) Accountancy by Distance Learning
 Hong Kong – CED (Intakes 37 & 39)
 Semester 1 Examinations 2010/2011
 Financial Management
 Module No. ACC3015

Question 3

TEA & Co is planning to buy CUP & Co, a company in the same business sector, and is considering paying cash for the shares of the company. The cash would be raised by TEA & Co through a 1 for 3 rights issue at a 20% discount to its current share price.

The purchase price of the 1 million issued shares of CUP & Co would be equal to the rights issue funds raised, less issue costs of \$320,000. Earnings per share of CUP & Co at the time of acquisition would be 44.8c per share. As a result of acquiring CUP & Co, TEA & Co expects to gain annual after-tax savings of \$96,000. TEA & Co maintains a payout ratio of 50% and earnings per share are currently 64c per share. Dividend growth of 5% per year is expected for the foreseeable future and the company has a cost of equity of 12% per year.

Information from TEA & Co Statement of Financial Position:

Equity and liabilities	\$000
Shares (\$1 par value)	3,000
Reserves	<u>4,300</u>
	7,300
Non-current liabilities	
8% loan notes	5,000
Current liabilities	<u>2,200</u>
Total equity and liabilities	<u>14,500</u>

Required:

(a) Calculate the current ex dividend share price of TEA Co and the current market capitalisation of TEA & Co using the dividend growth model. **(4 marks)**

(b) Assuming the rights issue takes place and ignoring the proposed use of the funds raised, calculate:

- (i) the rights issue price per share;
- (ii) the cash raised;
- (iii) the theoretical ex rights price per share; and
- (iv) the market capitalisation of TEA & Co.

(5 marks)

(c) Using the price/earnings ratio of TEA & Co, calculate the share price and market capitalisation of CUP & Co before acquisition.

(3 marks)

(d) Assuming a semi-strong form efficient capital market, calculate the post acquisition market capitalisation and share price of TEA & Co once the after-tax savings have been made public.

(5 marks)

(e) Discuss the factors that TEA & Co should consider, in its circumstances, in choosing between equity finance and debt finance as a source of finance from which to make a cash offer for CUP & Co.

(8 marks)

TOTAL 25 MARKS

PLEASE TURN THE PAGE...

School of Business and Creative Technologies
BA (Hons) Accountancy by Distance Learning
Hong Kong – CED (Intakes 37 & 39)
Semester 1 Examinations 2010/2011
Financial Management
Module No. ACC3015

Question 4

Gourmet Co is an importer/exporter of kitchen equipment. It is based in the UK but trades with other countries throughout Europe. The company is about to invoice a customer in Germany for €750,000, receivable in 3 months' time. Gourmet's treasurer 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 €750,000.

The spot rate of exchange is € 1.1434 to £1. The 3-month forward rate of exchange is €1.1288 to £1. The annual interest for borrowing in Germany is 2% and for Investing in the UK is 3%.

Required:

- (a) Advise the treasurer on which of the 2 methods is the most financially advantageous for Gourmet Co. Include relevant calculations in your advice. **(9 marks)**
- (b) Explain the causes of exchange rate fluctuations **(6 marks)**
- (c) Evaluate other methods available to hedge exchange rate risk **(10 marks)**

TOTAL 25 MARKS

END OF QUESTIONS