No. of Pages - 10
No of Questions - 05

SCHOOL OF ACCOUNTING AND BUSINESS
BSc. (APPLIED ACCOUNTING) GENERAL / SPECIAL DEGREE PROGRAMME

YEAR II SEMESTER II – INTAKE IV/V (GROUP A)
END SEMESTER EXAMINATION – JANUARY 2017

AFM 20530 Business Finance

Date	:	19th January 2017
Time	:	9.00 a.m. - 12.00 p.m
Duration	:	Three (03) hours

Instructions to Candidates:

- This paper consists of three sections (A, B and C).
- Section A – Answer **ALL** the questions in the sheet provided.
  Section B – Question is **compulsory**
  Section C – Answer only **Two** question out of the two questions given.
- The total marks for the paper is 100.
- The marks for each question are shown in brackets.
- Answers should be written neatly and legibly.

PART A

Answer **ALL** the questions

Question No. 01

1. Which of the following financial instruments will **NOT** be traded on a money market?
   a. Commercial paper
   b. Treasury bills
   c. Certificates of deposit
   d. Convertible bonds

2. Virgin Atlantic is a British airline operates in fifty countries around the world. Organization is now considering expanding their fleet of aeroplanes, thus consider acquiring three aeroplanes from model AX 202I. The decision to acquire aeroplanes will be a,
   a. Capital budgeting decision
   b. Financing decision
   c. Dividends decision
   d. Pay-out decision

3. In relation to an operating lease, which one of the following statements is correct?
   a. All the risks and rewards of ownership transfer to the lessee
   b. The asset and lease obligation will be recorded in the statement of financial position of lessee
   c. The lease period will cover almost all of the leased asset's useful economic life
   d. The lessor will be responsible for repairs and maintenance of the leased asset

4. The owners of a private company wish to dispose of their entire investment in the company. The company has an issued share capital of Rs.1m of Rs.0·50 nominal value ordinary shares. The owners have made the following valuations of the company's assets and liabilities.

   Non-current assets (book value) Rs.30m
   Current assets Rs. 18m
   Non-current liabilities Rs. 12m
   Current liabilities Rs.10m

The net realisable value of the non-current assets exceeds their book value by Rs.4m. The current assets include Rs. 2m of accounts receivable which are thought to be irrecoverable. What is the minimum price per share which the owners should accept for the company?

a. Rs.14
b. Rs.25
c. Rs.28
d. Rs.13

The following scenario relates to questions 5 and 6.

Ring Co has in issue ordinary shares with a nominal value of Rs.0·25 per share. These shares are traded on an efficient capital market. It is now 20X6 and the company has just paid a dividend of Rs.0·450 per share. Recent dividends of the company are as follows:

Year	20X6	20X5	20X4	20X3	20X2
Dividend per share	Rs.0·450	Rs.0·428	Rs.0·408	Rs.0·389	Rs.0·370

Ring Co also has in issue debentures which are redeemable in seven years' time at their nominal value of Rs.100 per debenture and which pays interest of 6% per year.

The finance director of Ring Co wishes to determine the value of the company.

Ring Co has a cost of equity of 10% per year and a before-tax cost of debt of 4% per year. The company pays corporation tax of 25% per year.

5. Using the dividend growth model, what is the market value of each ordinary share?
   a. Rs. 8·59
   b. Rs. 9·00
   c. Rs. 9·45
   d. Rs. 7·77

6. What is the market value of each debenture?
   a. Rs. 109·34
   b. Rs. 112·01
   c. Rs. 116·57
   d. Rs. 118·68

7. With regard to the treasury bills, which one of the following statements is correct?
    a. Non-resident Sri Lankans cannot invest in treasury bills
    b. Central Bank of Sri Lanka is authorized to issue Treasury bills
    c. Finance Department of Central Bank of Sri Lanka issues treasury bills on behalf of the government
    d. Corporate bodies incorporated outside Sri Lanka can invest in treasury bills

8. Which of the following statement about corporate bonds and debentures is incorrect?
    a. Bonds are often backed by a collateral whereas debentures are not.
    b. Debentures are issued not for a specific purpose.
    c. Bonds are issued typically to raise short-term capital for upcoming expenses or to pay for expansions
    d. Bonds are called revenue bonds

9. The 10% convertible bonds of Starch white Co. are quoted at Rs.142 per Rs.100 nominal. The earliest date for conversion is in four years' time, at the rate of 30 ordinary shares per Rs.100 nominal bond. The share price is currently Rs.4.15. Annual interest on the bonds has just been paid.

