 Serial No.……………..

Institute of Certified Management Accountants of Sri Lanka
Strategic Level
May 2015 Examination

Examination Date :	16th May 2015	**Number of Pages :**	06
Examination Time:	1.30 p:m. – 4.30 p:m.	**Number of Questions:**	05

Instructions to Candidates

1. Time allowed is **three (3) hours.**
2. Total: **100** Marks**.**
3. Answer **all** questions in Part I and **three (3)** questions from Part II.
4. The answers should be in **English Language.**

Subject	Subject Code
Financial Strategy and Policy	**(FSP / SL 3 - 403)**

PART I

Answer **all** questions

Question No. 01 (40 Marks)

Fashion Wear (FW) is a medium-sized textile company supplying items of children's wear to large retail stores. The company has been operating for many years and financial statements of the company for the year ended 31st March 2015 are as follows:

Rs. In million

Capital and Reserves		**Fixed Assets**			
Common stock (Rs 0.25 per share)	4	Freehold land and building at cost			20.1
Retained profit	28	Plant and machinery at cost		13.2	
	32	Less: Accumulated Depreciation		4.6	8.6
Loan (12%)	10	Net fixed assets			28.7
		Current assets			
		Stock at cost		14.2	
		Accounts receivable		8.1	
		Cash		1.0	
				23.3	
		Current Liabilities			
		Trade creditors	5.7		
		Proposed dividend	1.0		
		Taxation	3.3	(10)	13.3
Total Liabilities	42	Total Assets			42.0

Extracts from the profit and loss account for the year ended 31st March 2014.

	Rs.m
Turnover	78.4
Profit before interest and taxation	10.5
Interest payable	1.2
Profit before taxation	9.3
Taxation	3.3
Profit after Taxation	6.0
Dividends	1.0
Retained profit for the year	5.0

The company has recently secured a large contract to supply a new range of children's wear for one of its major customers. Although new equipment costing Rs.8 million will have to be purchased it is estimated that the profit before interest and taxation will increase by Rs. 3 million as a result of taking the contract.

Industrial Finance company has offered to finance the expansion in any one of the following ways:

I. The purchase of 4 million ordinary shares at a price of Rs. 2.00 per share.
II. The purchase of Rs. 4 million 10% Rs.1/- per preference shares and Rs.4 million 12.5% debentures.
III. The purchase of 2 million ordinary shares at Rs 2.00 per share and Rs. 4 million 12.5% debentures.

The company expects to maintain dividend per share at its current level. The rate of corporate tax is 35%.

You are required to:

(a) Prepare a profit and loss account for FW for the year ended 31st March 2015 for each of the three financing scheme. **(10 Marks)**

(b) Calculate earnings per share for the year ended 31st March 2015 and the level of gearing at that date under each financing scheme. **(06 Marks)**

(c) Calculate the level of profit before interest and taxation at which the earnings per share under scheme (a) and (b) are equal. **(08 Marks)**

(d) Briefly assess each of the financing schemes available to FW from the view point of an existing shareholder. **(12 Marks)**

(e) Briefly assess each financing schemes from the view point of total funds employed. **(04 Marks)**

State any assumptions that you made. **(Total 40 Marks)**

End of Part I

Part II

Answer any **three (3)** questions

Question No. 02 (20 Marks)

(a) Alba Company has paid the following dividends per share in recent years:

	2014	2013	2012	2011
Dividend (cents per share)	24.0	23.8	22.8	20.4

The dividend for 2014 has just paid and Alba Company has a cost of equity of 12%.

You are required to:

(i) Estimate geometric average historical dividend growth rate;

(ii) Estimate market price of Alba company shares to the nearest cents on an ex-dividend basis.

(08 Marks)

(b) Gannet company has ordinary shares in issue with a value of Rs. 0·50 each. The company has recently paid a dividend of Rs. 0·15 per share. Vannet Company is also listed on the Colombo Stock Exchange and operates in the same industry. Vannet plc has ordinary shares in issue with a value of Rs. 1·00 and a current market value of Rs. 3·00. The company has recently paid a dividend of Rs 0·27 per share. The rate of income tax on dividends is 10%.

Estimate the value of each ordinary share in Gannet Ltd. on a dividend yield basis. **(08 Marks)**

(c) Some years ago, Mega Ltd issued bonds that pay interest on an annual basis at the rate of 8·0%. Interest has just been paid on the bonds, which are due for repayment in exactly two years' time. The bonds will be redeemed at Rs.110 per Rs.100 nominal value. A yield of 10% per year is required by investors for such bonds.

