



CPA PART II SECTION 3  
CS PART II SECTION 3  
CCP PART II SECTION 3  
FINANCIAL MANAGEMENT

WEDNESDAY: 29 November 2017.

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 factors that might be considered when establishing an effective credit policy in an organisation. (4 marks)
- (b) Summarise four hindrances to international standardisation of Islamic finance. (4 marks)
- (c) Illustrate how the problem of window dressing manifests itself in measuring business performance using financial ratio analysis. (4 marks)
- (d) The management of Gumbo Ltd. intends to change the company's credit policy from 'net 30' to '3/10 net 60'. If this change is effected, annual sales are expected to increase by 25% from the current level of Sh.12 million. The proportion of bad debts is also expected to increase from 10% to 15% of the credit sales.

A new credit assistant officer will also have to be employed at a salary of Sh.500,000 per annum. If there is a change in the firm's credit policy, it is expected that 60% of the credit customers will benefit from the cash discount offer.

The inventory level and variable costs are however expected to remain constant at 20% and 40% of the annual sales respectively. The firm's rate of return on investment is 14% per annum.

The corporate tax rate is 30%.

All sales are on credit.

Assume a 360-day financial year.

**Required:**

Advise the management of Gumbo Ltd. on whether to adopt the new credit policy.

(8 marks)

**(Total: 20 marks)**

**QUESTION TWO**

- (a) Explain four limitations of dividend growth model. (4 marks)
- (b) Maji Mazuri Ltd. an all equity financed company has an issued share capital of Sh.10 million ordinary shares of Sh.10 par value. The company paid a dividend of Sh.0.4 per share last period and the market price per share is Sh.20 ex-dividend.

The company is contemplating raising additional funds through a rights issue. The management has proposed a 1 for 4 rights issue at an issue price of Sh.15 per share. The funds raised are intended to be used to finance a major new project which is expected to increase the company's annual after tax cash flows by Sh.950,000 in perpetuity.

- Required:**
- (i) The cum-right market price per share (MPS) after the announcement of the rights issue. (4 marks)
  - (ii) The theoretical ex-right market price per share. (2 marks)
  - (iii) The theoretical value of each right. (2 marks)
- (c) Evaluate the impact of the rights issue in (b) above on the value of wealth of an existing shareholder who holds 1,600 ordinary shares in Maji Mazuri Ltd. and Sh.10,000 in his savings account assuming that this shareholder decides to:
- (i) Exercise all his rights. (3 marks)
  - (ii) Sell all his rights. (3 marks)
  - (iii) Ignore the rights issue. (2 marks)
- (Total: 20 marks)**

**QUESTION THREE**

- (a) The ordinary shares of Kwekwe Ltd. are currently selling at Sh.60 each at the securities exchange. The company's price-earnings ratio is 6 times.

Kwekwe Ltd. adopts a 40% pay-out ratio as its dividend policy.

It is predicted that the company's earnings and dividends will grow at an annual rate of 10% for the first three years, 5% for the next two years and 4% thereafter in perpetuity.

The investors' minimum required rate of return is 12%.

**Required:**

- (i) The current intrinsic value of the shares. (6 marks)
- (ii) Advise the investors based on the result obtained in (a) (i) above. (2 marks)

- (b) Ray Properties Ltd. is planning to build a business mall. The project will cost Sh.180 million.

The firm's current optimal capital structure is as follows:

|                                   |                 |
|-----------------------------------|-----------------|
|                                   | <b>Sh."000"</b> |
| Ordinary shares (Sh.10 par value) | 480,000         |
| 10% debt (Sh.100 par value)       | 384,000         |
| Retained profit                   | <u>96,000</u>   |
|                                   | <u>960,000</u>  |

**Additional information:**

1. The firm will issue a new 15% debenture at Sh.120 each with a floatation cost of Sh.10 per unit. The par value of each debenture is Sh.100.
2. New ordinary shares will be issued at the current market price of Sh.30 each with a floatation cost of Sh.5 per share.
3. The most recent dividend paid by the company was Sh.5 per share.
4. The dividend is expected to grow at the rate of 5% per annum in perpetuity.
5. The firm expects to retain Sh.18 million to finance this investment.
6. The corporate tax rate is 30%.

**Required:**

- (i) The amount to be raised from equity capital, if the capital structure is to remain unchanged. (3 marks)
  - (ii) The number of ordinary shares the company should issue to raise the desired external equity capital. (3 marks)
  - (iii) The firm's weighted marginal cost of capital (WMCC). (6 marks)
- (Total: 20 marks)**

#### QUESTION FOUR

- (a) Describe four types of money market instruments. (4 marks)
- (b) Highlight three agency costs that might arise in the principal-agent relationship between shareholders and managers. (3 marks)
- (c) Karem Bottling Company is considering replacing one of the bottling machines with a more efficient one.

The old machine has a current net book value of Sh.2,400,000 with a remaining useful life of five years. The old machine has an estimated re-sale value of Sh.200,000 at the end of its useful life.

The existing machine's current disposal value is estimated to be Sh.1,060,000.

The new machine has a purchase price of Sh.4,700,000 and an estimated useful life of 5 years. The machine is expected to have an estimated market value of Sh.600,000 at the end of the five years.

The machine is expected to economise on electric power usage and repair costs which will save the company Sh.920,000 each year. In addition, the new machine is expected to reduce the number of defective bottles which will save an additional amount of Sh.120,000 annually.

The company's corporate tax rate is 30% with a required rate of return of 12%.

The company provides for depreciation on a straight line basis.

Assume capital gains are taxable.

#### Required:

- (i) The initial net cash outlay. (3 marks)
- (ii) The incremental net operating cash flows for years 1 through year 5. (4 marks)
- (iii) The total terminal cash flows. (2 marks)
- (iv) Using net present value (NPV) criteria, advise the management of Karem Bottling Company whether or not to purchase the new machine. (4 marks)

(Total: 20 marks)

#### QUESTION FIVE

- (a) Describe three factors that have limited the growth of venture capital investment in most developing countries. (6 marks)
- (b) Deye Ltd. has provided the following financial results:

| Year | Profit after tax (Sh. "million") |
|------|----------------------------------|
| 2014 | 6.0                              |
| 2015 | 6.2                              |
| 2016 | 6.3                              |
| 2017 | 6.3                              |

The firm's earnings yield is 12%.

#### Required:

The value of the firm based on the present value of the expected earnings approach. (4 marks)

- (c) A prospective investor is intending to buy ordinary shares of a firm listed at the securities exchange whose market price per share is Sh.30.

The forecasted market price per share for the following five months is estimated as follows:

| Month | Forecasted market price per share (Sh.) | Probability |
|-------|---|-------------|
| 1     | 33                                      | 0.2         |
| 2     | 30                                      | 0.1         |
| 3     | 27                                      | 0.3         |
| 4     | 36                                      | 0.15        |
| 5     | 39                                      | 0.25        |

**Required:**

The expected return from the investment.

(4 marks)

- (d) Chitsaka Limited estimates that it requires Sh.12,000,000 for its operations during the following year.

The company will sell marketable securities and deposits into a cost-free no-interest bank account.

The marketable securities currently provide an interest yield of 5% per year.

The cost of selling marketable securities is Sh.60 per transaction regardless of the size of the transaction.

Assume a 365-day financial year.

**Required:**

Using the Baumol cash management model, determine:

- (i) The optimal size of transaction for selling the marketable securities.

(4 marks)

- (ii) The frequency with which the securities should be sold.

(2 marks)

**(Total: 20 marks)**

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