SECTION A

FINANCIAL MANAGEMENT FUNCTION

A

1. Whilst the financial plans of the business are based on a single objective, it faces a number of constraints that put pressure on the company to address more than one objective simultaneously.

Required

What types of constraints might the company face when assessing its long-term plans? Specifically refer in your answer to:

(a) responding to various stakeholder groups; and

(5 marks)

(b) the difficulties associated with managing organisations with multiple objectives.

(5 marks)
(10 marks)
(Adapted from Paper 2.4 June 2002)

2. EPS and Shareholder wealth maximisation-JJG Co

JJG 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 JJG 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 JJG Co is as follows:

	2008	2007	2006	2005
Revenue ($m)	28·0	24·0	19·1	16·8
Profit before interest and tax ($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
Share capital ($m)	5·5	5·5	5·5	5·5
Reserves ($m)	13·7	10·4	7·6	5·1
8% Bonds, redeemable 2015 ($m)	20	20	20	20
Share price ($)	8·64	5·74	3·35	2·67

The par value of the shares of JJG Co is $1·00 per share. The general level of inflation has averaged 4% per year in the period under consideration. The bonds of JJG Co are currently trading at their par value of $100. The following values for the business sector of JJG 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%

Required:

(a) Evaluate the financial performance of JJG Co, and analyse 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.

Note: up to 7 marks are available for financial analysis.

(12 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 JJG Co;
(ii) the earnings per share of the company; and
(iii) the debt/equity ratio.

(6 marks)

(c) Analyse 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.

(7 marks)
(25 marks)
(Paper F9 June 2009)

3. Multiple stakeholders

Private sector companies have multiple stakeholders who are likely to have divergent interests.

Required:

Identify five stakeholder groups and briefly discuss their financial and other objectives.

(10 marks)
(Adapted from Paper 2.4 December 2002)

QUESTION BANK

SECTION B

FINANCIAL MANAGEMENT ENVIRONMENT

B

4. Financial management environment – Tagna

Tagna is a medium-sized company that manufactures luxury goods for several well-known chain stores. In real terms, the company has experienced only a small growth in revenue in recent years, but it has managed to maintain a constant, if low, level of reported profits by careful control of costs. It has paid a constant nominal (money terms) dividend for several years and its managing director has publicly stated that the primary objective of the company is to increase the wealth of shareholders. Tagna is financed as follows:

	$m
Overdraft	1·0
10 year fixed interest bank loan	2·0
Share capital	4·5
	7·5

Tagna has the agreement of its existing shareholders to make a new issue of shares on the stock market but has been informed by its bank that current circumstances are unsuitable. The bank has stated that if new shares were to be issued now they would be significantly under-priced by the stock market, causing Tagna to issue many more shares than necessary in order to raise the amount of finance it requires. The bank recommends that the company waits for at least six months before issuing new shares, by which time it expects the stock market to have become strong-form efficient.

The financial press has reported that it expects the Central Bank to make a substantial increase in interest rate in the near future in response to rapidly increasing consumer demand and a sharp rise in inflation. The financial press has also reported that the rapid increase in consumer demand has been associated with an increase in consumer credit to record levels.

Required:

(a) Briefly explain the nature and purpose of a stock exchange.

(5 marks)

(b) Discuss the possible advantages for a company of obtaining a listing on a stock exchange.

(5 marks)

(c) On the assumption that the Central Bank makes a substantial interest rate increase, discuss the possible consequences for Tagna in the following areas:

(i) sales;
(ii) operating costs; and,
(iii) earnings (profit after tax).

(9 marks)

(d) Explain and compare the public sector objective of 'value for money' and the private sector objective of 'maximisation of shareholder wealth'.

(6 marks)
(25 marks)
(Adapted from Paper 2.4 June 2003)

5. Financial intermediary

(a) Define the term 'financial intermediary', distinguishing between a 'broker' and a 'principal'. Give four examples of organisations that act as financial intermediaries.

(4 marks)

(b) Discuss three main benefits of financial intermediation.

(6 marks)
(10 marks)

6. Role of financial intermediaries - APX Co

APX Co achieved a turnover of $16 million in the year that has just ended and expects turnover growth of 8.4% in the next year. Cost of sales in the year that has just ended was $10.88 million and other expenses were $1.44 million.

The financial statements of APX Co for the year that has just ended contain the following statement of financial position:

	$m	$m
Non-current assets		22.0
Current assets		
Inventory	2.4	
Trade receivables	2.2	
		4.6
Total assets		26.6
	$m	**$m**
Equity finance:		
Share capital	5.0	
Reserves	7.5	
		12.5
Long-term bank debt		10.0
		22.5
Current liabilities		
Trade payables	1.9	
Overdraft	2.2	
		4.1
Total liabilities		26.6

The long-term bank loan has a fixed annual interest rate of 8% per year. APX Co pays taxation at an annual rate of 30% per year.

