THE INSTITUTE OF CHARTERED ACCOUNTANTS (GHANA)

NOVEMBER 2008 EXAMINATIONS
(PROFESSIONAL)

PART 3

FINANCIAL MANAGEMENT STRATEGY
(Paper 3.3)

Attempt ALL Questions

TIME ALLOWED: 3 HOURS

QUESTION 1

a) Maame Martha is considering buying a new machine which would have the following:

Cost	-	GH¢100,000
Scrap value	-	GH¢5,000
Useful life	-	5 years

The machine would produce 50,000 units per annum of a new product with an estimated selling price of GH¢3 per unit.

Direct cost would be GH¢1.75 per unit and annual fixed costs, including depreciation calculation on a straight-line basis, would be GH¢40,000 per annum.

In years 1 and 2, special sales promotion expenditure, not included in the above costs, would be incurred, amounting to GH¢10,000 and GH¢15,000 respectively.

As a consequence of this particular project, investment by the company in debtors and stocks would increase, during year 1, by GH¢15,000 and GH¢20,000 respectively, and creditors would also increase by GH¢10,000. At the end of the machine's life, debtors, stocks and creditors would revert to their previous levels.

You are required to:

Evaluate the project using the NPV method of investment appraisal, assuming the company's cost of capital is 10%.

(***10 marks)***

b) Liberty limited requires GH¢500,000 in financing over the next three years. They may borrow for three years at 20% p. a. or borrow for one year at 12% p.a. If they borrow for a year they can expect to refinance at the end of the year at 22% for one year, and then at 24% for another year.

i) How much will they have to pay at the end of three years in loan and interest under either option? There are no intermediate interest payments.

(***4 marks)***

ii) For the case where they borrow a year at a time and roll over, what is the effective annual rate over the three years?

(4 ***marks)***

iii) At what rate would they have to borrow in the third year under the second scenario for the two options to amount to the same thing?

(***2 marks)***

Total: 20 marks

QUESTION 2

a) Discuss the merits of centralising the cash management and liquidity management functions for a large diversified firm with many operating units which are geographically separate.

(***6 marks)***

b) Kaki-Pee Limited has provided you with the following data regarding next year's budget that has just been presented to the board by the Financial Controller of the company.

Basic Data		Budgeted average amount to be outstanding GH¢
Stock:	Raw material	240,000
	Work-in-Progress	180,000
	Finished goods	122,000
Debtors		300,300
Creditors		(211,200)
Budgeted average working capital		631,500

The following daily averages are available.

	GH¢
Sales	4,620
Cost of sales	3,600
Purchases of raw materials	1,920

You are required to assist the board in computing what the working capital cycle will be on the basis of the above figures.

(***7 marks)***

c) BBB Powers Ltd has proposed a renounceable rights offering. Under the terms, shareholders will receive two (2) new shares for every three (3) held at the price of GH¢3.00. Current market price is GH¢3.50.

i. Calculate the value of a right

ii. What is the ex-rights price?

iii. Explain the term renounceable rights

iv. Joe Mensah holds 9,000 shares. How much does he have to pay? What will be the immediate impact on his interest if he is unable to exercise this right?

(***7 marks)***

Total: 20 marks

QUESTION 3

a) The shareholders of Company M and Company T have agreed to merge both companies. Employees of both companies however believe that the merger will not yield any benefits since both companies are already experiencing steady growth in their respective markets. You have been appointed as a consultant to assist in the merger process.

You ascertain the following:

	Company M	Company T
	GH¢	GH¢
Revenues	400,000	200,000
Cost of sales and operating costs	300,000	120,000
Profit before tax	100,000	80,000
Expected growth rate	4%	6%
Cost of capital	10%	12%
Corporate tax	25%	25%

The merger is expected to result in a reduction in overall costs from 70% to 65% of revenues and generate a growth of 6% in revenues.

Required:

i) Demonstrate, with relevant computations, that the merger will be beneficial.

(***8 marks)***

ii) Distinguish between Operating Synergy and Financial Synergy, stating for each of the above, **three (3)** types of benefits that might accrue.

(***4 marks)***

b) Systems Ltd, a pharmaceutical company is considering borrowing from a local bank to expand its production. The company also has the option to list on the Ghana Stock Exchange so as to raise the needed fund for expansion.

Required:

i) Explain **three (3)** factors Systems Ltd should take into account when it decides to raise the needed funds through borrowing.

ii) Explain **three (3)** benefits Systems Ltd may obtain from listing on the Ghana Stock Exchange.

(***8 marks)***

Total: 20 marks

QUESTION 4

Baylon Partner Ltd has projected 25% growth in turnover next year. The company's growth plan will require some amount of external debt financing which will be used for capacity expansion. Extracts of the company's financial statements for the current year are shown below:

PROFIT AND LOSS	GH¢
Sales	400,000
Cost of sales	240,000
Gross profit	160,000
Less operating expenses	120,000
Operating profit	40,000
Corporate tax (25%)	10,000
Net profit after tax	30,000
Dividends	12,000

BALANCE SHEET	
FIXED ASSETS	220,000
CURRENT ASSETS	80,000
	300,000
CURRENT LIABILITIES	60,000
LONG-TERM DEBT	85,000
SHAREHOLDERS' FUND	155,000
	300,000

Additional information:

i) The company's current production cost structures are not expected to vary significantly. However, improved efficiencies in the production process will result in an overall savings of 5%.

ii) Operating expenses will increase by 30% during the year.

iii) No change is expected in the existing investment and dividend policies.

Required:

a) As the Chief Finance Officer of Baylon, you are required to forecast the amount of external long term financing that will be required for the coming year.

(***15 marks)***

b) Calculate the growth rate that Baylon can attain without any form of external financing.

(***1 mark)***

c) Calculate the sustainable growth rate for Baylon. (***1 mark)***

d) Apart from the on-going capacity expansion programme, state any **three (3)** other growth options that Baylon might consider. (***3 marks)***

Total: 20 marks

QUESTION 5

The Managing Director of Joe Lashishi Trading Company is concerned about the amount of cash being held in the company's vaults over time. He believes there must be a way of determining cash balances for the company. As the company's financial consultant, you have been requested to assist management in designing a cash flow management system.

You ascertain the following:

i) The company has an annual cash usage rate of GH¢5,500,000.

ii) Transaction cost per sale of securities is GH¢20.

iii) Annual interest rate is 35%.

iv) The minimum cash balance required to be held is GH¢50,000.

v) The standard deviation of daily cash balances is GH¢65,000.
(assuming 365 days in a year)

Required:

(a) i. Using the Baumol Model, estimate the optional cash balance that the company must keep. (***3 marks)***

ii. What is the limitation of this model? (***2 marks)***

(b) Using the Miller-Orr Model, estimate:

i. the spread between the lower and upper cash balance limits. (***2 marks)***

ii. upper limit for cash. (***2 marks)***

iii. return point after the firm reaches its limit. (***2 marks)***

(c) Explain any **three (3)** reasons why management should maintain adequate levels of cash.

(3 marks)

(d) As a trading company, Joe Lashishi exports and imports merchandise in many countries for which it receives and makes payments in foreign currency. This exposes the company to <u>foreign exchange risk</u>.

i. Explain foreign exchange risk. (***1 mark)***

ii. Describe any **three (3)** alternative approaches that the company can use to hedge against foreign exchange exposure

(***3 marks)***

iii. State and explain any **two (2)** other forms of risk to which the company may be exposed.

(***2 marks)***

Total: 20 marks