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# KASNEB

**CPA PART II SECTION 3**

**CS PART II SECTION 3**

**CCP PART II SECTION 3**

**FINANCIAL MANAGEMENT**

**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) "Provision for depreciation is an internally generated source of finance to a company".

Explain the basis upon which provision for depreciation is a source of finance to an organisation. (4 marks)

(b) MM Company Ltd. is contemplating raising additional finance for an expansion programme. The company is considering Sh.50 million for this expansion programme. The company's existing capital structure is given below:

| | **Sh."000"** |
|---|---|
| Ordinary share capital (Sh.20 par) | 60,000 |
| 10% debenture capital | 25,000 |
| 12% preference share capital | 15,000 |
| Reserves | 50,000 |
| | 150,000 |

Two alternative financing options available to the company are given as follows:

**Option 1**
Issue new ordinary shares at par to raise all the desired funds.

**Option II**
Issue new ordinary shares at par to raise Sh.30 million and the balance will be raised through the issue of 15% debentures.

The management are optimistic that this investment will enable the company to generate annual operating profit (EBIT) whose forecasted values in different states of nature and their probability of occurrence are given as follows:

| **State of Nature** | **Probability** | **Operating profit (EBIT)** |
|---|---|---|
| Good | 0.4 | 20,000 |
| Moderate | 0.25 | 15,000 |
| Poor | 0.35 | 10,000 |

The firm pays corporation tax at the rate of 30%.

**Required:**

(i) Determine the level of expected operating profit (EBIT) and expected earnings per share at the point of indifference between the firm's earning under financing options I and II. (6 marks)

(ii) Determine the range of expected operating profit within which each financing option will be recommended (Hint: a graph may be used to answer this question). (6 marks)

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(c) With reference to (b) above, indicate the financing option you would recommend assuming that the company's expected operating profits are:

(i) As forecasted by the organisation. (1 mark)

(ii) Sh.6,000,000 per annum. (1 mark)

(iii) Sh.15,000,000 per annum. (2 marks)

**(Total: 20 marks)**

**QUESTION TWO**

(a) In relation to financing of firm's activities, distinguish between the term "capital structure" and financial structure". (3 marks)

(b) The management of Swara Ltd. is considering replacing an existing machine which was bought 3 years ago at a cost of Sh.20 million. The machine was expected to have a useful life of 5 years with no resale value at the end of this period. A critical evaluation of this asset shows that the existing machine is usable for another five years at the end of which resale value is estimated at Sh.2 million. The current disposal value of the existing machine is estimated at Sh.10 million.

The new machine is not locally available. The management expect to import this machine at a cost of Sh.40 million. Installation cost of this machine is estimated at Sh.500,000.

Import duty payable and freight charges are estimated at Sh.300,00 and Sh.200,000 respectively. This machine is expected to have a useful life of five years, at the end of which resale value is estimated at Sh.5 million.

This investment is expected to lead to increased sales. To support increase in sales, the firm will require an extra investment in working capital at the beginning of the new machine's useful life. Inventory balance is expected to increase by Sh.800,000, debtors balance will increase by Sh.700,000 and creditors balance will increase by Sh.1,000,000.

However, the firm will require an extra investment in working capital at the end of the second year of Sh.250.000. The total investment in working capital will be recovered at the end of the machine's useful life.

The earnings before depreciation and tax to be generated by each asset during each year are given as follows:

| | Earning before depreciation and tax (EBDT) | |
|---|---|---|
| **Year** | **New machine Sh."000"** | **Existing machine Sh."000"** |
| 1 | 70,000 | 50,000 |
| 2 | 75,000 | 55,000 |
| 3 | 85,000 | 60,000 |
| 4 | 80,000 | 55,000 |
| 5 | 70,000 | 65,000 |

**Additional information:**

1. The new machine shall require an overhaul at the end of third year. The overhaul cost is estimated at Sh.2 million. The cost will be amortised separately on a straight line basis.
2. The firm provides for depreciation on all their non-current assets on a straight line basis.
3. The firm pays corporation tax at the rate of 30%.
4. The firm's capital structure which is optimal comprises of 70% equity and 30% debt. The cost of equity is 10% and before tax cost of debt is 8%.

**Required:**

Using the net present value technique, advise on whether the firm should replace the existing machine. (15 marks)

(c) State two limitations of the net present value method. (2 marks)

**(Total: 20 marks)**

## QUESTION THREE

(a) Briefly explain how Islamic finance differs from conventional finance. (6 marks)

(b) Ruiru Tanners Ltd. has a total of Sh.100 million invested in net assets as at the end of December 2014. The firm intends to increase its production capacity during the year 2015 by Sh.100 million. The company utilises debt, preferred stock and equity capital within its capital structure. Several alternative financing arrangements are available, namely;

- The company can issue 9% debentures with a par value of Sh.100 each at an issue price of Sh.90 each (market price). Maximum amount available is Sh.20,000,000. Any extra debt finance will be raised through the issue of 12% debentures at Sh.960 each. The par value of this debenture is Sh.1,000 each.
- The company can issue additional 15% preference shares with a par-value of Sh.50 at Sh.75 each.
- The company can issue new ordinary shares at the current market price of Sh.88 per share. Floatation cost equal to Sh.8 per share sold. The company's ordinary shareholders have consistently enjoyed a dividend whose annual growth rate on average has been 10% and this is expected to continue into the foreseeable future. The company's earning per share this year is Sh.10 and adopts a constant dividend payout ratio of 40% each year.
- The company can generate Sh.10 million from the internal sources to finance this expansion programme.

