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Section A - BOTH questions are compulsory and MUST be attempted

1 Doric Co, a listed company, has two manufacturing divisions: parts and fridges. It has been manufacturing parts for domestic refrigeration and air conditioning systems for a number of years, which it sells to producers of fridges and air conditioners worldwide. It also sells around 30% of the parts it manufactures to its fridge production division. It started producing and selling its own brand of fridges a few years ago. After limited initial success, competition in the fridge market became very tough and revenue and profits have been declining. Without further investment there are currently few growth prospects in either the parts or the fridge divisions. Doric Co borrowed heavily to finance the development and launch of its fridges, and has now reached its maximum overdraft limit. The markets have taken a pessimistic view of the company and its share price has declined to 50c per share from a high of \$2.83 per share around three years ago. A survey from the refrigeration and air conditioning parts market has indicated that there is potential for Doric Co to manufacture parts for mobile refrigeration units used in cargo planes and containers. If this venture goes ahead then the parts division before-tax profits are expected to

grow by 5% per year. The proposed venture would need an initial one-off investment of \$50 million. Suggested proposals The Board of Directors has arranged for a meeting to discuss how to proceed and is considering each of the following proposals :

1. To cease trading and close down the company entirely.
2. To undertake corporate restructuring in order to reduce the level of debt and obtain the additional capital investment required to continue current operations.
3. To close the fridge division and continue the parts division through a leveraged management buy-out, involving some executive directors and managers from the parts division. The new company will then pursue its original parts business as well as the development of the parts for mobile refrigeration business, described above. All the current and long-term liabilities will be initially repaid using the proceeds from the sale of the fridge division. The finance raised from the management buy-out will pay for any remaining liabilities, the additional capital investment required to continue operations and re-purchase the shares at a premium of 20%. The following information has been provided for each proposal :

Cease trading Corporate restructuring The existing ordinary shares will be cancelled and ordinary shareholders will be issued with 40 million new \$1 ordinary shares in exchange for a cash payment at par. The existing unsecured bonds will be cancelled and replaced with 270 million of \$1 ordinary shares. The bond holders will contribute \$90 million in cash. All the shares will be listed and traded. The bank overdraft will be converted into a secured ten-year loan with a fixed annual interest rate of 7%. The other unsecured loans will be

repaid. In addition to this, the directors of the restructured company will get 4 million \$1 share options for an exercise price of \$110, which will expire in four years. An additional one-off capital investment of \$80 million in machinery and equipment is necessary to increase sales revenue for both divisions by 7%, with no change to the costs. After the one-off 7% growth, sales will continue at the new level for the foreseeable future. It is expected that the Dorics cost of capital rate will reduce by 550 basis points following the restructuring from the current rate.

Management buy-out The parts division is half the size of the fridge division in terms of the assets and liabilities attributable to it. If the management buy-out proposal is chosen, a pro rata additional capital investment will be made to machinery and equipment on a one-off basis to increase sales revenue of the parts division by 7%. Sales revenue will then continue at the new level for the foreseeable future. All liabilities categories have equal claim for repayment against the company's assets. It is expected that Dorics cost of capital rate will decrease by 100 basis points following the management buy-out from the current rate. The following additional information has been provided: Redundancy and other costs will be approximately \$54 million if the whole company is closed, and pro rata for individual divisions that are closed. These costs have priority for payment before any other liabilities in case of closure. The taxation effects relating to this may be ignored. Corporation tax on profits is 20% and losses cannot be carried forward for tax purposes. Assume that tax is payable in the year incurred. All the non-current assets, including land and buildings, are eligible for tax

allowable depreciation of 15% annually on the book values. The annual reinvestment needed to keep operations at their current levels is roughly equivalent to the tax allowable depreciation. The \$50 million investment in the mobile refrigeration business is not eligible for any tax allowable depreciation. Doric's current cost of capital is 12%. Required : Prepare a report for the Board of Directors, evaluating the financial and non-financial impact of all the three proposals to Doric Co's main stakeholder groups, that includes:

- (i) An estimate of the return the debt holders and shareholders would receive in the event that Doric Co ceases trading and is closed down. (3 marks)
- (ii) An estimate of the income position and the value of Doric Co in the event that the restructuring proposal is selected. State any assumptions made. (8 marks)
- (iii) An estimate of the amount of additional finance needed and the value of Doric Co if the management buy-out proposal is selected. State any assumptions made. (8 marks)
- (iv) A discussion of the impact of each proposal on the existing shareholders, the unsecured bond holders, and the executive directors and managers involved in the management buy-out. Suggest which proposal is likely to be selected. (12 marks)

Professional marks will be awarded in question 1 for the appropriateness and format of the report. (4 marks) (35 marks)

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