Estimate expected market value for the bonds? **(04 Marks)**

(Total 20 Marks)

Question No. 03 (20 Marks)

Hansel Products Company is considering the introduction of a new type of skin cream to Asian market. The new product require the purchase of a new piece of equipment costing 300,000 and no residual value on completion of the project.

	Per tube (Rs.)
Selling price	60.0
Variable cost	22.0

Fixed costs of Rs. 200,000 per annum will be apportioned fair share to the new product from the company fixed costs. Other development currently being finalized will mean that the new product will have a life of only three years and the level of expected demand for the new product is uncertain. The marketing department has produced the following level of demand and the probability of each for all three years of the product's life.

Year 1		**Year 2**		**Year 3**	
Sales	**probability**	**Sales (units)**	**probability**	**Sales (units)**	**probability**
100,000	0.2	140,000	0.3	180,000	0.5
120,000	0.4	150,000	0.3	160,000	0.3
125,000	0.3	160,000	0.2	120,000	0.1
130,000	0.1	200,000	0.2	100,000	0.1

A rival business has offered to buy the right to produce and sell the new cream for Rs.1,000,000/-. The cost of finance is 10% and interest charges on the money borrowed to finance the project are expected to be Rs.300,000/-.

You are required to:

(a) Compute the expected net present value of the product. **(10 Marks)**

(b) Advice the directors on the appropriate course of action to take. Give reasons. **(10 Marks)**

(Total 20 Marks)

<u>Question No. 04 (20 Marks)</u>

The following information is provided for Dayan Company in relation to existing credit policy.

Annual turnover	20 million
Bad debt	Rs. 100,000/-
Credit policy	100% on credit
Settlement period for debtors (on average)	60 days
Existing O/D paying 14% annual interest	Rs.6 million

New Proposal by credit department:

Discount: pay within 30 days	2.5%
Maximum credit period	60 days
Additional cost	20,000 per year

Credit Dept. expects at least 60% of the customers will take discount advantage.

They further believe that the new policy will not result in any reduction in sales.

You are required to calculate the net annual cost or savings to the company of abandoning its existing credit policy and adopting the proposals of credit control department. **(Total 20 Marks)**

Question No. 05 (20 Marks)

(a) The following table indicates financial position of the Gabrial Company which is seen as a potential target for an acquisition. The acquisition value has been a matter of debate in recent weeks.

Statement of financial position for 2014

	Rs. Mn	Rs. Mn		Rs. Mn	Rs. Mn
Equity finance			Non-current assets		100.0
Stated value of Ordinary shares					
(Rs. 1/= per share)	40.0		Current assets		
Reserves	42.3	682.3	Inventory	6.8	
			Debtors	5.5	12.3
Non-current liabilities					
9% bonds		20.0			
Current liabilities		10.0			
Total equity and liabilities		112.3	Total assets		112.3

During recent past years

Year	2014	2013	2012	2011
Profit after tax (Rs. Mn)	12.0	10.0	9.4	8.6

Following additional information is provided:

- Market value of a company share is Rs. 4·00 per share.
- Industry average price/earnings ratio is 17 times.
- The expected net realizable value of the non-current assets and the inventory are Rs. 105m and Rs. 7·2m, respectively.
- In case of liquidation, only 75% of the debtors are expected to be collectible.

You are required to calculate the value of the company using the following methods**:**

(i) Market capitalization of equity.

(ii) Net asset value (liquidation); and

(iii) Price / earnings ratio method using the business sector average price/earnings ratio.

(14 Marks)

(b) The following rates appear in the foreign exchange market.

	Spot rate	**2 month forward**
Rs./1US$	126.88 / 127.05	128.70 / 130

(i) How many dollars should a firm sell to get Rs. 128.7 million after two months?

(ii) How many rupees does the firm require to pay to obtain US $ 2,000,000 in the spot market?

(06 Marks)
(Total 20 Marks)
End of Part II

Present value table

Present value of 1.00 unit of currency, that is $(1 + r)^{-n}$ where r = interest rate; n = number of periods until payment or receipt.

Periods (n)	Interest rates (r)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods (n)	Interest rates (r)									
	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.079	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

End of Question Paper