**Additional information:**

1. The company pays corporation tax at the rate of 30%.
2. The firm's existing capital structure which is considered to be optimal is given below:

| | Sh."000" | Sh. "000" |
|---|---|---|
| Debt capital: | | |
| 6% debenture capital | 10,000 | |
| 8% term loan | 20,000 | 30,000 |
| Preference shares (Sh.50 par value) | | 30,000 |
| Ordinary shares (Sh.5 par value) | 15,000 | |
| Retained earnings | 25,000 | 40,000 |
| | | 100,000 |

**Required:**

(i) The amount of funds to be raised from each source during the year 2015 so as to maintain the firm's existing optimal capital structure. (3 marks)

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

(iii) The levels of financing at which marginal cost of capital changes (Hint: break points in weighted marginal cost of capital curve). (2 marks)

(iv) The firm's weighted marginal cost of capital if it were to raise only Sh.20 million. (3 marks)

(v) The firm's weighted marginal cost of capital for the funds to be raised during the year 2015 for the three levels of financing. (4 marks)

**(Total: 20 marks)**

## QUESTION FOUR

(a) A Ltd. is considering taking over B Ltd. The forecasted annual net operating cash flows to be generated by the target firm are given as follows:

| Year | Net cash flow (NCF) Sh."million" |
|---|---|
| 1 | 5 |
| 2 | 8 |
| 3 – 7 | 10 |
| 8 – 10 | 15 |
| 11 – α | 12 |

The firm's minimum required rate of return is 5% above the risk free rate of return. The risk free rate of return 15%.

**Required:**

The maximum price payable by A Ltd. to acquire B Ltd. (6 marks)

(b) Shafana Ltd. currently operates with terms of net 72 days. The firm's average investment in accounts receivable is Sh.2,400,000 per year. Eighty percent of the firm's sales are always on credit. The company is considering introducing terms of 2/20 net 90 days.



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The firm's total sales per annum will increase by 50%. All cash customers and 40% of credit customers will take advantage of the cash discount.

Average collection period will increase to 80 days. Gross margin on sales is 40% while the cost of capital is 16%.

**Required:**
Advise the company on whether to switch to the new credit policy (Assume a year has 360 days). (6 marks)

(c) The shares of Bidii Ltd. are currently selling at Sh.60 each at the securities exchange. Bidii Ltd.'s price earning ratio is 6 times. The company adopts a constant 40% payout ratio as its dividend policy. It is predicted that the company's dividends will grow at an annual rate of 20% for the first three years, 15% for the next 2 years and thereafter at a constant rate of 10% per annum in perpetuity. The investor's minimum required rate of return is 12%.

**Required:**
(i) Current intrinsic value of the shares of Bidii Ltd. (6 marks)

(ii) Advise a prospective investor whether or not to buy shares of Bidii Ltd. (2 marks)

**(Total: 20 marks)**

**QUESTION FIVE**

(a) The most recent statement of financial position for Upendo Ltd. is presented below:

**Upendo Ltd.**
**Statement of financial position**
**As at 30th November 2014**

| | Sh. "000" | | Sh."000" |
|---|---|---|---|
| Inventory | 2,000 | Trade creditors | 2,200 |
| Debtors | 3,000 | Accrued expenses | 2,200 |
| Cash at bank | 3,800 | Long-term debt | 8,800 |
| Fixed assets (NBV) | 13,200 | Ordinary shares | 2,200 |
| | | Retained profit | 6,600 |
| | 22,000 | | 22,000 |

The company is about to embark on an advertising campaign which is expected to raise sales from their present level of Sh.27.5 million to Sh.38.5 million by the end of the next financial year ended 30 November 2015.

The firm is presently operating at full capacity and therefore will have to increase its investment in both current and fixed assets to support the projected level of sales. It is estimated that both categories of assets will rise in direct proportion to the projected increase in sales.

For the year just ended, the firm's after tax profit margin was 6% but is expected to rise to 7% of projected sales. The firm adopts a stable predictable dividend policy. The ordinary dividend payable for the year ended 30 November 2015 is expected to increase by 10% from the last year's dividend of Sh.1 million.

Upendo Ltd's trade creditors and accrued expenses are expected to vary directly with sales. In addition, long term debt financing will be used to finance next year's operations that are not forthcoming from other sources.

**Required:**
(i) Estimate the amount of additional funds to be raised through long term debt financing. (4 marks)

(ii) Prepare a forecast statement of financial position as at 30 November 2015. (6 marks)

(iii) Using the results obtained in (a) (i) and (ii) above, compute and interpret the following financial ratios for the year ended 30 November 2015:

(a) Return on equity. (2 marks)
(b) Total assets turnover. (2 marks)
(c) Capital gearing ratio. (2 marks)

(b) (i) Define the term financial innovation. (1 mark)

(ii) Highlight any three factors responsible for financial innovation. (3 marks)

**(Total: 20 marks)**

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