THE INSTITTUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF PAKSITAN (ICPAP)

Stage	**Knowledge**	Course Code	**K-203**
Examination	**Summer-2011**	Course Name	**Financial Management**
Time Allowed	**03 Hours**	Maximum Marks	**100**

NOTES:
1. All questions are to be attempted.
2. Answers are expected to the precise, to the point and well written.
3. Neatness and style will be taken into account in marking the papers.

Question No 1

Hammad Co is a listed company that plans to spend Rs10m on expanding its existing business. It has been suggested that the money could be raised by issuing 9% loan notes redeemable in ten years' time. Current financial information on Hammad Co is as follows.

Income statement information for the last year

	Rs 000
Profit before interest and tax	7,000
Interest	(500)
Profit before tax	6,500
Tax	(1,950)
Profit for the period	4,550

Balance sheet for the last year	Rs 000	Rs 000
Non-current assets		20,000
Current assets		20,000
Total assets		**40,000**
Equity and liabilities		
Ordinary shares, par value Rs 1	5,000	
Retained earnings	22,500	
Total equity		27,500
10% loan notes	5,000	
9% preference shares, par value Rs 1	2,500	
Total non-current liabilities		7,500
Current liabilities		5,000
Total equity and liabilities		**40,000**

The current ex div ordinary share price is Rs 4.50 per share. An ordinary dividend of 35 paisas 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 paisas. The loan notes are secured on the existing non-current assets of Droxfol Co and are redeemable at par in eight years' time. They have a current ex interest market price of Rs 105 per Rs 100 loan note. Hammad Co pays tax on profits at an annual rate of 30%.

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

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

Interest coverage ratio: 12 times

Required:

(a) Calculate the current weighted average cost of capital of Hammad Co. **(06)**

(b) Discuss whether financial management theory suggests that Hammad Co can reduce its weighted average cost of capital to a minimum level.

(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 coverage ratio;
(ii) Financial gearing;
(iii) Earnings per share. **(08)**

Assume that the dividend growth rate of 4% is unchanged. **(06)**

Question No 2

XY Co has annual sales revenue of Rs 6 million and all sales are on 30 days' credit, although customers on average take ten days more than this to pay. Contribution represents 60% of sales and the company currently has no bad debts. Accounts receivable are financed by an overdraft at an annual interest rate of 7%. XY Co plans to offer an early settlement discount of 1.5% for payment within 15 days and to extend the maximum credit offered to 60 days. The company expects that these changes will increase annual credit sales by 5%, while also leading to additional incremental costs equal to 0.5% of turnover. The discount is expected to be taken by 30% of customers, with the remaining customers taking an average of 60 days to pay.

Required:

(a) Evaluate whether the proposed changes in credit policy will increase the profitability of XY Co.

(b) AB Co, a subsidiary of XY Co, has set a minimum cash account balance of Rs 7,500. The average cost to the company of making deposits or selling investments is Rs 18 per transaction and the standard deviation of its cash flows was Rs 1,000 per day during the last year. The average interest rate on investments is 5.11%. Determine the spread, the upper limit and the return point for the cash account of AB Co using the Miller-Orr model and explain the relevance of these values for the cash management of the company.

(c) Identify and explain the key areas of accounts receivable management.

(d) Discuss the key factors to be considered when formulating a working capital funding policy. **(5x4=20)**

Question No 3

3 star Co is a UK-based company which has the following expected transactions..

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

The finance manager has collected the following information:

Spot rate (Rs per £):	1.7820 ± 0.0002
One month forward rate (Rs per £):	1.7829 ± 0.0003
Three months forward rate (Rs per £):	1.7846 ± 0.0004

Money market rates for 3 star Co:

	Borrowing	Deposit
One year sterling interest rate:	4.9%	4.6
One year dollar interest rate:	5.4%	5.1

Assume that it is now 1 April.

Required:

(a) Discuss the differences between transaction risk, translation risk and economic risk.

(b) Explain how inflation rates can be used to forecast exchange rates.

(c) Calculate the expected sterling receipts in one month and in three months using the forward market.

(d) Calculate the expected sterling receipts in three months using a money-market hedge and recommend whether a forward market hedge or a money market hedge should be used.

(e) Discuss how sterling currency futures contracts could be used to hedge the three month dollar receipt. **(4x5=20)**

Question No 4

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

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

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

Selling price and costs are expected to increase as follows:

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

Other information

Reliance 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.

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

Required:
(a) Calculate the net present value of buying the new machine and comment on your findings (work to the nearest Rs 1,000). **(08)**

(b) Calculate the before-tax return on capital employed (accounting rate of return) based on the average investment and comment on your findings. **(06)**

(c) Discuss the strengths and weaknesses of internal rate of return in appraising capital investments. **(06)**

Question No 5

a. Explain the concept of 'Working Capital Leverage' and comment on its usefulness in assessing the operating risk of a firm. **(10)**

b. The following data of Ex. Ltd and EM ltd. Are available:

	(Rs. Thousand)	
	Ex Ltd.	Em Ltd.
Current assets	350	50
Net fixed assets	50	350
EBIT	75	75
Sales	3500	500

a. Calculate the Working Capital Leverage for the two companies for a given percentage change in current assets and comment on the results.
b. Comment on the appropriateness of the investment strategies of the two firms. **(10)**

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