

**INSTITUTE OF BANKERS IN MALAWI**

**ADVANCED DIPLOMA IN BANKING EXAMINATION**

**SUBJECT: CORPORATE FINANCE (IOBM – AD320)**

**Date:**

**Time Allocated: 3 hours**

**INSTRUCTIONS TO CANDIDATES**

1 This paper consists of **TWO** Sections, A and B.

2 Section A consists of 4 questions. Each question carries 15 marks.

Answer **ALL** questions.

3 Section B consists of 4 questions, each question carries 20 marks. Answer **ANY TWO** questions.

4 You will be allowed **10 minutes** to go through the paper before the start of the examination, you may write on this paper but not in the answer book.

5 Begin each answer on a new page.

6 **Please write your examination number on each answer book used. Answer sheets without examination numbers will not be marked.**

7 DO NOT open this question paper until instructed to do so.

## SECTION A (60 MARKS)

## Answer ALL questions from this section

Question 1

Kanzingeni Investments is mainly in the business of manufacturing tricycles to alleviate mobility challenges of underprivileged citizens with physical disabilities. Priorityhe current selling price of a tricycle is K28,000. An investment opportunity has arisen where computer equipment from Japan, complete with software, has to be purchased in order to automate all production processes. The cost of the computer equipment is K155 million.

Exlplain five main factors that should be critically considered during analysis of this investment opportunity. **15 Marks**

**Answer**

**1 Compatibility with Corporate Strategy**

The objective of kanzingeni seems to be mainly social inorder to help people with physical disabilities have access to cheaper tricycles and also provide employment to them. If this project is implemented the pursuit of this objective will be significantly compromised since with technology a lot of people will lose their jobs and the cost of production may rise which will push up the prices of the tricycles.

**2 Availability of resources**

Kanzingeni should consider if enough financial resources are available to raise K155 million for purchasing of computer equipment. Caution should be taken that after purchasing the piece of equipment, other operations within the firm should not suffer from liquidity problems.

**3 Technical feasibility**

There is need to assess on the technical feasibility of the project. Matters to do with computer environment have to be analysed. Issues like technical support, whether to employ a technical team or rely on outsourced support. Whether the current premises would support the automated processes or there is need to move to other premises.

**4 Project definition**

The project has to be clearly defined, objectives spelt out, critical success factors, milestones and all processes communicated to the key people.

**5 Economic feasibility**

Economic feasibility goes beyond financial feasibility as it looks at the wider picture of the project. Issues of opportunity cost and impact on the wider economic environment are considered in more detail. This is in order to take advantage of all opportunities and minimise all economic risks.

**3 Marks each**

Question 2

Matola Enterprises is considering purchasing manufacturing equipment costing K38,000,000. It is expected that the piece of equipment shall add annual revenues as follows:

2016: K3,500,000; 2017: K8,000,000; 2018: K14,000,000; 2019:K16,500,000; 2020: K18,000,000; 2021: K19,500,000. Pp29

(a) What is the payback period of the investment. *Hint: Provide your answer in years and remaining months where necessary.* **5 marks**

(b) Compute the payback period using a discount rate of 12%. **6 Marks**

(c) Mention two reasons why Matola should not base the investment decision solely on the payback period. Pp 32 **2 Marks**

(d) Mention two advantages of using payback for investment appraisal. **2 Marks**

**Answer**

**Year Annual cashflow (MK,000) Cumulative net cashflow**

**2015 (38,000,000) (38,000,000) 3/4**

**2016 3,500,000 (34,500,000) 3/4**

**2017 8,000,000 (26,500,000) 3/4**

**2018 14,000,000 (12,500,000) 3/4**

**2019 16,500,000 4,000,000 3/4**

**2020 18,000,000 22,000,000**

**2021 19,500,000 41,500,000**

**Therefore payback period is (3 + 12,500,000/16,500,00 x 12) years 5/4**

**=3 years 9 months**

**Year Annual cashflow (MK,000) Discounted Cumulative net cashflow**

**2015 (38,000,000) (38,000,000) (38,000,000) 3/4**

**2016 3,500,000 3,125,000 (34,875,000) 3/4**

**2017 8,000,000 6,377,551 (28,497,449) 3/4**

**2018 14,000,000 9,965,122 (18,532,327) 3/4**

**2019 16,500,000 10,486,177 (8,046,150) 3/4**

**2020 18,000,000 10,213,925 2,167,775 3/4**

**2021 19,500,000 9,879,420 12,047,195**

**Therefore the payback period is (4+ 8,046,150/10,213,925 x 12) years 3/2**

**=3 years 9 months**

**It does not consider time value of money 1**

**It ignores total returns of investments such that you may opt for a project that generates lees income to an entity. 1**

**The advantages are:**

**It is simple to calculate and explain 1**

**It provides the initial basis of appraising an investment 1**

QUESTION 3

An investment proposal requires the injection of K40 million and has the following likelihood of providing returns:

Return Likelihood

K2 million 0.15

K5 million 0.25

K8 million 0.30

K13 million 0.20

K18 million 0.10

Required:

(a) Calculate the mean return of the proposed investment. **7 Marks**

(b) Calculate the standard deviation of the investment proposal. **5 Marks**

(c) Explain the meaning of *standard deviation of the expected return.* **3 Marks**

**Answer**

**Mean Return**

**2 \* 0.15= 0.3 1**

**5\* 0.25= 1.25 1**

**8\*0.3 = 2.4 1**

**13\*0.2= 2.6 1**

**18\*0.1= 1.8 1**

= 8.35 million/40 million = 20.88% **2**

=(0.05-0.2088)² \*0.15 =0.00378262 3/4

(0.125-0.2088)²\*0.25 =0.00175561 3/4

(0.2-0.2088)²\*0.3 =0.00002323 3/4

(0.325-0.2088)²\*0.2 =0.00270049 3/4

(0.45-0.2088)²\*0.1 =0.00581774 3/4

0.01407969 1/4

=√0.01407969

=0.375229

**=37.52% 1**

**Standard deviation of expected returns is the volatility of the returns. It means the chance that the real return will differ from the expected return. The high the chance of difference, the more risky the venture is perceived to be. 3 Marks**

QUESTION 4

Chilungamo had the following summarised balance sheet as at 31 December 2014:

K’000

Non current assets: 300,000

Current assets: 78,000

Total assets 378,000

Current Liabilities 130,000

Net Assets **248,000**

Financed by:

Ordinary Share capital 150,000

Retained earnings 28,000

15% Debentures 70,000

**248,000**

The directors of Chilungamo would like to raise more capital for the company

Required:

(a) Explain any two aspects from the balance sheet that show that Chilungamo needs more capital**. 5Marks**

(b) Recommend to the directors any two ways of financing the entity and give three advantages for each method of financing. **10 marks**

**Answer**

**(a) The two aspects are:**

**Current assets are only 78,000/130,000 (60%) of the current liabilities. This means that if the creditors demanded their dues at the same time, Chilungamo cannot afford to pay all of them using current assets. Therefore the entity indeed needs more capital so that there is enough working capital within itself. 2.5 Marks**

**The fact that non current assets are K300 million but shareholders funds are only K178 million which means that creditors are financing a significant proportion of the assets and operations and this is not financially healthy. 2.5 Marks**

**(b) The two ways are**

**IPO 1/2 Mark**

**Advantages**

**Helps in publicity or marketing of the entity through prospectus 3/2**

**More capital is raised through the public since existing shareholders may not have more funds to contribute 3/2**

**Diversification of shareholders enriches the strategic operations of the entity. 3/2**

**Rights Issue 1/2 Mark**

**Advantages**

**It does not dilute shareholding proportions of the entity 3/2**

**It is relatively cheaper than listing 3/2**

**It avoids public scrutiny on performance 3/2**

SECTION B

ANSWER ANY TWO QUESTIONS

QUESTION 5

Stokks Limited is a listed company with the following shareholding for issued shares and fully paid for:

Name of Share holder Number of Shares

Gremu 4,400

Stan 2,000

Public 1,600

The authorised share capital is 10,000 K1,000 ordinary shares. The current market price for Stokks share is K3,500.

The directors of Stokks have resolved to raise more capital for the company through a rights issue involving 1,000 shares at K3,000 per share.

Required:

(a) Define rights issue **2 Marks**

(b) Compute the number of shares that will be allocated to each of the three categories of share holders during the rights issue. **6 Marks** pp 77

Wonga Enterprises has offered to pay Stan K425,000 to buy rights to purchase half of Stans share allocation. Advise Stan on the best option whether to take up all the rights, lapse the rights offer or take up the rights offer and accept Wonga’s offer as well. Pp78 **10 Marks**

Mention any two problems associated with rights issue of shares. **2 Marks**

**Answer**

**Rights issue is the issuing of more shares to existing shareholders proportionate to number of shares held ordinarily at a price lower than the prevailing market price. 2**

**Gremu: 4,400/8,000\*1000= 550 2**

**Stan: 2,000/8,000\*1000= 250 2**

**Public 1,600/8000\*1000= 200 2**

**Taking up rights issue:**

**Value of shares: ( 2,000+250)\*3500= 7,875,000 2**

**Less cost of buying: 750,000 1**

**7,125,000**

**Lapse of rights issue**

**Value of shares: (2,000 \*3,500)= 7,000,000 2**

**Offering to Wonga**

**Value of Shares (2,000+125)\*3500= 7,437,500 2**

**Less purchase shares (750,000) 1**

**Add sell price to Wonga 425,000 1**

**7,112,500**

**This shows that Stan will be better off taking up the rights issue and not accept the offer from Wonga. 1**

**The problems are:**

**Current shareholders may not be interested or have capacity to take up the offer. 1**

**The entity is denied the opportunity to introduce new shareholders that may have improved ideas. 1**

QUESTION 6

(a) Explain any four differences between finance lease and operating lease. Pp 82 **8 Marks**

