Mock Exam 1 Question

Section B

Question 1:

Division X is a division of XYZ plc. Its net assets are currently £10million and it earns a profit of £2.2million per annum. Division X's Cost of Capital is 10% per annum. The division is considering two proposals.

Proposal 1 - involves investing a further £1million in fixed assets to earn an annual profit of £0.15million.

Proposal 2 - involves the disposal of assets at their net book value of £2.3million. This would lead to a reduction in profits of £0.3million. Proceeds from the disposal of assets would be credited to head office not Division X.

Required:

1) In what way can the use of Return On Investment (ROI) as a performance measure for investment centres lead to bad decisions? How does the Return on Income (RI) approach overcome this problem? (7 marks)

2) Calculate the current ROI and RI for Division X? (5 marks)

3) Calculate both ROI and RI on a change under each of the two proposals? (8 marks)

4) Comment on which proposal should X consider and why? (5 marks)

(Total 25 marks)