THE OPEN UNIVERSITY OF SRI LANKA
COMMONWEALTH EXECUTIVE MASTER OF BUSINESS/ PUBLIC ADMINISTRATION
FINAL EXAMINATION 2016
MCP 2610 - CORPORATE FINANCE
DURATION - 03 HOURS

Date : 17.07.2016 **Time : 9.30 am – 12.30 pm**

Instructions: Answer ALL five (05) questions. Numbering of the answers in your answer script should follow the numbers assigned to the questions in the paper. Illegible hand writing is liable to loose marks.
Use of non-programmable calculators are allowed.

Question No. 01

"Financial management can be defined as the management of the finances of an organization in order to achieve the financial objectives of the organization. The actions of stakeholder groups in pursuit of their expectations can exert influence on strategy, which will limit the achievement of financial objectives."

(a) Explain briefly the term "Finance" as a business function. What are the financial objectives in a business organization?

(04 Marks)

(b) Briefly explain the major decisions involved in finance as a business function.

(08 Marks)

(c) Explain the meaning of "Agency Problem" and discuss appropriate mechanisms to minimize the agency problem exists between shareholders and managers.

(08 Marks)

(Total :20 Marks)

Question No. 02

(a) State five (05) characteristics of equity shares.

(05 Marks)

(b) Discuss advantages and disadvantages of equity as a source of finance when compared to debenture.

(04 Marks)

(c) Furniture (Pvt) Ltd is a manufacturing company, which has managed to increase earnings over the last year. As a result, the board of directors has increased the dividend payout ratio (that is, the percentage of profit pay as dividend) from 30% for the year ended 31st March, 2014 to 40% for the year ended 31st March, 2015. The company has a cost of equity of 15%. The following information is also available.

Year ended 31st March;	**2014**	**2015**
Profit after tax (Rs.)	14,800,000	15,200,000
No. of ordinary shares	5,000,000	5,000,000

The dividend is expected to be increased at the rate 5% per annum. Companies similar to Furniture (Pvt) Ltd have a Price-to-earnings ratio of 12 times.

You are required to;

(i) Calculate the value of an equity share of Furniture (Pvt) Ltd. using the dividend growth model.

(04 Marks)

(ii) Calculate the value of an equity share of Furniture (Pvt) Ltd. using the earnings based valuation method.

(04 Marks)

(iii) Discuss the weaknesses of the dividend growth model as a way of valuing equity shares.

(03 Marks)

(Total: 20 Marks)

Question No. 03

Lanka Electrical Plc. carries out its principal activities under two departments – Manufacturing and Service. Manufacturing Department was set up primarily for the manufacturing and assembling of household electric and electronic appliances in collaboration with internationally recognized brand names. It is engaged in the assembling and manufacturing of Washing Machines, Refrigerators, Water Geyzers, Televisions, Air Conditioners and Cookers. Service Department handles the installation, repair, maintenance and all after sales services of all electrical and household appliances sold by the Company. The following are the extracts of the Company's annual report for the year ended 31st March, 2015.

Statement of Financial Position

Assets	31.03.2015 (Rs'000)	31.03.2014 (Rs'000)
Non-Current Assets		
Property, plant and equipment	236,799	237,711
Investments in subsidiaries	11,454	11,554
Fixed deposits	9,503	4,203
Total non-current assets	257,756	253,468
Current Assets		
Inventories	289,999	343,554
Trade and other receivables	90,881	160,256
Amounts due from related parties	647,657	671,326
Cash and cash equivalents	23,025	44,315
Total current assets	1,051,562	1,219,452
Total assets	**1,309,318**	**1,472,919**
Equity and Liabilities		
Stated capital	122,850	122,850
Capital reserves	2,100	2,100
Retained earnings	305,433	245,648
Total equity	430,383	370,598
Non-Current Liabilities		
Interest bearing borrowings	112,120	115,750
Retirement benefit obligations	41,613	40,406
Deferred tax liability	1,577	6,804
Total non-current liabilities	155,309	162,959
Current Liabilities		
Trade and other payables	226,185	181,948
Income tax	28,164	24,950
Amounts due to related parties	8,232	5,645
Interest bearing borrowings	384,277	683,492
Bank overdrafts	76,767	43,326
Total current liabilities	723,626	939,361
Total equity and liabilities	**1,309,318**	**1,472,919**

Statement of Income

	2014/2015 (Rs'000)	2013/2014 (Rs'000)
Net turnover	2,546,450	3,785,305
Cost of sales	(2,205,199)	(3,321,110)
Gross profit	341,251	464,195
Other income	46,972	21,981
Distribution cost	(47,518)	(43,784)
Administrative expenses	(205,303)	(143,397)
Finance expenses	(40,053)	(108,271)
Profit before tax	95,349	190,724
Income tax expense	(27,047)	(73,737)
Profit for the year	68,303	116,987

You are required to;

(a) Analyse and interpret the financial statements using financial ratios and discusses Lanka Electrical Plc's financial performance during the year ended 31st March 2015 and its position at the end of that year.

(16 Marks)

(b) Discuss two (02) limitations in financial ratios used above (a).

(04 Marks)

(Total: 20 Marks)

Question No. 04

(a) Briefly explain the difference between a straight bond and a convertible bond.

(04 Marks)

(b) Briefly discuss the following terms associated with options;

(i) Call option

(ii) In-the-money

(iii) Option premium

(06 Marks)

(c) A three-month call option is the right to buy stock at Rs 20. Currently the stock is selling for Rs 22 and the call is selling for a premium of Rs 5. You are considering buying 100 shares of the stock (Rs 2,200) or one call option (Rs 500).

(i) If the price of the stock rises to Rs 29 within three months, what would be the profit or losses on each position? What would be the percentage gains or losses?

(ii) If the price of the stock declines to Rs 18 within three months, what would be the profit or losses on each position? What would be the percentage gains or losses?

(10 Marks)

(Total: 20 Marks)

Question No. 05

(a) Explain briefly the terms 'Risk' and 'Return', and their importance in investment decisions.

(06 Marks)

(b) What is portfolio diversification? How can efficient diversification be achieved? Discuss.

(07 Marks)

(c) AB PLC is considering for an investment of Rs 150 million in the stock market. The following data is provided on two stocks evaluated for investment.

Stock	Expected Return	Standard Deviation
X	16%	0.3
Y	12%	0.2
Correlation between the two stocks is +1.0		

(i) Determine the expected return and risk of the investment under the following alternative portfolios;

Alternative I - Rs 150 million is equally invested in the stocks X and Y.

Alternative II - Of Rs 150 million, Rs 120 million is invested in the stock X and the rest in stock Y

(ii) Using the above information, explain whether AB PLC could achieve the diversification through the portfolios in Alternative I and II.

(07 Marks)

(Total: 20 Marks)

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