PROFESSIONAL LEVEL EXAMINATION

WEDNESDAY 9 SEPTEMBER 2015

(2½ hours)

FINANCIAL MANAGEMENT

This paper consists of **THREE** questions (100 marks).

1. Ensure your candidate details are on the front of your answer booklet. You will be given time to sign, date and print your name on the answer booklet, and to enter your candidate number on this question paper. You may not write anything else until the exam starts.

2. Answer each question in black ballpoint pen only.

3. Answers to each question must begin on a new page and must be clearly numbered Use both sides of the paper in your answer booklet.

4. The examiner will take account of the way in which answers are presented.

5. When the assessment is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details on a continuation booklet), it will be classed as misconduct.

A Formula Sheet and Discount Tables are provided with this examination paper.

IMPORTANT

Question papers contain confidential information and must NOT be removed from the examination hall.

DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK

You MUST enter your candidate number in this box.

1. Limehouse Ltd (Limehouse) is a UK-based engineering firm. Its financial year end is 31 August. The company was established by brothers Gordon and Michael Rowe in 1982. They are no longer directors of the company nor are they involved in its day-to-day running. They currently own 60% of its issued ordinary shares between them. The remaining shares are owned by the three directors of Limehouse and two of its senior managers.

Limehouse's external auditors are Chappell White Stepney (CWS), a firm of ICAEW Chartered Accountants. CWS also provides personal tax advice to Gordon and Michael.

The brothers wish to sell their shares in Limehouse to the company's other shareholders and have asked CWS for advice. Limehouse's directors have provided CWS with the following financial information from the company's management accounts:

Balance Sheet at 31 August 2015

	£'000	£'000
Non-current assets		
Land and Buildings		7,400
Plant and Machinery		3,650
Vehicles		585
		11,635
Current assets		
Inventories	2,550	
Trade receivables	1,388	
Bank and cash	82	
	4,020	
Current liabilities		
Trade payables	2,390	
		1,630
		13,265
Capital and Reserves		
£1 ordinary shares		3,000
Retained earnings		6,115
		9,115
Non-current liabilities		
6% debentures (issued in 2010 and redeemable in 2021)		4,150
		13,265

Income Statement extracts

Year ended 31 August	2012	2013	2014	2015
	£'000	£'000	£'000	£'000
Profit before interest and tax	1,840	1,880	1,875	2,450
Dividends proposed and paid	660	660	660	660

Limehouse's directors had the company's non-current assets independently revalued in April 2015. The values are shown below:

	£'000
Land and Buildings	10,250
Plant and Machinery	4,025
Vehicles	488

Assume that the corporation tax rate has been, and will continue to be, 21% pa.

The price earnings (P/E) ratio and dividend yield figures of four listed UK engineering companies at 31 August 2015 are shown below:

	P/E ratio	Dividend yield
Globe plc	18.5	2.5%
Burdett plc	19.0	3.4%
QM plc	14.4	2.9%
Fieldgate plc	16.5	3.6%

Requirements

(a) Using the information provided, prepare a report for Gordon and Michael Rowe advising them of a range of suitable prices for their shareholding in Limehouse. Your report should include supporting workings and a clear commentary as to the strengths and weaknesses of each of the valuation methods that you have used.

(23 marks)

(b) Discuss how the shareholder value analysis approach to company valuation differs from the valuation methods that you have used in part (a). **(8 marks)**

(c) Explain the ethical issues that CWS should consider with regard to its work for Gordon and Michael Rowe. **(4 marks)**

Total: 35 marks

2. You should assume that the current date is 31 August 2015

Rayner Davies plc ("Rayner") is a UK manufacturer of kitchenware. Its financial year-end is 31 August. Rayner currently sells its products to retail companies which then sell them to the public. It has now decided that it should also sell its products direct to the public online. To do so requires a significant financial investment.

Extracts from Rayner's most recent management accounts are shown below:

Income Statement for the year ended 31 August 2015

	£'000
Sales	25,800
Variable costs	(15,480)
Fixed costs	(4,900)
Profit before interest	5,420
Debenture interest	(410)
Profit before tax	5,010
Taxation (at 21%)	(1,052)
Profit after tax	3,958
Dividends proposed	(3,125)
Retained profit	833

Balance Sheet at 31 August 2015

	£'000
£1 ordinary shares	12,500
Share premium account	2,300
Retained earnings	8,145
	22,945
5% debentures (redeemable in 2017)	8,200
	31,145

Rayner's directors estimate that it would cost the company £6.9 million from either equity or debt sources to finance the proposed investment in online sales. Extracts from the minutes of the company's most recent board meeting are shown below:

Extract 1 - production director: "We should have a rights issue. I'm sure the shareholders would invest if we priced the shares at £3 each as our shares are currently quoted at £3.45 per share ex-div. Also a rights issue would be better for our gearing level than a debenture issue."