**Answer**

**(a) The differences are:**

**In a finance lease the lease extends for the entire useful life of the asset**

**The lessee is more involved with the maintenance of the asset in the finance lease arrangement than in the operating lease.**

**A finance lease is very difficult to cancel while the conditions for cancelling an operating lease are simple**

**Ownership usually transfers to the lesee after the finance lease period unlike in an operating lease.**

**2 Marks each**

8(b) Explain any four dividend policy models that are available for adoption by management and directors of entities**. 12 marks** pp 91

**Answer**

**(b) The dividend policies available are:**

* **Residual theory which propagates that dividends should be paid from money available after all investment opportunities have been utilised.**
* **Stable dividend policy implies that dividends should be consistent in order for shareholders that depend on dividend income to have a smooth regular cash flow over years.**
* **Constant Payout ratio: Under this policy, a constant proportion of annual earnings is paid out as dividends hence actual amount of dividend paid out varies as the earnings change.**
* **Payment in kind either through scrip dividend or share repurchase**

**3 Marks each**

QUESTION 7

Wakawaka Investment has the following summarised financial statements:

Statement of Comprehensive Income for the year ended 31 December 2014

Turnover 1,400,000

Operating expenses 860,000

Profit before interest and tax 540,000

Interest 7,000

Profit before tax 533,000

Tax 160,000

Profit after tax 373,000

Dividend 186,000

Retained earnings 187,000

Statement of Financial Position as at 31 December 2014

Non current assets 2,300,000

Net working capital 800,000

**3,100,000**

Ordinary Share Capital (10,000 fully paid) 2,400,000

10% Debentures 700,000

**3,100,000**

The current share price is K135 and the tax rate is 30%

Required

Calculate the following:

(a) Dividend per share. **2 Marks**

(b) Return on equity. **4 Marks**

(c) Gearing ratio. **4 Marks**

(d) Cost of equity capital. **4 Marks**

(e) Weighted cost of capital. **6 Marks**

**Answer**

**(a) Total dividend paid- 186,000**

**Number of shares: 10,000**

**Dividend per share= 186,000/10,000**

**= K18.60 per share**

**(b) Return on equity: Net Profit after Tax / Equity Share capital 1**

**=373,000/2,400,000 2**

**=15.54% 1**

**(c) Gearing Ratio: long term liabilities/ Total capital 1**

**=700,000/3,100,000 2**

**=22.58% 1**

**(d) Cost of equity capital**

**Ke=D0/p 1**

**Dividend per share =186,000/10,000 2**

**=18.60 1**

**18.60/135 1**

**=13.78% 1**

**(e) Weighted cost of capital:**

**Values of financing:**

**Equity: 10,000 X 135= 1,350,000 1**

**Debenture= 700,000 1/2**

**Total 2,050,000**

**Proportions: Equity= 1,350,000/2,050,000 =0.66 3/4**

**Debt= 700,000/2,050,000 =0.34 3/4**

**0.66(13.78%)+0.34(10%)\*1-0.3 2**

**=9.09+2.38 1**

**=11.47%**

QUESTION 8

(a) Palmore Inc are negotiating to merge with State Espresso. Both companies are manufacturers of cigarettes. You are the Finance Director of Palmore Inc. Write a report to the Shareholders of Palmore Inc highlighting any four tax benefits that might arise from the merger. **14 Marks**

**Answer**

**TO: Shareholders, Palmore Inc**

**From: Finance Director**

**Date: xxxxxx**

**Subject: Tax Benefits from Merger with Espresso**

**Candidates should include the following as main content of the report:**

**1 One of the companies may have a tax charges on income while the other may have tax credits due to losses which may never be utilised. The merger shall ensure that the tax charges are reduced and the tax losses are utilised due to the net off effect in the single entity.**

**2 Unused debt capacity can be utilised through the merger and this brings more tax savings since the interest on the borrowing is a tax deductible expense.**

**3 The merger will require revaluation of assets in which assets shall have adjusted bases that will be subject to capital allowances which have the effect of reducing tax liability.**

**4 Combination of fixed assets brings in the benefit of avoiding taxes like import duty or VAT hence acts like a major saving in taxes.**

**4 Marks each and 2 for format**

10(b) Mention any three sources of resistance to mergers and reasons behind the resistance. **6 Marks**

**Answer**

**The three sources are**

**(1) Tax authorities may provide resistance if in their opinion, the merger is to be done solely for tax benefits that may not have been there ordinarily. 2 Marks**

**2 Employees of the companies may resist since they fear job losses and may demand retirement benefits since they shall be employed by a new firm altogether thereafter. 2 Marks**

**3 Fair trade organisations may resist mergers if the merger will negatively affect competition in the market. 3 Marks**

**END OF EXAMINATION PAPER**