    What is the current conversion value of the bond?
    a. Rs. 1.245
    b. Rs. 124.5
    c. Rs. 4260
    d. Rs. 3000

10. Which of the following is **not true** of a rights issue by a listed company?
    a. Rights issues do not require a prospectus
    b. The rights issues price can be at a discount to market price
    c. If shareholders do not take up the rights, the rights lapse
    d. Relative voting rights are unaffected if shareholders exercise their rights

(Total 20 Marks)

PART B

Question is compulsory and MUST be attempted.

Question No. 02

a. Briefly explain cost of capital and its importance in project appraisal

(05 Marks)

b. Risk is an important factor that must be considered in evaluating individual investments. Explain the concepts of **systematic and unsystematic risk.**

(08 Marks)

c. The following Statement of financial position relates to the Mango PLC for the year ended 31st December 2015.

	Rs 000'	Rs 000'	Rs 000'
Assets			
Non-current assets			90,000
Current assets			
Inventory		8,000	
Trade receivables		14,000	
Cash		5,000	
			27,000
Total assets			117,000
Equity and Liabilities			
Equity			
Ordinary share capital		40,000	
Preference share capital		15,000	
Retained earnings		9,000	
Total Equity			64,000
Non-current liabilities			
Long term borrowings			25,000

Current liabilities		
Trade payables	10,000	
Other payables	18,000	
		28,000
Total equity and liabilities		117,000

The ordinary shares of the company has a nominal value of Rs. 10 per share and ex div market price of Rs. 25 per share.

Company pay dividends annually and the next annual dividend will be paid in one year's time and dividends are expected to grow by 4% per year into the foreseeable future. The next annual dividend is expected to be Rs.2 per share.

The long-term borrowings of Mango PLC consist of 7% bonds that are redeemable in six years' time at their nominal value of Rs.100 per bond. The current ex interest market price of the bonds is Rs.103.50.

The preference shares of Mango PLC have a nominal value of Rs. 10 per share and pay an annual dividend of 8%. The ex div market value of the preference shares is Rs. 6 per share. Mango PLC Co pay profit tax at an annual rate of 25% per year.

Required

I. Calculate after tax cost of debt of Mango PLC.

(07 Marks)

II. Calculate weighted average after tax cost of capital of Mango PLC.

(05 Marks)

III. Briefly list down the drawbacks of the method occupied in the calculation of cost of equity.

(05 Marks)

(Total 30 Marks)

PART C

Answer **Only Two** questions

Question No. 03

a. Briefly list down the situations where business valuations are required.

(05 Marks)

b. Fine Tune PLC is a technology company involve in the manufacture of mobile phones, soft wares, mobile phone apps and etc. they have developers and AI architects who are highly specialized. Abilities of these key personnel are a key driver of success of the company.

Business was started 15 years ago and now occupy twenty full time software developers and five AI architects who constantly engage in product upgrade and new product development. The shareholders of Fine Tune PLC mainly comprise of the original founders of the business who would now like to realize their investment. Thus they have hired you as a consultant to perform a business valuation for the company.

