

 **INTI** International
University & Colleges

FINAL
Examination Paper

(COVER PAGE)

Session : January 2018

Programme : DIPLOMA IN FINANCE

Course : FIN2150: FINANCIAL MANAGEMENT

Date of Examination : 3rd January 2018 (Saturday)

Time : 08.00am-10.00am Reading Time : Nil

Duration : 2 Hours

Special Instructions :

This paper consists of **SIX (6)** questions. Answer any **FOUR (4)** questions in the answer booklet provided. All questions carry equal marks.

Materials permitted :

Non-Programmable Calculator

Materials provided :

Answer booklet

Examiner(s) : Ms. Eunice Mok Pei See

Moderator : Ms. Lim Tan Chin

This paper consists of 6 printed pages, including the cover page.

INTI INTERNATIONAL COLLEGE PENANG
DIPLOMA IN FINANCE (DIF)
FIN2150: FINANCIAL MANAGEMENT
FINAL EXAMINATION: JANUARY 2018 SESSION

Instructions: This paper consists of **SIX (6)** questions. Answer any **FOUR (4)** questions in the answer booklet provided. All questions carry equal marks.

Question1

- a) With the aid of a diagram, explain the function of financial markets. Your explanation need to include the 4 main components: Surplus unit, deficit unit, direct finance and indirect finance. (16 marks)
- b) Identify the THREE (3) most common reasons why the business need financing? (9 marks)

Questions 2

- a) Zezac Corporation has 400,000 shares of common stock outstanding, a P/E ratio of 8, and \$500,000 available for common stockholders. The board of directors has just voted a 3-2 stock split.
- i. If you had 100 shares of stock before the split, how many shares will you have after the split? (2 marks)
 - ii. What was the total value of your investment in XYZ stock before the split? (2 marks)
 - iii. What should be the total value of your investment in XYZ stock after the split? (2 marks)
 - iv. In view of your answers to (ii) and (iii) above, why would a firm's management want to have a stock split? (4 marks)
 - v.
- b) Modigliani & Miller dividend irrelevancy theory suggests that shareholders can manufacture their own dividends.
- i. Explain why it is necessary for companies to pay out dividends. (5 marks)

- ii. Suggest factors that should be considered before paying out dividends to shareholders. (5 marks)
- c) You are considering investing in a project with the following possible outcomes:

States	Probability of Occurrence	Investment Returns
State 1: Economic boom	15%	16%
State 2: Economic growth	45%	12%
State 3: Economic decline	25%	5%
State 4: Depression	15%	-5%

Calculate the expected rate of return and variance for this investment. (5 marks)

Question 3

- a) You buy a \$1000 face-value, 30-year, coupon bond with 5% coupon rate for \$500. What is the current yield of this bond? Suppose that you sell this bond next year for \$505, what is the holding period return on this bond? (5 marks)
- b) Use the information for the question(s) below.

Luther Industries needs to raise \$25 million to fund a new office complex. The company plans on issuing ten-year bonds with a face value of \$1,000 and a coupon rate of 7.0% (annual payments). The following table summarizes the YTM for similar ten-year corporate bonds of various credit ratings:

Rating	AAA	AA	A	BBB	BB
YTM	6.70%	6.80%	7.00%	7.40%	8.00%

- i) Show the working on what rating must Luther receive on these bonds if they want the bonds to be issued at par? (5 marks)
- ii) Suppose that when these bonds were issued, Luther received a price of \$972.42 for each bond. Show the working on what is the likely rating that Luther's bonds received? (5 marks)
- c) Miller/Hershey's preferred stock is selling at \$54 on the market and pays an annual dividend of \$4.20 per share.
- i. What is the expected rate of return on the stock? (2 marks)
- ii. If an investor's required rate of return is 9%, what is the value of the stock for that investor? (2 marks)