The following accounting ratios have been forecast for the next year:

Gross profit margin:	30%
Operating profit margin:	20%
Dividend payout ratio:	50%
Inventory turnover period:	110 days
Trade receivables period:	65 days
Trade payables period:	75 days

Overdraft interest in the next year is forecast to be $140,000. No change is expected in the level of non-current assets and depreciation should be ignored.

Required:

(a) Discuss the role of financial intermediaries in providing short-term finance for use by business organisations.

(4 marks)

(b) Prepare the following forecast financial statements for APX Co using the information provided:

(i) an income statement for the next year; and
(ii) a statement of financial position at the end of the next year.

(9 marks)

SOLUTION BANK

SECTION C

WORKING CAPITAL MANAGEMENT

C

8. EOQ and receivables management - Asifco Inc

Strategy

You are required to solve three independent parts in this question. Therefore, if you make an error in your calculations for one question, it will not affect the outcome in another question. In addition each step carries marks. Thus each question will help you to score more marks.

In part (a) remember that costs involved in the current ordering policy include cost of ordering the inventory and the cost of holding it. Also, while calculating cost of holding inventory under the EOQ model, it is important to include the cost of holding inventory on the buffer inventory.

While attempting Part (b), be careful to consider the effects of salaries and redundancy packages paid.

Part (c) is a simple theory question and will test your knowledge of management of receivables.

(a) In order to calculate the savings of the company under the EOQ policy, the total ordering cost under the current ordering policy should be compared with the total ordering cost under the EOQ policy.

Cost of current ordering policy

Ordering cost	=	Number of orders x Cost per order		
	=	(625,000/100,000) units x $125	= $781	
				1 mark
Calculation of holding cost				
Annual demand			= 625,000 units	
Weekly demand	=	Annual demand/50 weeks	= 12,500 units	
Therefore consumption during two weeks lead time = 25,000 units				
				0.5 marks
Buffer inventory	=	Re-order level - Usage during lead time		
	=	35,000 - 25,000	= 10,000 units	
				0.5 marks
Average annual inventory held	=	Buffer inventory + Ordering quantity/2		
	=	10,000 + (100,000/2)	= 60,000 units	
				0.5 marks
Holding cost per year	=	Average annual inventory held x Cost of holding one unit		
	=	60,000 units x $0.60	= $36,000	
				1 mark
Total cost using current policy - A	=	Ordering cost + Holding cost		
	=	781 + 36,000	= $36,781	
				1 mark

Cost of EOQ ordering policy

Economic Order Quantity (EOQ) $= \sqrt{\dfrac{2\ Co\ D}{Ch}}$

Where;
C_o = Ordering cost
C_h = Holding cost
D = Annual demand

$= \sqrt{\dfrac{2 \times 125 \times 625{,}000}{0.6}}$ = 16,137 units (approx.)

1 mark

Number of orders per year = Annual demand / EOQ
= 625,000 units/16,137 units = 39 orders

0.5 marks

Ordering cost = Cost per order x Number of orders per year
= $125 x 39 = $4,875 1 mark

Holding cost
(i) ignoring buffer inventory = Annual cost of holding one unit x (Consumption during lead time/2)
= $0.6 x (25,000 units/2) = $7,500

1 mark

(ii) including buffer inventory = Annual cost of holding one unit x ((Consumption during lead time/2)+ Buffer inventory)
= $0.6 x ((25,000 units/2) + 10,000 units) = $13,500

1 mark

Total cost using EOQ policy - B = Ordering cost + Holding cost
= 4,875 + 13,500 = $18,375

1 mark

As a result of making use of the EOQ policy for ordering, Asifco would save:
= Total cost using current policy – Total cost using EOQ policy
= A – B = $36,781 - $18,375 i.e. **$18,406**

1 mark
Maximum marks 8

(b) Decision to factor receivables

In order to take a decision to factor receivables, Asifco would need to analyse the costs of factoring versus the existing finance costs incurred by them.

	$	**Marks**
Expected receivables ($7,900,000 x 125%)	9,875,000	1
Existing finance cost (overdraft cost per annum i.e. $9,875,000 x 10%) – **A**	**987,500**	1
Expected level of revenue ($25.5 million x 125%)	31,875,000	1
Receivables for factor's credit period ($31,875,000 x 60/365)	5,239,726	1
Finance cost (Interest of 11% on the amount of receivables advanced by factor ($5,239,726 x 70%))	403,459	1
Finance cost (Interest on balance, financed by overdraft ($5,239,726 x 30% x 10%))	157,192	1
Administration expenses ($31,875,000 x 0.5%)	159,375	1
Less: Administration expenses saved (Salaries of credit control staff = ($42,000 x 2) - ($9,000 x 2))	(66,000)	1
Cost of factoring - B	**654,026**	1

Cost savings while factoring receivables **(A - B)** **$333,474**

As a result, it would be advisable to factor receivables, with a total saving of $333,474.

1 mark
Maximum marks 10