	Rs 000'	**Rs 000'**	**Rs 000'**
Assets			
Non-current assets			120,000
Patents			10,000
Goodwill			30,000
Current assets			
Inventory		12,000	
Trade receivables		14,000	
Cash		10,000	
			36,000
Total assets			196,000
Equity and Liabilities			

Equity		
Ordinary share capital	70,000	
6% Preference share capital	29,000	
Retained earnings	20,000	
Total Equity		119,000
Non-current liabilities		
10% Debentures		45,000
Current liabilities		
Trade payables	12,000	
Other payables	20,000	
		32,000
Total equity and liabilities		196,000

Notes

1. The net assets of Fine Tune PLC are the net book values of tangible non-current assets plus net working capital. However:
   - A recent valuation of the buildings was Rs.15, 000,000 above the book value.
   - Inventory includes mobile phones of previous models which have a realisable value of Rs. 1,000,000 below their cost.
   - Due to a dispute with one of their clients, an additional allowance for bad debts of Rs. 750,000 could prudently be made.

2. 10% debentures are repayable in five years' time at par value of Rs. 100 per debenture and has after tax cost of debt of 4%

3. Cost of preference shares of the company is 8%. Nominal value of the preference shares is Rs. 10 per share.

4. Risk free rate of return of the country is 7% and the market risk premium and beta are 5% and 1.2 respectively.

5. Company has recently paid a dividend of Rs. 1.5 per share and expect a constant dividend growth of 5% in the foreseeable future.

Required

I. Calculate the value of the ordinary shares under the following methods and comment on the suitability of the method in valuing Fine Tune PLC shares.

   i. Net asset value method

(06 Marks)

   ii. Dividend growth model

(06 Marks)

II. Calculate the value of debentures and preference shares

(08 Marks)

(Total 25 Marks)

<u>Question No. 04</u>

a. Rabbit PLC is a manufacturing company operates in the country of Beeland. The annual demand for the product is 1,800,000 units and the purchase price is Rs. 50 per unit.

   It costs Rs. 200 order cost per order and the holding cost per unit is 10% of purchase price. Suppliers have offered to give a bulk discount of 10% of purchase price for orders above 15,000 units.

Required

I. Calculate the EOQ of the company (ignore bulk discount)

(05 Marks)

II. Calculate and comment whether accepting the bulk discount is beneficial for the company.

(05 Marks)

b. Rabbit PLC is considering a change of credit policy which will result in an increase in the average collection period from one month to two months. The relaxation in credit is expected to produce an increase in sales in each year amounting to 20% of the current sales volume.

Selling price per unit	Rs. 100
Variable cost per unit	Rs.85
Current annual sales	Rs. 18,000,000

The required rate of return on investments is 20%. Assume that the 20% increase in sales would result in additional inventories of Rs.150, 000 and additional accounts payable of Rs.40, 000.

Required

I. Advise the company on whether or not to extend the credit period offered to customers, if: Existing customers do not change their payment habits, and only the new customers take a full two months credit

(10 Marks)

II. Briefly explain overtrading with its symptoms

(05 Marks)

(Total 25 Marks)

Question No. 05

Lion air is an airline company operates in 70 countries around the world. Company was established fifty years ago by Mr. John Sheppard. Since then company has been growing tremendously and it is now a listed company on New York stock exchange. They obtained the stock market listing through a Placement of shares and Mr. John Sheppard has held 35% of shares as at 31st December 2015 and the rest is owned by few number of institutional shareholders.

They intend to expand the company in to two other destinations collaborating with other airlines. They wish to finance the expansion by way of debt financing. Company therefore is in the process of deciding which financial instruments are to be issued. To support this activity company has consulted a rating agency and they have given a credit rating of B++.

To support this expansion finance manager has decided to cut off the dividend pay-out of the year and has increased the retention ratio. Thus 85% of the profit will be retained in the company.

Required

a. Briefly explain the difference between Finance and Financial Management

(04 Marks)

b. Explain Financial decisions with examples for each from the scenario given

(09 Marks)

c. Suggest the most suitable source of finance and financial instrument for the Lion air PLC and justify the reasons for your suggestion

(03 Marks)

d. Write short notes on any **three** of the following topics

I. Money market Vs Capital market
II. Short term Vs Long term sources of finance
III. Initial public offering (IPO) Vs. Private Placement
IV. Operating lease Vs Finance lease

(09 Marks)

(Total 25 Marks)