



CPA PART II SECTION 3

CS PART II SECTION 3

CCP PART II SECTION 3

FINANCIAL MANAGEMENT

THURSDAY: 26 November 2020.

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) Islamic banking is grounded on Sharia Law. To earn money, Islamic banks use equity participation system.

**Required:**

With reference to the above statement:

- (i) Explain the term "equity participation system". (2 marks)
- (ii) Discuss three principles of Islamic finance. (6 marks)
- (iii) Describe two types of financing arrangements that could be adopted under Islamic finance. (4 marks)
- (b) In the context of financial markets:
- (i) Distinguish between "commodities markets" and "derivatives markets". (4 marks)
- (ii) Summarise four functions of financial markets. (4 marks)

**(Total: 20 marks)**

QUESTION TWO

- (a) Jaribu Ltd. has been operating in the country for many years. The directors of the company wish to raise additional capital through a rights issue in order to explore opportunities in the region. The directors have decided to make a one-for-five rights issue at a discount rate of 30% on the current market value. The company's most recent financial statements are presented below:

**Income statement for the year ended 31 March 2020**

	Sh. "million"
Sales	1,400
Net profit before interest and taxation	52
Interest payable	24
Net profit before taxation	28
Corporation taxation	7
Net profit after taxation	21
Ordinary dividends payable	14
Retained profit for the year	7

**Capital and reserves as at 31 March 2020**

	Sh. "million"
Sh.0.25 ordinary shares	60
Revaluation reserves	140
Accumulated profits	320
	520

**Additional information:**

1. The shares of the company are currently traded at the local Securities Exchange at a price to earnings (P/E) ratio of 16.
2. An investor holding 10,000 ordinary shares in the company has received the information on the forthcoming rights issue but cannot decide whether to take up the rights issue, sell the rights or allow the rights to lapse.

**Required:**

- (i) The theoretical ex-rights price of an ordinary share. (3 marks)
  - (ii) The price at which the rights are likely to be traded. (1 mark)
  - (iii) Evaluate each of the three options available to the investor with 10,000 ordinary shares. (6 marks)
  - (iv) Comment on the wealth of the investor based on each of the options evaluated in (a) (iii) above. (2 marks)
- (b) Nderu Suppliers Ltd. is reviewing its working capital commitments for enhanced efficiency.

The following information relating to the period ended 31 March 2020 is provided:

Turnover for the year	Sh.15,000,000
<b>Costs as percentages of sales</b>	<b>(%)</b>
Direct materials	30
Direct labour	25
Variable overheads	10
Fixed overheads	15
Selling and distribution	5

**Additional information:**

1. On average:
  - Account receivables take two and a half months before payment.
  - Raw materials are in inventory for three months.
  - Work in progress represents two months worth of half produced goods.
  - Finished goods represent one month's production.
2. Credit is taken as follows:
  - Direct materials 2 months
  - Direct labour 1 week
  - Variable overheads 1 month
  - Fixed overheads 1 month
  - Selling and distribution Half a month
3. Work in progress and finished goods are valued at material, labour and variable expenses cost.
4. Labour force is paid for 50 working weeks a year.

**Required:**

Assess the working capital requirements for the company.

(8 marks)

(Total: 20 marks)

**QUESTION THREE**

(a) The following information relates to Bawabu Traders:

1. The minimum cash balance is Sh.8,000.
2. The variance of daily cash flows is Sh.4,000,000, equivalent to a standard deviation of Sh.2,000 per day.
3. The transaction cost for buying or selling securities is Sh.50.
4. The interest rate is 0.025 per cent per day.

**Required:**

Using Miller-Orr Model of managing cash, determine the following:

- (i) The spread. (2 marks)
- (ii) Upper cash limit. (2 marks)
- (iii) Return point. (2 marks)
- (iv) Propose a decision rule for cash management to the company based on your calculations in (a) (i) to (a) (iii) above. (2 marks)

(b) The following information was extracted from the books of Domingo General Merchants Ltd.:

**Statement of financial position as at 31 December 2019:**

	Sh. "000"	Sh. "000"
Non-current assets		10,115
Investments		821
Current assets	3,658	
Less: Current liabilities	(1,735)	<u>1,923</u>
<b>Total assets</b>		<u>12,859</u>
Financed by:		
Ordinary share capital: 3,000,000 shares each Sh.1		3,000
General reserves		<u>7,125</u>
Shareholders' funds		10,125
7% Bonds		1,300
Corporation taxation		<u>1,434</u>
Total equity and liabilities		<u>12,859</u>

