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FINANCIAL MANAGEMENT REVISION KIT

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TOPICALLY ARRANGED

Updated With August 2025 Past Paper with Answers

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PART A

PAST EXAMINATION QUESTIONS

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INTRODUCTION TO CAPITAL STRUCTURE DECISIONS

QUESTION 1

August 2025 Question One B and C

(b) Shabana Ltd. is intending to raise additional capital to finance a new project. The current market price per share (MPS) of the company is Sh.44 Cum-Div of the year 2024 declared but not yet paid. For the past six years, the company paid the following stream of dividends:

Year	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Dividend per share (Sh.)	3.0	3.2	3.4	3.6	3.8	4.0

The existing capital structure of the firm is as follows:

	Sh.“000”
Ordinary share capital (Sh.20 par value)	60,000
Reserves	20,000
14% debenture (Sh.100 par value)	30,000
10% preference share capital (Sh.30 each)	20,000
	130,000

Additional information:

1. The existing 14% debentures are currently selling at Sh.124 cum-interest.
2. The existing 10% preference shares are currently trading at Sh.25 each.
3. Corporation tax rate is 30%.

Required:

Compute the company’s existing overall weighted average cost of capital (WACC).

(6 marks)

(c) Suppose the company in (b) above wants to raise additional Sh.50 million to finance an expansion programme as follows:

- 30% from retained earnings.

- 30% from the issue of new ordinary shares at Sh.40 each. A floatation cost of 2% of the issue price will be incurred and discount cost of Sh.3 per share issued will also be incurred.
- 40% of the additional funds will be raised from the issue of new 12% irredeemable debentures at current market value of Sh.110 each. The firm will incur Sh.10 floatation cost per unit issued.

Required:

(i) Compute the firm's weighted marginal cost of capital (WMCC). (4 marks)

(ii) Compute the number of ordinary shares to be issued to raise the desired external equity capital. (2 marks)

QUESTION 2

April 2025 Question One B

Pivot Ltd. is considering raising an additional Sh.20 million to finance an expansion programme. The firm's existing capital structure which is considered to be optimal is as follows:

	Sh."000"
Ordinary share capital	100,000
Reserves	50,000
16% debentures (Sh.1,000 par value)	62,500
14% preference shares capital (Sh.20 per value)	37,500
	250,000

Additional information:

1. The firm expects to generate Sh.4 million from retained earnings for this expansion programme.
2. Additional new ordinary shares will be issued at Sh.90 each subject to a floatation cost of Sh.10 per share.
   The most recent dividend paid by the company is Sh.4 per share. The firm's dividends are expected to grow at the rate of 5% per annum in perpetuity.
3. The company will issue new 16% debentures at a price of Sh.1,100 with a floatation cost of Sh.5 per debenture.
4. New 14% preference shares will be issued at Sh.30 with a floatation cost of Sh.2 per share.
5. Corporation tax rate applicable is 30%.

Required:

(i) The cost of retained earnings. (2 marks)

(ii) The cost of new ordinary share capital. (2 marks)

(iii) The cost of new 16% debentures. (3 marks)

PART B

SUGGESTED ANSWERS AND SOLUTIONS

TOPIC 6

INTRODUCTION TO CAPITAL STRUCTURE DECISIONS

QUESTION 1

August 2025 Question One B and C

(b) Shabana Ltd.

The company's existing overall weighted average cost of capital (WACC).

Cost of capital

Source	**Market value**	**Sh "000"**	**Market value weights**
Ordinary share capital	$\frac{60,000}{20} \times 40$	120,000	$\frac{120}{169.667} = 0.71$
Reserves	-	-	-
14% Debenture	$\frac{30,000}{100} \times 110$	33,000	$\frac{33}{169.667} = 0.194$
10% preference share capital	$\frac{20,000}{30} \times 25$	16,667	$\frac{16.667}{169.667} = 0.098$
Total current market price	169,667		1.00

Workings

Working 1

Cost of ordinary share capital (K_s)

$K_s = \left[\frac{D_0(1+g)}{P_0} + g\right] 100\%$ but $g = \sqrt[5]{\left(\frac{4}{3} - 1\right) \times 100\%}$ g = 5.92%

