

Applied Skills

# Financial Management (FM)

September/December 2018 – Sample Questions



ME

**Time allowed:** 3 hours 15 minutes

This question paper is divided into three sections:

Section A – ALL 15 questions are compulsory and **MUST** be attempted

Section B – ALL 15 questions are compulsory and **MUST** be attempted

Section C – BOTH questions are compulsory and **MUST** be attempted

**Formulae Sheet, Present Value and Annuity Tables are on pages 4–6.**

**Do NOT open this question paper until instructed by the supervisor.**

**Do NOT record any of your answers on the question paper.**

**This question paper must not be removed from the examination hall.**

Think Ahead

**ACCA**

The Association of  
Chartered Certified  
Accountants

**Section C – BOTH questions are compulsory and MUST be attempted**

Please write your answers to all parts of these questions on the lined pages within the Candidate Answer Booklet.

**31** Melanie Co is considering the acquisition of a new machine with an operating life of three years. The new machine could be leased for three payments of \$55,000, payable annually in advance.

Alternatively, the machine could be purchased for \$160,000 using a bank loan at a cost of 8% per year. If the machine is purchased, Melanie Co will incur maintenance costs of \$8,000 per year, payable at the end of each year of operation. The machine would have a residual value of \$40,000 at the end of its three-year life.

Melanie Co's production manager estimates that if maintenance routines were upgraded, the new machine could be operated for a period of four years with maintenance costs increasing to \$12,000 per year, payable at the end of each year of operation. If operated for four years, the machine's residual value would fall to \$11,000.

Taxation should be ignored.

**Required:**

- (a) (i) **Assuming that the new machine is operated for a three-year period, evaluate whether Melanie Co should use leasing or borrowing as a source of finance.** (6 marks)
- (ii) **Using a discount rate of 10%, calculate the equivalent annual cost of purchasing and operating the machine for both three years and four years, and recommend which replacement interval should be adopted.** (6 marks)
- (b) **Critically discuss FOUR reasons why NPV is regarded as superior to IRR as an investment appraisal technique.** (8 marks)

**(20 marks)**

**32** Oscar Co designs and produces tracking devices. The company is managed by its four founders, who lack business administration skills.

The company has revenue of \$28m, and all sales are on 30 days' credit. Its major customers are large multinational car manufacturing companies and are often late in paying their invoices. Oscar Co is a rapidly growing company and revenue has doubled in the last four years. Oscar Co has focused in this time on product development and customer service, and managing trade receivables has been neglected.

Oscar Co's average trade receivables are currently \$5.37m, and bad debts are 2% of credit sales revenue. Partly as a result of poor credit control, the company has suffered a shortage of cash and has recently reached its overdraft limit. The four founders have spent large amounts of time chasing customers for payment. In an attempt to improve trade receivables management, Oscar Co has approached a factoring company.

The factoring company has offered two possible options:

**Option 1**

Administration by the factor of Oscar Co's invoicing, sales accounting and receivables collection, on a full recourse basis. The factor would charge a service fee of 0.5% of credit sales revenue per year. Oscar Co estimates that this would result in savings of \$30,000 per year in administration costs. Under this arrangement, the average trade receivables collection period would be 30 days.

**Option 2**

Administration by the factor of Oscar Co's invoicing, sales accounting and receivables collection on a non-recourse basis. The factor would charge a service fee of 1.5% of credit sales revenue per year. Administration cost savings and average trade receivables collection period would be as Option 1. Oscar Co would be required to accept an advance of 80% of credit sales when invoices are raised at an interest rate of 9% per year.

Oscar Co pays interest on its overdraft at a rate of 7% per year and the company operates for 365 days per year.

**Required:**

- (a) Calculate the costs and benefits of each of Option 1 and Option 2 and comment on your findings.** (8 marks)
- (b) Discuss reasons (other than costs and benefits already calculated) why Oscar Co may benefit from the services offered by the factoring company.** (6 marks)
- (c) Discuss THREE factors which determine the level of a company's investment in working capital.** (6 marks)

**(20 marks)**