



ATD LEVEL II

FUNDAMENTALS OF FINANCE

TUESDAY: 18 May 2021.

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) Distinguish between the following sets of terms as used in financial markets:

(i) "Quoted companies" and "unquoted companies". (2 marks)

(ii) "Bonus issue" and "rights issue". (2 marks)

(b) Summarise two advantages of the internal rate of return (IRR) method used in evaluation of the viability of an investment project. (4 marks)

(c) Kopex Ltd.'s capital structure is as follows:

| | Sh. "million" |
|---|---------------|
| Ordinary share capital (Sh.20 each) | 1,920 |
| 12% preference share capital (Sh.20 each) | 1,440 |
| 9% debentures | <u>960</u> |
| | <u>4,320</u> |

Additional information:

- The ordinary shares are currently trading on the securities exchange at Sh.75 per share.
- The ordinary dividend for the previous financial year was Sh.10.60 per share. The dividends are expected to grow at an annual growth rate of 8% for the foreseeable future.
- The preference shares have a current market value of Sh.20 per share.
- The debentures are irredeemable and have a current market value of Sh.1,080 per Sh.1,000 nominal value.
- Corporation tax rate is 30%.

Required:

(i) Kopex Ltd.'s market weighted average cost of capital (MWACC). (8 marks)

(ii) Explain two reasons why Kopex Ltd. could prefer to use market weights instead of book value weights in the computation of the weighted average cost of capital. (4 marks)

(Total: 20 marks)

QUESTION TWO

(a) Describe four factors to be taken into account in the design of a firm's credit policy. (8 marks)

(b) The following balances were extracted from the books of Ushauri Ltd. for the year 2020:

| | Balances as at | |
|----------------------|--------------------------------|--------------------------|
| | Beginning of year Sh. "000" | End of year Sh. "000" |
| Finished goods stock | 1,000 | 4,000 |
| Accounts receivable | 1,500 | 4,500 |
| Accounts payable | 1,200 | 2,800 |

Additional information:

1. The firm's sales and cost of sales are Sh.20 million and Sh.15 million respectively. 80% of the firm's sales are credit sales.
2. All purchases of stock are on credit basis.
(Assume that a year has 360 days).

Required:

The firm's working capital operating cycle for the year 2020. (6 marks)

- (c) Kevin Machokah obtained a loan of Sh.1,200,000 from a commercial bank at an interest rate of 12.5% per annum. The loan is to be repaid in equal semi-annual installments over a period of 3 years. The loan interest is to be amortised on a reducing balance basis.

Required:

Loan amortisation schedule for Kevin Machokah. (6 marks)

(Total: 20 marks)

QUESTION THREE

- (a) Explain three areas where the concept of time value of money might be applied. (6 marks)
- (b) Explain three reasons why organisations prefer retained earnings as a source of finance. (6 marks)
- (c) Maize Mills Ltd. expects to generate net income of Sh.10,000,000 in the current financial year.

Additional information:

1. The firm's management has established that acceptable investment proposals of Sh.6,000,000 require financing.
2. The firm currently adopts a residual dividend policy.
3. The number of issued ordinary shares is 10,000,000.

Required:

- (i) The optimal total dividend payable and dividend per share assuming the firm adopts a residual dividend policy. (3 marks)
- (ii) The optimal total dividend payable and dividend per share assuming the firm adopts a 50% payout ratio policy. (3 marks)
- (iii) Advise the company on the dividend policy to adopt based on your answer in (c) (i) and (c) (ii) above. (2 marks)

(Total: 20 marks)

QUESTION FOUR

- (a) Outline four differences between "Islamic banking" and "conventional banking". (8 marks)
- (b) Kenvit Ltd. is considering investing in one of the following two projects X and Y, which require an initial cash outlay of Sh.2,200,000 each. Each of the projects has an estimated productive life of five years.

The following information relates to the two projects:

1. The projects will generate the following annual cash inflows:

| Year | Project X Sh. | Project Y Sh. |
|------|------------------|------------------|
| 1 | 200,000 | 400,000 |
| 2 | 600,000 | 900,000 |
| 3 | 1,200,000 | 800,000 |
| 4 | 900,000 | 700,000 |
| 5 | 500,000 | 600,000 |

2. The company's cost of capital is 10% per annum.

Required:

Advise the management of Kenvit Ltd. on the project to undertake based on the following investment evaluation methods:

- (i) Net present value (NPV). (8 marks)
 - (ii) Profitability index (PI). (4 marks)
- (Total: 20 marks)**

QUESTION FIVE

- (a) Explain four conflicts that could arise in the course of achieving a firm's objectives. (8 marks)
- (b) Summarise four benefits of regulating financial markets in your country. (4 marks)
- (c) Explain the term "unique risk" as used in finance. (2 marks)
- (d) John Kim purchased shares of Barbex Ltd. at the beginning of the year at Sh.125 per share. The forecasted price per share at the end of the year and the probability of its occurrence in different economic conditions are given as follows:

| Economic conditions | Probability | Forecasted share price |
|---------------------|-------------|------------------------|
| High growth | 0.30 | Sh. 120 |
| Low growth | 0.40 | 130 |
| Stagnation | 0.20 | 140 |
| Recession | 0.10 | 160 |

Required:

- (i) Expected rate of return of the company's shares. (2 marks)
 - (ii) The standard deviation of the return. (4 marks)
- (Total: 20 marks)**
-

access thousands of free content here: www.freekcepastpapers.com

