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Business Finance - 2 Practice Questions - Unit 3

MCQs

1

Ans (C) £ 5.9m

2

Ans (D) A subsidiary company is controlled by it's parent

3

Ans (A) Cancel all relationships between the group members and add the figures for assets and liabilities together

4

Ans (B) £ 2.4m

5

Ans (D) £ 340,000

6

Ans (D) The parent can influence the management of the associate

7

Ans (A) The company is profitable because it prices it's sales aggressively

8

Ans (D) The stock market is confident in the company

9

Ans (c) There is a cost associated with holding assets that do not generate a return

10

Ans (B) 11.4 p

11

Ans (D) The company has no liquidity problems

12

Ans (D) EBITDA is regarded as less prone to manipulation than net profit

13

Ans (B) In the event that the entity is wound up the net asset value per share ~~exceeds~~ is likely to represent the best possible outcome the shareholders can expect

14

Ans (C) 97 days

15

Ans (A) provides shareholders with an important insight into the risks associated with their investments, but is relatively unimportant to lenders

16

Ans (C) 7.77

17

Ans (B) A decrease in trade receivables and an increase in cash

18

Ans (B) The company has a large number of warrants in issue

19

Ans (A) The company's selling price are at an optimal level

20

Ans (B) 7.77

21 (a)

Ans. (a) The investments made by any company into some other company (s) can be categorised as subsidiary, associate or minority interest company

(b) The company who invests is referred to as the parent company

(c) If the parent company has greater than 50% shares or voting rights in the invested company, then the invested company becomes the subsidiary of the parent company

(d) They can be referred together as a group of companies. But they do not have a legal standpoint

(e) The parent company has a controlling interest on the subsidiary

eg ABC Ltd. brought 100% shares of XYZ Ltd at par. Then, XYZ Ltd is a subsidiary of parent company ABC Ltd.

21 (b)

Ans (a) In the case of a subsidiary, associate or minority interest, the parent company needs to prepare a consolidated set of financial statements for it's shareholders.

(b) Consolidation happens only at the parent company level

(c) Since, the parent company has invested money in the companies of the group, the shareholders have all the rights to know about the performance of the group as whole

(d) Since, these investments are an investment of shareholders capital by the parent company, it is important for them to be informed about the performance of the group

(e) The key objective of any business is to maximise shareholder wealth. And for this, it is important for the shareholders to know the performance of the parent company's group as well.

22 (a)

Ans (1) The investment of a company into another company can result either into a subsidiary, associate or minority interest company.

(2) The company which is investing is referred to as the parent company

(3) ~~b~~ If the parent company has less than 50% but greater than 20% shares or voting rights in the invested company, then the invested company is referred to as an associate.

(4) This gives rise to a significant influence of the parent company on the associate company

22 (b)

Ans (1) In the case of consolidation of associates, we cancel out all the internal relationships among the group

(2) The assets and liabilities of the associate are added upt with that of parent company only upto the percentage which the parent company has shares or voting rights in the associate

eg. Consider ABC Ltd and XYZ Ltd. ABC Ltd acquires 30% stake in XYZ Ltd for £100. ABC Ltd ~~takes~~ raises this £100 by loan

	ABC Ltd	XYZ Ltd
Assets		
Cash	50	200
Trade Receivables	200	50
Total assets	250	250
Equity and liabilities		
Capital (£1 nominal)	50	200
& Reserves	100	50
Equity	150	250
Loan	100	0
Total equity and liability	250	250

Now, 30% of XYZ Ltd's equity is 30% of 250 = 75
But ABC Ltd acquired it at premium of £25
Thus, goodwill on consolidation = £25

ABC Ltd (Consolidated Balance sheet)	
Assets ~~50 + 30% × 200~~	£
Cash ~~200 + 30% × 50~~ 50 + 30% × 200	110
Trade receivable 200 + 30% × 50	215
Goodwill	25
Total assets	350
Equity and liabilities	
Capital	50
Reserves	100
Loan	200
Total equity and liabilities	350

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Ans (1) For constructing a set of consolidated financial statements, first of all, the companies may it be subsidiary, associate or minority interest needs to be identified

(2) Then, unconsolidated financial statement of each entity needs to be collected

(3) Now while consolidating, all internal relationships among the group needs to be removed.

