Mock Exams

ACCA

Paper F9

Financial Management

Mock Examination 1

Question Paper	
Time allowed	
Reading and Planning Writing	**15 minutes** **3 hours**
ALL FOUR questions are compulsory and MUST be attempted	
During reading and planning time only the question paper may be annotated	

DO NOT OPEN THIS PAPER UNTIL YOU ARE READY TO START UNDER EXAMINATION CONDITIONS

Question 1

It is currently December 20X7. Phoenix Co, which manufactures building products, experienced a sharp increase in profits before interest and tax from the $25m level in 20X5-6 to $40m in 20X6-7 as the economy emerged from recession, and demand for new houses increased. The increase in profits has been entirely due to volume expansion, with margins remaining static. It still has substantial excess capacity and therefore no pressing need to invest, apart from routine replacements.

In the past, Phoenix has followed a rather conservative financial policy, with restricted dividend payouts and relatively low borrowing levels. It now faces the issue of how to utilise an unexpectedly sizeable cash surplus. Directors have made two main suggestions. One is to redeem the $10m secured loan stock issued to finance a capacity increase several years previously, the other is to increase the dividend payment by the same amount. Phoenix's present capital structure is shown below.

	$m
Issued share capital (25c par value)	70
Reserves	130
Payables falling due after more than one year:	
7% secured loan notes 20Y7	10

Further information

(i) Phoenix has not used an overdraft during the two years.
(ii) The rate of tax on company profits is 30%.
(iii) The dividend paid by Phoenix in 20X5-6 was 1.50 cents per share.
(iv) Sector averages currently stand as follows.

Dividend cover	2.6 times
Gearing (long-term debt/equity)	45%
Interest coverage	6.5 times

Required

(a) Calculate the dividend payout ratios and dividend covers for *both* 20X5-6 *and* for the reporting year 20X6-7, if the dividend is raised as proposed. **(7 marks)**

(b) You have recently been hired to work as a financial strategist for Phoenix, reporting to the finance director. Using the information provided, write a report to your superior, which identifies and discusses the relative merits of the two proposals for utilising the cash surplus. **(18 marks)**

(Total = 25 marks)

Question 2

(a) Discuss:

(i) The significance of trade payables in a firm's working capital cycle; and **(4 marks)**

(ii) The dangers of over-reliance on trade credit as a source of finance. **(4 marks)**

(b) Keswick Co traditionally follows a highly aggressive working capital policy, with no long-term borrowing. Key details from its recently compiled accounts appear below.

	$m
Sales (all on credit)	10.00
Earnings before interest and tax (EBIT)	2.00
Interest payments for the year	0.50
Shareholders' funds (comprising $1m issued share capital, par value 25c, and $1m revenue reserves)	2.00
Receivables	0.40
Inventories	0.70
Trade payables	1.50
Bank overdraft	3.00

A major supplier, which accounts for 50% of Keswick's cost of sales, is highly concerned about Keswick's policy of taking extended trade credit. The supplier offers Keswick the opportunity to pay for supplies within 15 days in return for a discount of 5% on the invoiced value.

Keswick holds no cash balances but is able to borrow on overdraft from its bank at 12%. Tax on corporate profit is paid at 30%.

Required

Determine the costs and benefits to Keswick of making this arrangement with its supplier, and recommend whether Keswick should accept the offer.

Your answer should include the effects on:

- The working capital cycle
- Interest coverage
- Profits after tax
- Earnings per share
- Return on equity
- Capital gearing **(12 marks)**

(c) Sellmoor Co is considering a proposal to change its credit policy from allowing its receivables a credit period of 50 days, to either 40 days or 60 days, and supplied you with the following data.

Period of credit allowed to receivables	*Annual turnover (all on credit)*
Days	$'000
50 (current)	420
40	350 (estimated)
60	520 (estimated)

The average profit/volume ratio for the company is 22% and the cost of financing receivables is 12%.

Required

Compute and explain briefly what the effect on profit of each proposal by Sellmoor Co would be, if adopted. **(5 marks)**

(Total = 25 marks)

Question 3

(a) Briefly explain the main features of the following.

(i) Sale and leaseback
(ii) Hire purchase
(iii) Finance leases **(6 marks)**

(b) Howgill Co is the leasing subsidiary of a major commercial bank. It is approached by Clint Co, a company entirely financed by equity, which operates in the pharmaceutical industry, with a request to arrange a lease contract to acquire new computer-controlled manufacturing equipment to further automate its production line. The outlay involved is $20m. The equipment will have only a four-year operating life due to the fast rate of technical change in this industry, and no residual worth. The basic project has a positive net present value when operating cash flows are discounted at the shareholders' required rate of return.

Howgill would finance the purchase of the machinery by borrowing at a pre-tax annual rate of 14½%. The purchase would be completed on the final day of its accounting year, when it would also require the first of the annual rental payments. Howgill currently pays tax at 30%, 12 months after its financial year end. A writing-down allowance is available based on a 25% reducing balance.

Under the terms of the lease contract, Howgill would also provide maintenance services, valued by Clint at $750,000 pa. These would be supplied by Howgill's computer maintenance sub-division at no incremental cost as it currently has spare capacity which is expected to persist for the foreseeable future. Clint has the same financial year as Howgill, also pays tax at 30% and its own bank will lend at 17½% before tax.

Required

Calculate the minimum rental which Howgill would have to charge in order to just break even on the lease contract. You may assume that the rental is wholly tax-allowable as a business expense.

(6 marks)

(c) Assume that Howgill does proceed with the contract and charges an annual rental of $7m. Calculate whether, on purely financial criteria, Clint should lease the asset or borrow in order to purchase it outright:

(i) Ignoring the benefit to Clint of the maintenance savings **(6 marks)**
(ii) Allowing for the maintenance savings. **(3 marks)**

(d) Discuss the non-financial factors that may influence the decision whether to lease or buy. **(4 marks)**

(Total = 25 marks)

Question 4

(a) KB Co has a paid-up ordinary share capital of $1,500,000 represented by 6 million shares of 25c each. It has no loan capital. Earnings after tax in the most recent year were $1,200,000. The P/E ratio of the company is 12.

The company is planning to make a large new investment which will cost $5,040,000, and is considering raising the necessary finance through a rights issue at 192c.

Required

(i) Calculate the current market price of KB Co's ordinary shares. **(2 marks)**

(ii) Calculate the theoretical ex-rights price, and state what factors in practice might invalidate your calculation. **(6 marks)**

(iii) Briefly explain what is meant by a deep-discounted rights issue, identifying the main reasons why a company might raise finance by this method. **(3 marks)**

(b) As an alternative to a rights issue, KB Co might raise the $5,040,000 required by means of an issue of convertible loan notes at par, with a coupon rate of 6%. The loan notes would be redeemable in seven years' time. Prior to redemption, the loan notes may be converted at a rate of 35 ordinary shares per $100 nominal.

Required

(i) Explain the term *conversion premium* and calculate the conversion premium at the date of issue implicit in the data given. **(4 marks)**

(ii) Identify the advantages to KB Co of issuing convertible loan notes instead of the rights issue to raise the necessary finance. **(5 marks)**

(iii) Explain why the market value of convertible loan notes is likely to be affected by the dividend policy of the issuing company. **(5 marks)**

(Total = 25 marks)