Extract 2 - marketing director: "You can't trust the stock market because it's inefficient. Also there are too many irrational investors. I think that our shares are overpriced and that a figure closer to £3 per share is more accurate, so a rights issue at £3 wouldn't be very attractive."

Extract 3 - human resources (HR) director: "Why don't we stop paying such a large dividend? If we used this year's proposed dividend plus what we have in the bank, that would give us approximately £3.5 million and so we'd only need to raise an extra £3.4 million rather than the full £6.9 million."

You are a member of Rayner's finance team. Your manager has asked you to provide relevant workings for her in advance of the next board meeting. She has provided you with the following assumptions for the year ended 31 August 2016:

- Sales will be 20% higher than in the year ended 31 August 2015
- Annual fixed costs attributable to the online investment would be £1.5 million
- Dividends per share would remain unchanged from those proposed for the year ended 31 August 2015
- Rayner's contribution to sales ratio remains constant

Requirements

(a) Assume that Rayner raises the £6.9 million required by either:

- a rights issue at £3 per share, or
- an issue of 6% redeemable debentures at par

Using your manager's assumptions, **for each method of finance**:

(i) Prepare a forecast Income Statement for the year ended 31 August 2016 **(8 marks)**

(ii) Calculate Rayner's earnings per share for the year ended 31 August 2016. **(3 marks)**

(iii) Calculate Rayner's gearing ratio (debt / debt + equity) using book values at 31 August 2016. **(4 marks)**

(b) Evaluate the implications for Rayner of choosing equity or debt as its means of raising the £6.9 million. You should, where possible, make reference to your calculations in part (a) above and the comments of the production director. **(7 marks)**

(c) Discuss the marketing director's views on the stock market and the assertion that Rayner's shares are overpriced. **(7 marks)**

(d) Discuss the HR director's view that Rayner should not pay a dividend for the year ended 31 August 2015 to help finance the online investment, making reference to relevant theories. **(6 marks)**

Total: 35 marks

3. You should assume that the current date is 30 September 2015

IMT Ltd (IMT) manufactures and distributes scientific instruments for university researchers, pharmaceutical companies and research laboratories. It is based in the UK and has been trading since 2008.

Because IMT's instruments have very high technical specifications they are made to order. Lead times between order and delivery can be as much as six months. Sales were only made in the UK until IMT began exporting to the USA last year. IMT's board has not hedged its exposure to currency risk because most of the American orders were relatively small.

The company has now received an order from a prestigious research laboratory in California and a price of $5.3 million has been agreed. Work will start on the contract in October and the $5.3 million will be received in six months' time on 31 March 2016. IMT's board met recently and three specific issues regarding overseas trade were raised. The minutes included the following:

Issue 1: "We've seen in the financial press that sterling has strengthened against the US dollar in the past two months. I think that we should consider hedging the Californian contract."

Issue 2: "We have longer-term plans to expand our sales market into Europe, South America and Asia. This might involve us in establishing manufacturing and distribution facilities overseas. We need to consider the currency risks that could arise from such an expansion."

Issue 3: "As we don't have any specific use for the receipt from the Californian contract until the end of 2016, we ought to consider investing the sterling in a UK deposit account in March 2016. That is six months away. Can we protect against a possible fall in interest rates before then?"

You work in IMT's finance team. To aid the board's decision regarding the possible hedging of the Californian contract, you have been asked to report back to them with relevant workings. The following data has been collected from IMT's bank on 30 September 2015:

Spot rate ($/£)	1.5386 – 1.5398
Sterling interest rate (borrowing)	4.0% pa
Sterling interest rate (lending)	3.6% pa
US dollar interest rate (borrowing)	2.8% pa
US dollar interest rate (lending)	2.4% pa
Six-month forward contract premium ($/£)	0.0096 – 0.0084
Forward contract arrangement fee (per $ converted)	£0.0030
Six-month over the counter (OTC) call option on dollars – exercise price ($/£)	1.5210
Six-month over the counter (OTC) put option on dollars – exercise price ($/£)	1.5280
Relevant OTC option premium (per $ converted)	£0.0050

Requirements

(a) With reference to Issue 1, calculate IMT's sterling receipt from the Californian contract if it:

(i) does not hedge the dollar receipt and sterling
- strengthens by 5% by 31 March 2016 or
- weakens by 5% by 31 March 2016.

(ii) uses a money market hedge

(iii) uses an OTC currency option

(iv) uses a forward contract **(10 marks)**

(b) With reference to your calculations in part (a), advise IMT's board whether or not it should hedge its dollar receipt from the Californian contract. **(9 marks)**

(c) With reference to Issue 2, explain the different types of currency risk that could arise were IMT to expand its operations overseas as indicated. **(6 marks)**

(d) With reference to Issue 3, explain how IMT might hedge its exposure to interest rate risk. **(5 marks)**

Total: 30 marks