



**CERTIFIED PUBLIC ACCOUNTANT ADVANCED
LEVEL 2 EXAMINATIONS**

A2.1: STRATEGIC CORPORATE FINANCE

DATE: WEDNESDAY, 27 JULY 2022

MARKING GUIDE AND MODEL ANSWERS

SECTION A

QUESTION ONE

Marking Guide

Sub question	Requirement	Marks
a	Specifying correctly all leasing costs (0.5 marks for each year), maximum 2	2
	Computed annual PVs on leasing (0.5 marks for each, maximum 2	2
	Total PV on leasing	1
	Residual value on Asset	0.5
	Maintenance costs (0.5 marks for each), maximum of 2Marks)	2
	Computed annual PVs on Asset purchase (0.5 marks for each), maximum of 2.5 marks	2.5
	Total PV on Asset purchase	1
	Recommendation	1
	Maximum	12
b	Calculation of sources of funding 0.5 marks each source, maximum 2 Marks	2
	Analysis of potential post acquisition problems (1 mark for each well explained point, maximum 5 Marks)	5
	Presentation and format of the report	1
	Maximum	8
c	Annual revenue - Real terms (0.5 marks for each), maximum of 2	2
	Annual costs - Real terms (0.5 marks for each), maximum of 1 mark	1
	Annual revenue - Nominal terms (0.5 marks for each), maximum of 2.5 marks	2.5
	Annual costs - Nominal terms (0.5 marks for each), maximum of 2.5 marks	2.5
	Annual profit figures (0.5 marks for each), maximum of 1 mark	1
	Annual tax paid - 30% (0.5 marks for each), maximum of 1 mark	1
	Annual tax saved (0.5 marks for each), maximum of 1 mark	1
	Computed annual PVs (0.5 marks for each), maximum of 3 mark	3
	NPV figure	0.5
	Recommendation/conclusion	0.5
	Maximum	15
d	Award 1 mark to each well explained point, maximum 5 marks	5
e	Award 1 mark to each well explained point, maximum 4 marks	4
f	Explanation formula, assumptions or limitation of CPAM (1 mark each, maximum 2 marks)	2
	Problems associated with acquisitions (0.5 marks each, maximum 2 marks)	2
	Explanations, advantages or disadvantages of FDI (0.5 marks, maximum 2 marks)	2
	Maximum	6
	Total Marks	50

Model Answers

a)

Leasing - FRW '000					
Year	0	1	2	3	4
Leasing costs-FRW 000'	(105,000)	(108,150)	(111,395)	(114,736)	
Discount factor - 18%	1.000	0.847	0.718	0.609	0.516
PV-FRW 000'	(105,000)	(91,603)	(79,982)	(69,874)	0
Total PV - Cost of leasing-FRW 000'	(346,459)				

Borrowing - FRW '000					
Year	0	1	2	3	4
Purchase cost-FRW 000'	(350,000)				
Residual value-FRW 000'					42,000
Maintenance costs-FRW 000'	(13,000)	(13,520)	(14,061)	(14,623)	
Total costs-FRW 000'	(363,000)	(13,520)	(14,061)	(14,623)	42,000
Discount factor - 18%	1.000	0.847	0.718	0.609	0.516
PV-FRW 000'	(363,000)	(11,451)	(10,096)	(8,906)	21,672
Total PV - Cost of borrowing-FRW 000'	(371,781)				

Mr. Tuyizere should recommend R Ltd to lease the equipment as opposed to the acquisition since the leasing option is FRW 25 million less costly.

b)

Report

To: Buy-out team

From: Tuyizere & Sons Ltd

Date: X-X-20XX

Subject: MBO Financing Scheme Overview

The financing scheme involves the purchase of assets with a net book value of FRW 3,500 million for an agreed price of FRW 4,500 million. The finance that will be raised will provide funds of 5 million from the following sources of funding:

Source of Funds	Amount: FRW'000
Equity	500,000
Preference shares	2,400,000
Bank loan	1,400,000
Overdraft	700,000
Total	5,000,000

Of the funds raised only FRW 500 million will be available to the business after the purchase price has been paid. This will be in the form of unused overdraft facilities.

Gearing

As is common to MBOs the gearing level will be very high. There is only FRW 500 million of equity compared to FRW 4,000 million of debt finance (including the preference shares and excluding the unused element of the overdraft amounting to FRW 500 million). The gearing level will mean that the returns to equity will be risky, but the buyout team own 45% of a 4,500 million company for an investment of only FRW 200 million. The rewards are potentially very high.

The only issue with the high level of gearing is that after the acquisition, it would be very hard to raise additional operational/working capital through loans. As all assets are almost secured to the loan, this implicates that the level of interest and loan repayments would probably restrict other borrowings.