(4) Goodwill on consolidation should be calculated as this will balance, the premium amount paid over the

book value of equity
(5) If there is a balance of non-controlling interest, then even that needs to be accounted for
(6) All these adjustments eventually would help to balance the consolidated financial statements

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Ans (1) The reliance of Alpha on Mega Group's consolidated financial statements has set limitations
(2) A group of companies does not have a legal standpoint i.e it is not a legal entity.
(3) Thus, even though Global is part of Mega group, it does not mean that legally Global would be covered by any other group company in case of default
(4) Also, consolidated financial statements represent the financial position of the group as a whole and not just of Global alone
(5) If Alpha is considering the fact that Mega group's parent company would back Global in case of inability to service the contract, then Alpha should get a legal and a formal guarantee that the parent company would back Global in respect to the contract.
(6) Also, Alpha should not ignore the fact that the financial statements are prepared on accrual, realisation and cost concept basis

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Ans (1) The group of companies prepare a consolidated ~~for~~ set of financial statements with the view that the group is a single entity

(2) However, a group of companies does not have a legal standpoint i.e it is not a legal entity

(3) Thus, in the case of granting trade credit, other companies in the group are not legally liable to back the company in case of default.

(4) They could simply let the company go into bankruptcy.

(5) However, it should be noted in most cases it would be contrary. In order to safeguard the group's reputation, the companies in the group would cover for the payments if the customer company defaults.

(6) But a written and a legal guarantee should be undertaken perhaps from the parent company for the same.

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Ans (1) Basic earnings per share (Basic EPS) is the ratio that gives the information about the net income i.e profit after tax and the outstanding equity shares who have rights over those profits.

$$\text{Basic EPS} = \frac{\text{Net income (PAT)} - \text{Preference dividends}}{\text{Weighted average no. of shares o/s}}$$

(2) Diluted earnings per share (Diluted EPS) is the ratio that takes into account the number of equity shares outstanding as well as the potential effects on EPS considering the hybrid instruments like convertibles,

warrants and options to be converted into equity shares.

$$\text{Diluted EPS} = \frac{\text{Net income (PAT)} - \text{Preference dividends}}{\text{Weighted avg equity shares o/s} + \text{Net shares converted}}$$

(3) Thus, from the above two formulae, it is intuitional that diluted EPS < Basic EPS. But a significantly lower diluted EPS might create a sense of worry among the equity shareholders.

(4) A significantly lower diluted EPS would mean that the number of hybrid instruments that could be converted into equity shares are in large numbers.

(5) And because of this, the shareholders will lose control and it will result in equity dilution.

(6) Though the process of conversion will bring cash inflow, but the gains from the same might not be sufficient to compensate the change.

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Ans (1) It is important for companies to publish diluted EPS in addition to basic EPS. The need for diluted EPS arises because of the basic EPS considering only the number of equity shares outstanding for the period.

(2) Companies in addition to equity shares also issues hybrid instruments such as convertibles, warrants and options. If these instruments are exercised, then there will be dilution of EPS as the number of equity shares

have increased.

(3) Thus, companies have to published diluted EPS to give the potential effect because of the conversions

(4) Also, this EPS ratio is going to be used to calculate P/E ratio. Any error or misstatement of EPS would cause an effect on the P/E ratio as well

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Ans (1) Rapid receivables and inventory turnover ratios can be achieved by reducing trade receivables and ~~sales~~ inventory respectively

(2) An advantage of having rapid receivables and ~~turnov~~ inventory turnover ratio is that the company will be sound in terms of liquidity

(3) This is because, generally the case is when trade receivables and inventory decrease, there is increase in cash with the company.

(4) But there are possible disadvantages for the same.

(5) Reduced receivables might be interpreted as a strict trade credit policy. This would result in the company losing it's customers for a more linient trade credit terms.

(6) Reduced inventory might mean that you are running out of stock for sales. You are depleted of your inventory.

29

Ans (1) Return on Capital Employed (ROCE) $= \dfrac{\text{PBIT}}{\text{Equity + Debt}}$

(2) ROCE signifies as to what are the returns to the capital providers as per the operating profit
(3) Though, it is true that ROCE gives information to the shareholders and lenders as to what are the returns on their investment, it alone can't give exact information
(4) Ratio analysis is ~~a~~ quite complex and ambiguous at places
(5) ROCE won't help the company to know as to what should be increased or decreased in order to gain more profits
(6) Other profit ability ratios such as Gross profit margin, Operating profit margin and net profit margin would help the company to get the respective improvement areas.

