KASNEB

ATD LEVEL II

FUNDAMENTALS OF FINANCE

TUESDAY: 23 May 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) Differentiate between "business risk" and "financial risk". (4 marks)

(b) Discuss three advantages of leasing as a source of finance. (6 marks)

(c) Ufanisi Ltd. is considering raising additional Sh.10 million to finance an expansion programme.

The firm's capital structure which is considered to be optimal is given as follows:

	(%)
Equity capital	60
8% debt capital (Sh.100 par)	30
10% preference share capital (Sh.50 par)	10
	100

The firm expects to raise Sh.2 million from internal sources.

The firm pays a constant ordinary dividend of Sh.2 per share in each year. This is expected to remain so in the foreseeable future.

Additional information:

1. The firm will issue new ordinary shares at a current price of Sh.25 per share and will incur a floatation cost of Sh.5 per share.
2. New 8% irredeemable debentures will be issued at par of Sh.100 each. Floatation cost of 5% of par value will be incurred.
3. New 10% preference shares will be issued at Sh.60 each. Par value of each share is Sh.50. Floatation cost of Sh.2 per share will be incurred.
4. Corporate tax rate applicable is 30%.

Required:

Weighted marginal cost of capital of the firm. (10 marks)

(Total: 20 marks)

QUESTION TWO

(a) Highlight four circumstances under which a company would prefer to use debt financing to other sources of finance. (4 marks)

(b) Describe two factors that influence the credit period extended by a company to its customers. (4 marks)

(c) Kenland Ltd. is considering its capital budget for the year 2018. The following information relates to four mutually exclusive projects:

Project:		**P1**	**P2**	**P3**	**P4**
Amounts:		**Sh. "000"**	**Sh. "000"**	**Sh. "000"**	**Sh. "000"**
Initial cash outflows		(8,000)	(10,000)	(20,000)	(16,000)
Cash inflows:	Year 1	2,000	4,000	8,000	6,000
	Year 2	4,000	6,000	12,000	10,000
	Year 3	6,000	6,000	10,000	8,000

Additional information:
1. The firm has a capital budget ceiling of Sh.20 million and the cost of capital is 10%.
2. The cash flows are assumed to occur at the end of the year.

Required:
Advise the company on the project to undertake using the following investment appraisal techniques:

(i) Net present value (NPV). (6 marks)

(ii) Profitability index (PI). (6 marks)
(Total: 20 marks)

QUESTION THREE

(a) Explain the following principles that govern Islamic finance:

(i) Principle of equity. (2 marks)

(ii) Principle of participation. (2 marks)

(iii) Principle of ownership. (2 marks)

(b) Describe four financial market participants, citing the role played by each of the participants. (8 marks)

(c) A prospective investor is considering buying shares of Company X which are currently selling at the securities exchange for Sh.100.

The forecasted market price of each share at the end of one year's holding period and the corresponding probability of occurrence are given as follows:

Economic condition	**Probability of occurrence**	**Forecasted market price per share after one year (Sh.)**
Poor	0.2	90
Moderate	0.5	110
Good	0.3	120

Required:
(i) The expected rate of return for company X's share. (2 marks)

(ii) The standard deviation of return for company X's share. (4 marks)
(Total: 20 marks)

QUESTION FOUR

(a) Explain three key dates, with reference to dividend payment chronology. (6 marks)

(b) Discuss two limitations of using a firm's overall cost of capital as an investment discount rate. (4 marks)

(c) Stelwat Onyango borrowed Sh.1,500,000 from a bank at the rate of 1.5% per month. The loan is to be repaid monthly over a period of 6 months. Interest on the loan is to be paid on a reducing balance basis.

Required:
Prepare a loan amortisation schedule. (6 marks)

(d) Billy Kamar expects to make equal annual payments into his savings account at the beginning of each year over a period of 5 years. The sum deposited will earn interest at the rate of 10% per annum, compounded annually. He will be targeting to raise a cumulative sum of Sh.2,000,000 to undertake a capital investment.

Required:
Determine the annual instalment payment into Billy Kamar's savings account. (4 marks)
(Total: 20 marks)

QUESTION FIVE

(a) Summarise the following categories of agency problem:

(i) Managers versus owners. (2 marks)

(ii) Creditors versus owners. (2 marks)

(iii) Owners versus other parties. (2 marks)

(b) Describe two benefits of shareholders' wealth maximisation as an objective of a firm. (4 marks)

(c) ABC Ltd. expects to make payments of Sh.4,500,000 in the coming year. The firm's investment in marketable securities generates an annual return of 20%.

The firm incurs a cost of Sh.20 per transaction when buying or selling marketable securities.

The minimum cash balance maintained by this company at all times is Sh.10,000.
(Assume a 360-day year).

Required:
Using Baumol's model of cash management, determine:

(i) ABC Ltd.'s optimal cash balance. (3 marks)

(ii) Total relevant cost incurred in each year. (3 marks)

(iii) The cash conversion cycle (period) in days. (2 marks)

(iv) Average cash balance that will be maintained by ABC Ltd. (2 marks)

(Total: 20 marks)

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