**Summary of profits and dividends:**

Year ended 31 December	2015	2016	2017	2018	2019
	Sh. "000"	Sh. "000"	Sh. "000"	Sh. "000"	Sh. "000"
Profit after interest and before tax	1,737	2,090	1,940	1,866	2,179
Less: Tax	(573)	(690)	(640)	(616)	(719)
Profit after interest and tax	1,164	1,400	1,300	1,250	1,460
Less: Dividends	620	680	740	740	810
Retained earnings	<u>544</u>	<u>720</u>	<u>560</u>	<u>510</u>	<u>650</u>

**Additional information:**

- The current (1 January 2020) market value of ordinary shares is Sh.3 per share ex div.
- The bonds are redeemable at par in ten years time.
- The current market value of the bonds is Sh.77.10 per Sh.100 of nominal value and the annual interest has just been paid on the bonds.
- There have been no issues or redemptions of ordinary shares or bonds during the past five years.
- The corporate tax rate is 30%. Assume that there have been no changes in corporate tax rate for the past five years.

**Required:**

The weighted average cost of capital (WACC) that the company should use as a discount rate when appraising new investment opportunities.

(12 marks)

**(Total: 20 marks)**

**QUESTION FOUR**

- (a) Ulanda Engineering Works Ltd. is contemplating the purchase of a new machine to replace the existing one. The existing machine was purchased two years ago at an installed cost of Sh.500,000. The machine was estimated to have an economic life of 5 years with nil salvage value but a critical analysis of its performance now shows that it is usable for the next five years with a resale value of Sh.100,000. The current disposal value of existing machine is Sh.200,000.

The new machine would cost Sh.600,000 and require Sh.50,000 in installation cost. Since the machine is not locally available, the company plans to import it and will pay import duty and freight charges of Sh.150,000 and Sh.100,000 respectively. The new machine shall require an overhaul at the end of third year which is expected to cost Sh.100,000. The overhaul cost is to be amortised on a straight line basis over the remaining useful life of the machine.

To support the increased business resulting from purchase of the new machine, accounts receivable would increase by Sh.250,000, inventories and accounts payable shall increase by Sh.200,000 and Sh.300,000 respectively.

At the end of five years, the new machine would be sold for Sh.250,000.

The estimated profit before depreciation and taxes over the next five years period for both machines are given as follows:

Year	Existing machine Sh. "000"	New machine Sh. "000"
1	120	260
2	150	280
3	130	250
4	145	240
5	135	270

**Additional information:**

1. The corporation tax rate is 30%.
2. The company uses the straight line method of depreciation.
3. The cost of capital is 13%.
4. Capital gains are tax exempt.

**Required:**

- (i) The incremental initial cash outlay. (4 marks)
  - (ii) The incremental net operating cash flows associated with the proposed machine replacement. (6 marks)
  - (iii) Should the existing machine be replaced? Justify your answer. (4 marks)
- (b) Upendo Ltd. has issued 5,000,000, Sh.20 par value ordinary shares which are presently trading at Sh.25 per share at the Securities Exchange. Upendo Ltd. has plans to issue rights to purchase one new ordinary share at a price of Sh.20 per share for every four shares held.

**Required:**

- (i) The theoretical ex-right price of Upendo Ltd.'s share. (4 marks)
- (ii) The theoretical value of a right of Upendo Ltd. before the shares sell ex-right. (2 marks)

**(Total: 20 marks)**

**QUESTION FIVE**

- (a) Donnat Ltd. has a capital structure that consists of Sh.150 million, 15% debentures and Sh.450 million in ordinary shares of Sh.20 par value.

The company adopts a 100% payout ratio as its dividend policy.

The finance manager of Donnat Ltd. intends to raise an additional Sh.20 million to finance an expansion programme and is considering two alternative financing options:

**Option 1:** Issue a 12% debenture stock.

**Option 2:** Issue additional ordinary shares of Sh.20 par value.

The corporation tax rate is 30%.

**Required:**

Calculate the earnings before interest and tax (EBIT) and earnings per share (EPS) at the point of indifference in firm's earnings under financing option (1) and (2) above. (8 marks)

- (b) (i) Walter's model on dividend policy believes in the relevance concept of a dividend. According to this concept, a dividend decision of the company affects its valuation.

**Required:**

Discuss four assumptions of Walter's model. (8 marks)

- (ii) Explain the risk-return trade off in the context of investments. (4 marks)

**(Total: 20 marks)**