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Ans (1) Gearing ratios include ratios such as debt to equity and debt to capital ratio
(2) Different countries will have different acceptable gearing ratios
(3) One reason for this difference could be that the interest rates and other factors in the economy differs from country to country.
(4) Thus investors might have different perceptions for the same
(5) According to national laws too, there might be countries ~~who~~ which require a certain ~~to~~ mix of debt and equity
(6) The market prices and values of ~~a~~ companies will differ from country to country. There might be equity investors in some countries which are comfortable in letting the company raise more debt

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Ans (1) EBITDA is earnings before interest, taxation, depreciation and amortisation

(2) An advantage of comparing the profitability of two competing companies in terms of their EBITDA rather their profit for the year is that you get less manipulated figures and the comparison would actually bring out the performance of the company in terms of their operations

(3) All the four entries that are excluded are subjective and can lead to more ~~mapu~~ manipulation of profit figure

(4) A potential disadvantage of the same would be that you won't get the information of the company as a whole, and thus the comparison might lead to different conclusions than otherwise

(5) It ignores interest, thus it ignores the capital structure of the company and hence might lead to wrong interpretation of their performance

(6) Not only that, but even depreciation and amortisation are important concepts to consider to know the accounting values of the assets

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Ans. (1) The difference between the ~~types~~ ~~o~~ two types of EPS figures is that the diluted EPS takes into effect the earnings per share considering the conversion of hybrid instruments like convertibles, warrants and options into equity shares

(2) Since, Derek has a substantial shareholding in the company, ~~it's~~ ~~er~~ his earnings may get diluted because of the ~~diversions~~ conversions.

(3) However, the basic EPS would be a more relevant figure since, it signifies as to how effective was the company is managing the equity invested by Derek and other shareholders.

(4) The 'diluted EPS' would be more of possible worst case scenario that signifies how the investment would perform if the hybrid instruments issued by the respective company were exercised and converted to equity shares.

33.

Ans. (1) Interpretation of a company's accounting ratios requires some understanding of the nature of the business and the industry in which it performs in order to make informed decisions.

(2) Different industries and types of business will have different acceptable ranges of ratio values.

(3) The capital structure of different companies in different industries will be of a different suitable proportion of debt and equity. For instance, it is difficult for the IT industry to raise debt. Thus, in general parlance IT industry's equity proportion of capital structure would be large.

(4) Also, ratios like DSO, DIO, DPO, etc. won't be consistent across all industries.

(5) There are some industries in which because of the nature of the business itself, there would be lower trade credit days being given

(6) Thus, in order to interpret the positive and negative ~~sto~~ points of the ratio figures, it is important to understand the nature of the business and the industry in which it operates.

34 (i)

Ans The impact that the acquisition of each entity would have on Dayton's financial indicators are as follows.

(a) Revenue

→ The revenue of Echo is £250m and that of Foxton is £140m. Both of the figures being less than the revenue of £500m of Dayton

→ Thus, upon consolidation the revenue figures of Echo and Foxton upon that of Dayton won't have the same effect.

→ The revenue of Dayton will comparatively increase upon acquisition with Echo than Foxton.

(b) Return on capital employed

→ The ROCE of Echo and Foxton is lower than that of Dayton

→ Both of them will lead to a decrease in Dayton's ROCE upon ~~consol~~ acquisition. The change can be illustrated as follows:

	Dayton	Echo	Foxton
Revenue (A)	£500m	£250m	£140m
Profit margin (B)	26%	22%	33%
Operating profit (A x B) (C)	£130m	£55m	£46.2m
Return on capital employed (D)	18%	14%	11%
Capital employed (C/D) (E)	£722.2m	£392.86m	£420m
Dayton's revised ROCE upon acquistion		16.59%	15.43%

Calculation for Dayton's revised ROCE upon acquisition with:

(1) Echo = $\frac{130 + 55}{722.2 + 392.86}$ = 16.59104%

(2) Foxton = $\frac{130 + 46.2}{722.2 + 420}$ = 15.42637%

(c) Profit margin

→ Foxton has the higher profit margin between the two alternatives.

→ Thus, Foxton will enhance and improve Dayton's profit margin upon acquisition.

→ It can be illustrated as follows. (Referring to the figures in the table formed in point '(b) Return on Capital Employed' of this answer)

Calculation for Dayton's revised profit margin upon acquisition with.