$K_s = \left[\frac{4(1+5.92)}{100} + 0.0592\right] 100\%$

$K_s = 16.51\%$

Working 2

After tax cost of 14% Debentures

$K_d = \frac{Interest\ (1-0.30)(100\%)}{M_{vd}-f}$

$K_d = \left[\frac{\frac{14\% \times 100}{100}(1-0.30}{124-14}\right] \times 100\% = 8.9\%$

Working 3

Cost of 100% preference share capital (K_p)

$K_p = \frac{D_p}{M_{vp}} \times 100\%$

$K_p = \left(\frac{\frac{10}{100} \times 30}{25}\right) \times 100\% = 12\%$

Weighted average cost of capital (WACC)

WACC = $(K_s W_s + W_d K_d + W_p K_p)$

WACC = 16.51% × 0.71 + 0.194 × 8.9 + 12% × 0.098

WACC = 14.62%

(c) The company in (b) above

(i) **Weighted marginal cost of capital (WMCC).**

Source	**Amount**	**Sh. "000"**	**Proportion**
Retained profit	$\frac{30}{100} \times 50{,}000$	= 15,000	$\frac{15}{50} = 0.30$
Issue of ordinary shares	$\frac{30}{100} \times 50{,}000$	= 15,000	$\frac{15}{50} = 0.30$
Issue of new 12% debentures	$\frac{40}{100} \times 50{,}000$	$= \frac{20{,}000}{50{,}000}$	$\frac{20}{50} = 0.40$

(WK1) Cost of retained profit (K_r)

$K_r = \frac{D_0 (1+g)}{P_o} + g \times 100\%$

$K_r = \left[\frac{4(1+0.0592)}{40} + 0.0592\right] \times 100\% = 16.51\%$

(WK2) Cost of Ordinary share capital

$K_s = \frac{D_0 (1+g)}{P_o - f} + g \times 100\%$

$K_s = \left[\frac{4(1.0592)}{40 - \frac{2}{100}(40-3)} + 0.0592\right] \times 100\%$

$K_s = \left[\frac{4(1.0592)}{36.2} + 0.0592\right] \times 100\% = 17.62\%$

(WK3) After tax cost of 12% irredeemable debentures:

$K_d = \left[\frac{Int\,(1-t)}{m_{vd} - f}\right] \times 100\%$

$K_d = \left[\frac{\frac{12}{100} \times 100\,(1-0.3)}{110-10}\right] \times 100\% = \left(\frac{12}{100} \times 0.7\right) \times 100\% = 8.4\%$

Weighted average cost of capital (Marginal) = WMCC

WMCC = 16.51% × 0.3 + 17.62 × 0.3 + 8.4% × 0.4

= 13.6%

(ii) **Number of ordinary shares to be issued**

$$\frac{Desired\ external\ equity}{Issue\ price - floatation\ cost} = \frac{15,000,000}{40-3.8}$$

$$= \frac{15,000,000}{36.2} = 414,364.6409 \text{ shares}$$

QUESTION 2

April 2025 Question One B

Pivot Ltd.

(i) **The cost of retained earnings** (K_r)

$$K_r = \left\{\frac{D_0(1+g)}{P_0} + g\right\} \times 100\%$$

$$= \frac{Sh\ 4\ 91,05)}{90} + 0.05 \times 100\%$$

$$K_r = 9.667\% \cong 9.67\%$$

(ii) **The cost of new ordinary share capital** $(K_s|K_e)$

$$K_e = \left\{\frac{D_0(1+g)}{P_0 - f} + g\right\} \times 100\%$$

$$= \left\{\frac{4(1.05)}{90 - 10} + 0.05\right\} \times 100\% = 10.25\%$$

(iii) **The cost of new 16% debentures** (K_d)

$$K_d = \left\{\frac{Interest}{vd - f}\ (1-t)\right\} \times 100\%$$

$$K_d = \left\{\frac{1000 \times 16\%}{1100 - 5} \times (1 - 0.3)\right\} \times 100\% = 10.2283105\%$$

$$K_d = 10.23\%$$

(iv) **The cost of new preference shares** (K_p)

$$K_p = \left[\frac{Dividend\ Rate \times Par\ value}{P_0 - f}\right] \times 100\%$$

$$K_p = \left(\frac{14\% \times 20}{30 - 2}\right) \times 100\% = \frac{2.8}{28} \times 100\% = 10\%$$

(v) **The company's weighted marginal cost of capital (WMCC).**

WMCC = $w_r k_r + w_e k_e + w_d k_d + w_p k_p$