KASNEB

ATD LEVEL II

FUNDAMENTALS OF FINANCE

PILOT PAPER

September 2015. **Time Allowed: 3 hours.**

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings.

QUESTION ONE

(a) Explain three factors that a company could consider when formulating its dividend policy. (6 marks)

(b) Outline four advantages of paying scrip dividends by a company. (4 marks)

(c) The following information was extracted from the books of Kogello Limited as at 31 March 2015:

	Sh. '000'
Ordinary share capital (par value Sh.25)	8,000
8% preference share capital (par value Sh.24)	6,000
10% preference share capital (par value Sh.20)	4,000
10% Debentures	4,000

Additional information:

1. The market prices per share as at 31 March 2015 were as follows:

	Sh.
Ordinary shares	30
8% preference share	20
10% preference share	25

2. The market value of 10% debentures as at 31 March 2015 was Sh.5,000,000.
3. The corporation tax rate is 30%.
4. The company has maintained a payment of an ordinary dividend per share of Sh.3.80 over the past five years.

Required:

The weighted average cost of capital (WACC) using market weights. (10 marks)

(Total: 20 marks)

QUESTION TWO

(a) In relation to financing of firm's activities, explain the meaning and relevance of the following terms:

(i) Stock split. (3 marks)

(ii) Stock repurchase option. (3 marks)

(b) Umoja Ltd. is contemplating undertaking any of the following three mutually exclusive projects A, B and C. Each project requires an initial cash outlay of Sh.5 million. Details of each of the projects are given as follows:

Project A

This project is expected to generate an annual net operating cash flow of Sh.2,000,000 each year over its useful life of five years. Estimated re-sale value of the project after 5 years is Sh.500,000.

Project B

This project is expected to generate a net cash flow of Sh.650,000 each year in perpetuity.

Project C

This investment is expected to have a useful life of 3 years with no resale value at the end of this period. The annual contribution to be generated by the project each year are given as follows:

	Year 1	Year 2	Year 3
Contribution (Sh.'000')	2,500	3,000	3,500

The annual fixed operating costs excluding depreciation are estimated at Sh.200,000 per annum. Provide for depreciation on a straight line basis and corporation tax is payable at the rate of 30%. The minimum required rate of return from this investment is 10%.

Required:
Using net present value, advise management of the company on the project to undertake. (14 marks)
(Total: 20 marks)

QUESTION THREE

Super Products Ltd. started operations on 1 April 2014. The company raised the required equity capital of Sh.260 million and debt at an annual rate of interest of 18% before commencing business.

Given below are some statistics extracted from the books of the company in respect of the financial statements prepared to 31 March 2015:

	Sh."000"
Total fixed assets (NBV)	300,000
Operating costs (excluding debt interest)	156,000
Dividend declared and paid	16,880
Cash and bank balances	12,500

80% of the sales are on credit. The current assets on 31 March 2015 consisted of only stock, debtors, cash and bank balances as given above while current liabilities consisted of only creditors and tax provided for in respect of the year ending 31 March 2015. Taxation was provided for at the rate of 30%.

You are provided with the following financial ratios which have been determined from the financial statements of Super Products Ltd:

Fixed assets turnover	1.8 times
Gross profit margin	45%
Stock turnover	4.4 times
Interest cover	4 times
Average debt collection (based on 360 days of the year)	84 days
Current ratio	2.5:1

Required:

(a) In respect of the year ended 31 March 2015, you are required to prepare the company's:

(i) Income statement. (8 marks)

(ii) Statement of financial position. (8 marks)

(b) The following statistics have been provided with respect to the industry in which the company operates:

- Acid test ratio 1.2:1
- Return on equity 21%
- Capital gearing ratio 35%

Required:
Comment on the performance of the company relative to these industry statistics. (4 marks)
(Total: 20 marks)

QUESTION FOUR

(a) ABC Ltd. earnings and dividends over the last five years have steadily increased as shown below:

Year	EPS Sh.	DPS Sh.
2010	6	2.5
2011	6.5	2.7
2012	7.0	2.8
2013	7.3	3.5
2014	7.5	4.0

Wambua, a prospective investor is considering buying shares of this company which are currently selling at Sh.120 each.

The investor's minimum required rate of return is 16%.

Required:
Advise the investor on whether he should buy the shares of the company or not. (10 marks)

(b) Firms strive to pursue objectives which at times overlap with each other and in some cases conflict with each other. Briefly explain overlaps and conflicts that may arise amongst objectives that firms strive to achieve. (10 marks)
(Total: 20 marks)

QUESTION FIVE

(a) AMR Ltd. makes cash payments of Sh.20,000 per week. The interest rates on marketable securities is 10% and every time the company sells marketable securities, it incurs a cost of Sh.30.

Required:
Using Baumol's model in cash management;

(i) Determine the optimal amount of marketable securities to be converted into cash every time the company makes the transfer. (4 marks)

(ii) Determine the total number of transfers from marketable securities to cash per year. (2 marks)

(iii) Determine the total cost of maintaining the cash balance per year. (2 marks)

(iv) Determine the firm's average cash balance. (2 marks)

(b) A company has invested in a project whose return distributions is given as follows:

Possible return (%)	Probability
0.10	0.05
0.02	0.10
0.04	0.20
0.09	0.30
0.14	0.20
0.20	0.10
0.28	0.05
	1.00

Required:

(i) The asset's risk using the standard deviation. (3 marks)

(ii) The expected return of the project. (2 marks)

(c) Outline five motives of leasing an asset from the point of new of a company. (5 marks)
(Total: 20 marks)

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