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CPA INTERMEDIATE LEVEL

PILOT PAPER

FINANCIAL MANAGEMENT

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) Summarise five methods of issuing ordinary shares. (5 marks)
- (b) Mountain Mall (MM) Ltd. is considering a project with the following cash flows:

End year	Cash flows (Sh.)
0	-40,000
1	100,000
2	-20,000

Additional information:

- The firm's cost of capital is 15%.
- Corporation tax rate is 30%.

Required:

- (i) Compute the two internal rates of return (IRR) associated with these cash flows. (4 marks)
- (ii) If the firm's cost of capital falls between the two IRR values calculated in b(i) above, advise the firm on whether to accept or reject the project. (3 marks)
- (c) KUDS Ltd.'s current earnings per share (EPS) is Sh.24. The firm adopts a 40% dividend payment ratio as its dividend policy. The firm has in issue 10,000,000 ordinary shares.

The existing capital structure of the firm is given as follows:

	Sh. "000"
Ordinary share capital	1,600,000
Retained profits	600,000
Share premium	200,000
12% debt	<u>800,000</u>
	<u>3,200,000</u>

Additional information:

- The expected rate of return on market portfolio is 15%.
- The risk free rate of return is 10%.
- The firm's equity beta coefficient is 1.4.

Required:

- (i) Using the capital asset pricing model (CAPM), determine the minimum required return on the company's equity shares. (2 marks)
- (ii) Using the dividend growth model, compute the current value of each equity share. (6 marks)

(Total: 20 marks)

QUESTION TWO

- (a) Describe four main principles of Islamic finance. (4 marks)
- (b) Economics Industries Ltd. is an all equity financed company with a cost of capital of 18.75%. The company is evaluating five annual capital investment projects with the following extended returns and risks as measured by the Beta factor.

Project	Initial outlay (Sh.)	Annual cash flows (Sh.)	Beta coefficient
A	300,000	330,000	0.3
B	300,000	340,000	0.5
C	400,000	480,000	1.0
D	500,000	590,000	1.5
E	500,000	600,000	2.0

Additional information:

- The risk free rate of return is 7.7%.
- The market rate of return is 16%.

Required:

- The beta factor of Economic Industries Ltd. (1 mark)
 - Advise the management of Economics Industries Ltd on the project to undertake. (5 marks)
 - Compute the beta factor of the accepted project (s) based on results in b (ii) above. (2 marks)
- (c) Examine three key differences between behavioral finance and traditional finance. (6 marks)
- (d) Explain the meaning of the term “mutual fund”. (2 marks)

(Total: 20 marks)

QUESTION THREE

Office Point Ltd. is considering two alternative proposals for financing a major expansion scheme requiring an investment of Sh.100 million. The first is to raise the required funds through a public issue of ordinary shares at the current market price per share of Sh.2.00.

The other proposal is to raise the finance by way of a term loan at an interest rate of 4% over the base rate of 5% per annum.

The terms and conditions under which the company's existing loan capital has been raised include the following special covenants:

- The company's debt ratio should not exceed 40%.
- A times interest earned ration of not less than 10 times should be maintained.

Office Point Ltd's earnings before interest and tax (EBIT) during the financial year ended 31 December 2020 was Sh.150 million, and the company's latest financial statement reveals the following information:

	Sh. “million”
Total Assets	<u>425</u>
Debt 8% loan stock	75
Common stock (200m ordinary shares)	100
Retained earnings	250
Total liabilities & equity	425

Additional information:

- Investment of the additional capital of Sh.100 million is expected to result in the earnings before interest and tax (EBIT) for 2021 being 30% higher than the figure for 2020.
- Interest at the rate of 8% would continue to be paid on the existing loan capital of Sh.75 million.
- The company would maintain its existing policy of paying a dividend of Sh.0.25 per share.
- Corporation tax rate is 30%.

Required:

- (i) Assess the impact of the two alternative financing proposals on the company's earnings per share (EPS). (5 marks)
 - (ii) Calculate the EBIT - EPS indifference point. (3 marks)
 - (iii) Calculate Office Point Ltd.'s debt ratio and times interest earned ratio for 2020, and assess the impact of each of the two alternative financing proposals on these ratios in the company's financial statement for year 2021. (6 marks)
 - (iv) Discuss six key factors that are considered by businesses when deciding between debt and equity finance. (6 marks)
- (Total: 20 marks)**

QUESTION FOUR

- (a) Jade Smith will deposit Sh.500,000 in his savings account on 31 December 2021. He will deposit an additional Sh.200,000 at the end of each subsequent year in that account, the sum deposited is expected to earn interest at the rate of 8% per annum, compounded annually.

Required:

- (i) Determine the cumulative amount that is expected to be in his account at the end of year 2025. (6 marks)
 - (ii) The rate of return expected to be earned over the projected period. (2 marks)
- (b) Briefly explain three factors that might influence working capital requirements of a firm. (6 marks)
 - (c) Merchant Sport Club uses 100 replacement lamps for its street lights. Each lamp costs the Club Sh.8. Ordering costs are estimated at Sh.27 per order. Holding costs are at 25% of the cost of each lamp. The Club currently orders according to the EOQ basis.

The supplier has now offered the club a 2% discount if the Club will buy 600 lamps at a time.

Required:

- Using suitable calculations, advise the club on whether to accept the discount offer or not. (6 marks)
- (Total: 20 marks)**

QUESTION FIVE

- (a) Utawala Ltd. plans to buy shares of Mcop Ltd. that are currently selling at Sh.20 each at the National Securities Exchange.

The forecasted price per share and probability of their occurrence on different states of nature are as follows:

State of nature	Probability	Forecasted Share Price (Sh.)
Excellent	0.30	25
Normal	0.20	22
Poor	0.35	21
Very poor	0.15	19

Required:

- (i) Expected rate of return of the company's shares. (3 marks)
 - (ii) The standard deviation of returns. (4 marks)
- (b) Explain four conflicts that could arise in the course of achieving a firm's objectives. (8 marks)
 - (c) Enumerate five functions of the Central Bank in your country. (5 marks)
- (Total: 20 marks)**
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