

FINANCIAL MANAGEMENT (FM)

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CR.NO 1

This scenario relates to five requirements.

Constant Co is a company that operates internationally and has two subsidiary companies located in foreign countries. Business operations are undertaken in several different currencies. The parent company and the two subsidiaries manage their own financial affairs

Constant Co has annual credit sales of \$45m. Experience indicates that approximately 2% of credit sales become bad debts each year. The most recent financial statements of Constant Co show trade receivables of \$7.5m.

Constant Co is considering introducing an early settlement discount of 1.25%, in exchange for payment within 30 days. It believes that approximately 70% of credit customers would take the discount, while the remaining 30% of credit customers would continue to pay as at present. Bad debts would be expected to fall by \$225,000 per year.

Instead of introducing the early settlement discount, Constant Co could accept an offer it has received from a factor. If the offer is accepted, the factor would take over managing the trade receivables of the company, in exchange for an annual fee of 1.5% of credit sales, and would advance 80% of the value of trade receivables at an interest rate of 5% per year. The factor has indicated that it will reduce average trade receivables days to 40 days and reduce bad debts to 0.5% of credit sales.

Annual credit sales are not expected to be affected by any change in trade receivables management policy Constant Co has a short-term finance cost of 4% per year Assume there are 360 days in each year

Requirements:

Using the financial information provided about Constant Co:

1. Evaluate the financial effect of early settlement discount 4 marks
2. Evaluate the financial effect of factor's offer 5 marks
3. Advise which proposal is financially preferable 1 mark
4. Discuss Three benefits of centralized treasury management 6 marks
5. Discuss two cash management models used in financial management 4 marks

CR.NO 2

The following financial information relates to Mean Co:

	\$m
Ordinary Shares	15
Reserves	45
7% loan notes	10
Bank loan	5
Total equity and non-current liabilities	75

The ordinary shares have a nominal value of \$0.50 per share and a current market price of \$7.26 per share. A dividend of \$0.49 per share has just been paid and future dividend growth of 5% per year is expected.

The market price of the 7% loan notes is \$94.59 per loan note and interest has just been paid. The loan notes are redeemable in seven years' time at their nominal value of \$100 per loan note.

Variable rate interest is paid on the bank loan and the average interest paid over the last year has been 8.5%.

Mean Co pays corporation tax of 20%

Requirements:

1. Calculate the market value weighted average cost of capital of Mean Co. 10 marks
2. Critically discuss the relationship between capital structure and weighted average cost of capital, referring where necessary to relevant theory and concepts. 10 marks

Examiner Report

Section-A

1. Apollo Co needs a \$10m nine-month loan in three months' time and buys a '3-12' FRA 4.6%-4.1%. In three months' time Apollo Co borrows the \$10m at a rate of 4.5%. What will be the payment or receipt under the FRA for Apollo Co?

- A. \$7,500 payment
- B. \$7,500 receipt
- C. \$10,000 payment
- D. \$10,000 receipt

2. Which TWO of the following are likely to occur in a country that experiences relatively low inflation?

- A. Decrease of profitable investment opportunities
- B. The domestic currency will devalue
- C. Domestic demand for goods and services will rise
- D. The weighted average cost of capital will fall

3. Two companies, Cain and Abel, have the following average levels of working capital:

Working Capital Level	Cain	Abel
	\$m	\$m
Maximum	20	24
Minimum	15	18

Cain's working capital is financed with \$17m of long-term debt and Abel's working capital is financed with \$18m of long-term debt.

The balance of finance is from short-term sources.

Identify, by clicking on the relevant boxes in the table, which type of working capital funding strategy each company is employing ie aggressive, matching or conservative.

Cain's working capital funding strategy	Aggressive	Matching	Conservative
Abel's working capital funding strategy	Aggressive	Matching	Conservative

4. Remi Co is a listed company; its ordinary shares have a nominal value of \$0.50 per share and a total nominal value of \$30m. The following data applies to Remi Co:

Latest total ordinary dividend	\$3.0m
Earning Yield	12.0%
Dividend Yield	4.0%

What is the earnings per share of Remi Co?

- A. \$0.30
- B. \$0.33
- C. \$0.15
- D. \$0.83

Section-B

Example of a case scenario

Jesse Henriques holds a diversified investment portfolio.

Jesse holds equity shares in Larrospa Co, which is expected to pay a dividend of \$0.60 per share in the near future. The company is planning to undertake a large investment in the near future and as a result expects future dividends to increase by 2% per year. Larrospa Co has a cost of equity of 11%.

Jesse also holds 7% convertible loan notes of Rallento Co, which have a current market value of \$97.50 per \$100 nominal value. The loan notes can be redeemed at a premium of 15% to nominal value in five years' time or can be converted on the same date into 20 shares per loan note held.

Jesse has invested in the 10% preference shares of Burgins Co, which have a nominal value of \$2 per share. The total nominal value of the investment is \$20,000 and the annual dividend has just been paid. The cost of capital of the preference shares is 8%.

Question one

Using the dividend growth model, what should be the current share price of Larrospa Co?

- A. \$6.67
- B. \$6.80
- C. \$7.27
- D. \$7.40

Question two

Which THREE of the following can be problems when valuing shares using the dividend growth model?

- A. It may be difficult to decide on the value of the future cost of equity
- B. The model does not take into account the effect of a share repurchase
- C. Companies may not have sufficient cash available to maintain constant dividend growth
- D. The cost of equity may exceed the dividend growth rate
- E. The model uses profits rather than cash flows to calculate share values
- F. If dividends have not been paid in the past, the model cannot be used

Question three

What is the share price of Rallento Co at which Jesse will be indifferent between converting and redeeming the loan notes (to the nearest \$0.01)?

\$_____.

Question four

What is the current value of Jesse's total holding of preference shares in Burgins Co (to the nearest dollar)?

\$_____.

Question five

Jesse would like to confirm his understanding of terms and theories he has seen when reading about the factors which influence the market price of investments. Which of the following statements is correct?

- A. Fundamental analysis is based on the existence of patterns in past share prices
- B. The random walk hypothesis is based on share values being unchanged when new information becomes available
- C. Noise trading is based on the belief that stock markets are inherently inefficient
- D. Technical analysis is based on identifying features within companies that will influence share prices in the future