



ATD LEVEL III

PILOT PAPER

FUNDAMENTALS OF FINANCE

December 2021.

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) (i) Distinguish between internal and external sources of finance for a limited liability company. (2 marks)
- (ii) Discuss the advantages of leasing an asset compared to borrowing or purchase of an asset. (4 marks)
- (b) Explain the types of agency costs that arise in agent-principal relationship between shareholders and managers. (4 marks)
- (c) Suggest the merits of using discounted cash flows in evaluating long term investments. (4 marks)
- (d) ABC Ltd. is in the Telecommunications Industry. The company's statement of financial position as at 31 December 2020 is as shown below:

Liability and Owners Equity	Sh.'000'	Assets	Sh.'000'
Current liabilities	12,500	Current assets	32,500
18% debentures (Sh.1,000 par)	16,000	Net fixed assets	42,875
10% preference shares	6,250		
Ordinary shares (Sh.10 par)	12,500		
Retained earnings	<u>28,125</u>		
	<u>75,375</u>		<u>75,375</u>

Additional information

- The debentures are now selling at Sh.950 in the market and will be redeemed 10 years from now.
- By the end of the last financial period, the company had declared and paid Sh.5.00 as dividend per share. The dividends are expected to grow at an annual rate of 10% in the foreseeable future. Currently, the company's shares are trading at Sh.38 per share at the local stock exchange.
- The preference shares were floated in 2015 and their prices have remained constant.
- Most banks are lending money at an interest of 22% per annum.
- The Corporation tax rate is 40% per annum.

Required:

The market weighted cost of capital for this firm.

(6 marks)

(Total: 20 marks)

QUESTION TWO

- (a) Outline four factors that might influence the working capital needs of a firm. (4 marks)
- (b) Highlight the mechanism of resolving the agency problem between shareholders and debenture holders. (5 marks)
- (c) Suggest reasons why the market for venture capital is not well developed your country. (5 marks)

- (d) The following information was from XYZ feasibility studies on the viability of two investment alternatives:

Project I

Initial cost Sh.100,000 and Sh.160,000 at the beginning of year 4 it will generate the following inflows:

Year	Sh.
1 – 3	80,000 per annum
4 – 6	50,000 per annum

Project II

Initial cost Sh.200,000 and Sh.80,000 at the beginning of year 4 and it will generate the following inflows:

Year	Sh.
1 – 2	100,000 per annum
3 – 6	70,000 per annum

Required:

Using the cost of finance of 12%, compute the net present value (NPV) and the profitability index (P.I) of these two projects, and advise the company accordingly.

(6 marks)

(Total: 20 marks)

QUESTION THREE

- (a) Distinguish between business risk and financial risk. (4 marks)
- (b) Discuss the traditional functions of a financial manager in a contemporary corporate set-up. (8 marks)
- (c) Consider the returns of two securities, A and B which depend on the states of nature with the following probabilities:

State	Probability	Returns	
		A	B
Favourable	0.3	12	6
Moderate	0.4	15	7.5
Unfavourable	0.3	10	5

Required:

Advise the investor on which of the two securities to invest in on the basis of risk and expected return. (8 marks)

(Total: 20 marks)

QUESTION FOUR

- (a) Explain the concept of time value of money. (2 marks)
- (b) Joseph intends to invest in a piece of land costing Sh.850,000. He is certain that he will sell the piece of land for Sh.910,000 the same time next year, a sure gain of Sh.60,000. Given that banks are offering a 10% interest, should he invest in this project? (2 marks)
- (c) Discuss the weaknesses associated with profit maximisation as a goal of the firm. (4 marks)
- (d) Suggest practical problems faced by finance managers in capital budgeting decisions. (6 marks)
- (e) Highlight the factors influencing the dividend policy of a firm. (6 marks)

(Total: 20 marks)

QUESTION FIVE

- (a) ABC Limited is considering a project with the following details:

	Sh.
Project X cost	500,000
Scrap value	100,000

The stream of income before depreciation and taxes are as follows:

	Sh.
Year 1	100,000
Year 2	120,000
Year 3	140,000
Year 4	160,000
Year 5	200,000

Use a tax rate of 50% and straight-line depreciation.

Required:

- (i) Calculate the Accounting Rate of Return (ARR) and advice the company. (6 marks)
- (ii) Highlight the advantages of using the ARR technique in evaluating projects (4 marks)
- (b) Outline the key functions of Capital Markets. (5 marks)
- (c) Highlight the key principles of Islamic finance. (5 marks)

(Total: 20 marks)

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