- iii. Considering the investor's required rate of return, does this stock seem to be a desirable investment? (2 marks)
- d) The required rate of return on TKF preferred has fallen from 5.75% at the time of issue to the present rate of 5%. The stock now sells for \$115. What was the original price? (4 marks)

Question 4

- a) Mandalay Bay's stock currently sells for \$30 per share, expects to pay a dividend of \$2.25 next year, has a growth rate of 6% that is expected to continue, and new issues of common stock are subject to flotation costs of 7%.
- i. What is Mandalay Bay's cost of retained earnings? (3 marks)
 - ii. What is Mandalay Bay's cost of new common stock? (3 marks)
 - iii. Why is the cost of new common stock typically higher than the cost of retained earnings? (4 mark)
- b) Ximcard Plc is investigating the possibility of purchasing an old copper mine in Jinta, a small country in South America. The investment project will be evaluated using the capital asset pricing model to calculate the cost of equity. The following information has been provided:
- Beta of Ximcard plc = 1.2
 Yield of short-dated Treasury bills = 3.4%
 Market risk premium = 5.50%
- Calculate the cost of equity using the Capital Asset Pricing Model as the discount factor to appraise the proposed investment project. (3 marks)
- c) Given the following data:
- Beta
 Share X = 0.75
 Share Y = 1.34
 Share Z = 0.98
- Returns on the Market Portfolio = 12.1%
 Expected Returns on Share X = 9.7%
- i. Using the Capital Asset Pricing Model (CAPM), what are the expected returns on Shares Y and Z? (6 marks)

- ii. If the average return of share Z is 10%, how would its price adjust to reestablish market efficiency if CAPM applies? (3 marks)
- iii. What do you regard as the main limitations of the CAPM? (3 marks)

Question 5

- a) What is the NPV of a \$46,800 project that is expected to have an after-tax cash flow of \$14,000 for the first two years, \$10,000 for the next two years, and \$8,000 for the fifth year? Use a 10% discount rate. Would you accept the project?
 - i) Show the cash flows year by year for the project. (4 marks)
 - ii) Should the project be accepted base on the net present value method using a 10% discount rate? (6 marks)
 - iii) What is the internal rate of return for the above projects? (6 marks)
- b) Explain internal rate of return (IRR) as investment appraisal technique and its limitations? (9 marks)

Questions 6

- a) A large bakery buys flour in 25 pound bags. The bakery uses an average 405 bags per month (assume monthly usage is the same). Preparing an order and receiving a shipment of flour involves a cost of \$10 per order. Annual carrying costs are \$75 per bag.
 - i. Determine the economic order quantity. (4 marks)
 - ii. What is the average number of bags on hand? (1 mark)
 - iii. How many orders per year will there be? (2 marks)
 - iv. Compute the cost of ordering flour, the cost of carrying the inventory, and the minimum total cost. (3 marks)

- b) The balance sheet for Peterson Manufacturing Company is presented below.

Peterson Mfg. Co.
Balance Sheet
December 31, 2016

Cash	\$32,000	Current liabilities	\$72,000
Accounts receivable	40,000	Long-term liabilities	48,000
Inventories	<u>48,000</u>	Common equity	<u>120,000</u>
Total current assets	\$120,000		
Net fixed assets	120,000		
Total	<u>\$240,000</u>	Total	<u>\$240,000</u>

During 2016, the firm earned \$28,000 after taxes based on net sales of \$480,000.

- i. Calculate Peterson's current ratio and net working capital. (3 marks)
 - ii. Assume that Peterson's uses \$20,000 of its cash to reduce current liabilities. Re-compute the current ratio and net working capital. (3 marks)
 - iii. What effect, if any, does the change proposed in question b (ii) have on Peterson's liquidity? (4 marks)
- c) Sunrise Inc. uses permanent sources of financing to cover its peak level of current assets. When it does not need the money to finance inventories and accounts receivable, it invests the excess funds in short-term certificates of deposit. What are the advantages and disadvantages of this policy? (5 marks)

- The End -