(1) Echo = $\frac{130 + 55}{500 + 250}$ = 24.667%

(2) Faxton = $\frac{130 + 46.2}{500 + 140}$ = 27.53137%

(d) Gearing :
→ Both, Echo and Faxton have lower ~~to~~ gearing ratios than Dayton
→ And upon acquisition, the liabilities would add up causing the gearing to increase further ahead.

(e) Price / Earnings ratio
→ P/E ratio = $\frac{MPS}{EPS}$
→ Echo has a higher P/E ratio than both Dayton and Faxton
→ This would mean, that the market value the company highly incomparison to the EPS.
→ This could be interpreted as the acquisition of Echo would be more expensive than Faxton.

(ii)
Ans (1) The published financial statements are not designed for the purpose of deciding a price for a controlling interest in the target company.
(2) The aims of any financial statement is to help the user groups in making informed decisions and to convey the company's financial ~~st~~ position.

(3) A published set of financial statements gives insight into the past financial performance of the company.

(4) The financial statements in it's entirety does not tell about the future business plans or the future business performance

(5) Also, referring to the published financial statements for making investment decisions might not be appropriate as the statements are prepared upon accrual, realisation and historic cost concept basis

(6) The published financial statements do not give true value as the prepares of these financial statements might have used some other likely applicable accounting standards due to the absence of a particular accounting standards for that circumstances.

(iii)

Ans (1) Goodwill on consolidation is formed when a company acquires shares or voting rights of another company by paying more than the book value of the company's assets

(2) Acquisition of Echo leading to a much larger amount of goodwill on consolidation than Foxton means that Echo would have a larger value of intangible assets.

(3) The financial statements of any company do not include the value of intangibles because of the money measurement concept

(4) Thus, the intangible assets of Echo are higher and also has a higher value than Foxton which would lead to a higher goodwill on consolidation figure.

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Ans (i)

	Particulars (Ratios)	February	January
1	Gross profit margin	$\frac{532}{(900-200)} = 76\%$	$\frac{525}{700} = 75\%$
2	Current ratio	$\frac{1042+29}{185} = 5.8:1$	$\frac{952}{360} = 2.6:1$
3	Trade receivables T/O	$\frac{1010}{900} \times \frac{365}{12} = 34$ days	$\frac{720}{700} \times \frac{365}{12} = 31$ days
4	Trade payables T/O	$\frac{185}{368-200} \times \frac{365}{12} = 34$ days	$\frac{360}{175+200} \times \frac{365}{12} = 29$ days

(ii)

Ans (1) The sales of £200,000 to charity was at cost price. Thus it didn't let the company make gross profit over that sales.

(2) That is why, for the calculation of gross profit margin for February the revenue is taken as £700,000

(3) The purchase of new equipment was being temporarily funded by bank overdraft. And it is going to be replaced by a long term loan in May. Thus, the liability of bank overdraft of £371,000 is converted into asset of £29,000 after adding back £400,000.

(4) Since, the sale to charity was at cost price, the cost price is added back to January's cost of sales and deducted from that of February's cost of sales.

(iii)
Ans (1)

$$\text{Return on capital Employed (ROCE)} = \frac{\text{PBIT / EBIT / Operating profit}}{\text{Debt + Equity}}$$

(2) The finance director's argument that ROCE should be reviewed annually, but not monthly is appropriat
(3) ROCE takes into consideration the capital employed ~~This~~ The figure for capital employed may not be consistent over all the month.
(4) As in case of vapor, the company's debt is going to increase substantially in May of £400,000.
(5) Also, it might be the case that the company's expenses, depreciation, etc might be ~~d~~ higher in a month but lower in the other.
(6) Thus, a monthly ROCE ratio would not accurately give the sense of profitability that an annual ROCE ratio does.
(7) That is why, the company ∴ for monthly performance should refer to secondary profitability ratios

36 (i)
Ans (1) A basic problem in the valuation of the business would be the market price

(2) Since, Patel has the option to buyback the equity basis on the valuation, he being the director might indulge in some manipulation

(3) He might not reveal the profitability of a product or the idea of a new line of product

(4) And also, the venture capitalist might indulge in influencing the valuation

(ii)

Ans (1) One of the approach that ~~the~~ can be employed to value the company at the end of year five would be to compare a similar company in the same industry

(2) The position, business plans, the past financial records can be matched and appropriate assumptions and adjustments can be considered.