

# KASNEB

CPA PART II SECTION 3

CS PART II SECTION 3

CCP PART II SECTION 3

FINANCIAL MANAGEMENT

WEDNESDAY: 25 May 2016.

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 four principles of capital budgeting. (8 marks)

(b) A firm is considering the following investment projects:

Project	Cash flows (Sh.)			
	Year 0	Year 1	Year 2	Year 3
A	1,000,000	500,000	500,000	-
B	1,000,000	-	650,000	850,000
C	1,000,000	300,000	500,000	1,000,000
D	1,000,000	800,000	400,000	400,000

The firm's opportunity cost of capital is 15%.

### Required:

(i) Rank the projects using payback period method. (3 marks)

(ii) Rank the projects using net present value (NPV) method. (3 marks)

(c) Chigiri Ltd. is a private company which intends to be listed in the securities exchange. The company has recently made a dividend issue of Sh.3.20 per share. This dividend is expected to grow at the rate of 15% per annum for 2 years and then drop to 12% per annum for the next 3 years. Thereafter, the dividend will grow at 6% per annum indefinitely. The required rate of return is 11%.

### Required:

The intrinsic value of the share. (6 marks)

(Total: 20 marks)

## QUESTION TWO

(a) The existing capital structure of Mwarakaya Limited is given as follows:

	Sh. "000"
Ordinary share capital (Sh.100 par value)	40,000
Reserves	15,000
12% debentures (Sh.100 par value)	25,000
10% preference share capital (Sh.20 par value)	<u>20,000</u>
	<u>100,000</u>

### Additional information:

- Ordinary shares of Mwarakaya Limited are currently selling at Sh.80 each.
- The 12% debentures and 10% preference shares are currently selling at Sh.90 and Sh.30 respectively.
- The most recent ordinary dividend paid by the company is Sh.2.00. This is expected to grow at the rate of 10% each year in perpetuity.
- The corporate tax rate is 30%.

### Required:

The weighted average cost of capital (WACC). (6 marks)

(b) The following information relates to the dividend per share (DPS) for Zomollo Ltd.:

Earnings per share (EPS) for year 2016	Sh.6.00
Dividend per share (DPS) for year 2015	Sh.2.40
Target payout ratio	0.60
Adjustment rate	0.70

**Required:**

Using the Lintner model, predict the dividend per share for the year ended 31 December 2016. (3 marks)

(c) James Chiwende is considering the purchase of a 4-year Sh.1,200,000 par value bond. The bond has a coupon interest rate of 10% per annum.

The investor's required rate of return is 8%.

**Required:**

The current value of the bond. (3 marks)

(d) Mwatata Ltd. currently operates with terms of net 80 days. The firm's average investment in accounts receivable amount to Sh.4,400,000 per annum. Eighty per cent of the firm's sales are always on credit. The company is considering introducing terms of 2/20 net 90 days.

The relaxation of terms of sale will increase the firm's total sales by 60%. All cash customers and 40% of the credit customers will take advantage of the cash discount. The average collection period will increase to 80 days up from the current average collection period of 72 days. Bad debts are expected to remain at 3% of credit sales.

Inventory levels are estimated to be 5% of the firm's turnover and creditors will increase by Sh.1,000,000.

Gross margin on sales is 40%. The cost of capital is 16%. Corporate tax rate is 30%.

Assume 360 days in a year.

**Required:**

Advise the management of Mwatata Ltd. on whether to switch to the new credit policy. (8 marks)

(Total: 20 marks)

**QUESTION THREE**

(a) The following data was extracted from the financial statements of Jaribuni Limited for the year ended 31 December 2015:

	Sh. "millions"
Cash and cash equivalents	200
Fixed assets	567
Sales (credit)	2,000
Net income	100
Current liabilities	211
Notes payable to bank	40
Current ratio	3:1
Debtors collection period	40.55 days
Return on equity	12%

Assume 365 days in a year.

**Required:**

(i) Accounts receivable. (2 marks)

(ii) Current assets. (2 marks)

(iii) Return on total assets. (2 marks)

(iv) Equity. (2 marks)

(v) Quick ratio. (2 marks)

- (b) Manjewa Limited maintains a minimum cash balance of Sh.2,000,000. The standard deviation of its daily net cash flow is estimated at Sh.22,000. The transaction cost of buying and selling of marketable securities is Sh.60 per transaction. The rate of interest for the marketable securities is 5% per annum.

Assume 365 days in a year.

**Required:**

Using the Miller-Orr cash management model, determine:

- (i) The spread. (5 marks)
- (ii) The upper cash limit. (2 marks)
- (iii) The return point. (3 marks)

**(Total: 20 marks)**

**QUESTION FOUR**

- (a) Highlight four shortcomings of financial deepening. (4 marks)
- (b) (i) Define the term "franchising". (2 marks)
- (ii) Suggest four reasons why franchising could be considered as an alternative source of finance to a company. (4 marks)

- (c) Ngoba Ltd. has just paid an annual dividend of Sh.38 per share. The management of the company has a target to increase the market share value to Sh.800 per share by considering appropriate investment policies. Shareholders expect a return on investment of 12%.

**Required:**

The annual expected growth rate. (5 marks)

- (d) Laika Ltd. has identified five investment projects with the following details:

Investment project	Initial outlay (Sh. "millions")	Net present value of investment (Sh. "millions")
A	120	24.0
B	160	43.2
C	100	17.0
D	90	21.6
E	110	19.8

**Additional information:**

- None of the investment projects could be delayed.
- Amount available for investment is limited to Sh.300 million, therefore, the company cannot undertake all the investment projects.
- All the five projects are divisible.

**Required:**

Advise the management of Laika Ltd. on the most appropriate investment projects to undertake. (5 marks)

**(Total: 20 marks)**

**QUESTION FIVE**

- (a) Discuss four principles of Islamic financing. (8 marks)

- (b) Highlight four factors that could be taken into account when making dividend decisions. (4 marks)

- (c) (i) The agency problem could be resolved using goal congruence. Explain the term "goal congruence". (2 marks)

- (ii) One of the ways creditors could protect themselves against the inherent risk that might arise from agency conflict is through adopting restrictive covenants.

With reference to the above statement, describe three restrictive covenants in a debt contract. (6 marks)

**(Total: 20 marks)**