Cash commitments

The annual cash commitments from the financing structure are summarized below:

1. Loan repayments

Annual payments will have to be made in the repayment of capital and interest on the FRW 1,400 million bank loan. The annual amount will be:

FRW 1,400 million / 3.605* = FRW 388 million

* The cumulative discount factor for 5 years at 12% interest rate

2. Redeemable preference shares

The redeemable preference shares will be either cumulative or non-cumulative. Assuming that they are cumulative FRW 2,400 million will, on average, have to be paid every year. There is a little flexibility in that if the dividend cannot be met it can be postponed (but not avoided).

The redeemable preference shares will have to be repaid after 10 years. This can either be provided for over the 10 years, or an alternative source of finance found to replace the funds. Assuming that they will be required to be provided for according to the terms of the financing package this will require a commitment of 240 million p.a. which will be also a burden to the company.

3. Overdraft

The element of the overdraft used to finance the purchase price is effectively a source of long-term finance. The rate of interest is not known but if we make the (unrealistic) assumption that it is also at 12%, then the FRW 700 million drawn down will cost FRW 84 million pa. In total there will be a commitment to pay approximately FRW 712 million p.a.

This will be the first priority of the new company. The management team will need to generate sufficient funds from the only available source, operations, in order to meet this commitment.

4. Other cash requirements

There will be other cash commitments requirements such as:

- Funds to invest in working capital and fixed assets as required
- Enhancing management team to ensure the 12% growth in revenue is kept
- Other investments that may be necessary
- Potential dividends payment

Institutional involvement

The company has 55% shares allocated to other institutions, as this equity stake is the majority of shares, this side may provide other sources of financing although they may also participate and influence in appointing directors, management.

Conclusion

The financing scheme will place a heavy cash burden on the company, particularly in the early years. The involvement of the institutions will perhaps prove unwelcome, but the MBO would be impossible without accepting it.

c)

Year	0	1	2	3	4	5
	FRW 000'	FRW 000'	FRW 000'	FRW 000'	FRW 000'	FRW 000'
Initial investment	(2,000,000)					
Revenue - Real terms		600,000	670,000	716,900	767,083	820,779
Costs - Real terms	(336,000)	(381,900)	(381,900)	(381,900)	(381,900)	
Revenue - Nominal terms		630,000	738,675	829,901	932,394	1,047,545
Costs - Nominal terms	(336,000)	(404,814)	(429,103)	(454,849)	(482,140)	
Profit	(336,000)	225,186	309,572	375,052	450,254	1,047,545
Tax paid - 30%		(67,556)	(92,872)	(112,516)	(135,076)	(314,263)
Tax saved		120,000	120,000	120,000	120,000	120,000
Net cash flows	(2,336,000)	277,630	336,701	382,537	435,178	853,281
Discount rate - 11%	1.000	0.901	0.812	0.731	0.659	0.593
Present values	(2,336,000)	250,145	273,401	279,634	286,782	505,996
NPV	(740,042)					

Note: The FRW 20 million paid as the advisory fees should not be considered as it is a sunk cost

Conclusion: The project's NPV is negative and therefore the project is not financially viable and should not be undertaken.

Workings:

W1 - FRW'000

Tax allowable depreciation = 2,000,000 x 20% = 400,000

Tax saved at 30% = 400,000 x 30% = 120,000

W2 - FRW'000

Revenue - Real terms		600,000	670,000	670,000*1.07 = 716,900	716*1.07 = 767,083	767,083*1.07 = 820,779
Costs - Real terms	600,000*56%=(336,000)	670,000*57%=(381,900)	(381,900)	(381,900)	(381,900)	

W3 - FRW'000

Revenue - Nominal terms		630,000 = 600,000*1.05	738,675 = 670,000*1.05 ²	829,901 = 716,900*1.05 ³	932,394 = 767,083*1.05 ⁴	1,047,545 = 820,779*1.05 ⁵
Costs - Nominal terms	(336,000)	(404,814) = (336,000)*1.06	(429,103) = (381,900)*1.06 ²	(454,849) = (381,900)*1.06 ³	(482,140) = (381,900)*1.06 ⁴	

d) Tuyizere & Sons' report should not be used as the only basis for the African investment decision, for the following reasons.

- i. The decision should be taken after evaluating the risk/return trade-off; financial factors (e.g. the expected NPV from the investments); strategic factors; and other issues including political risk. Political risk is only one part of the decision process (although in extremely risky countries it might be the most important one).
- ii. Just because previous clients have not invested in countries with scores of less than 30, does not necessarily mean that Umurava Investment Ltd should not. The previous countries may not have been comparable with these in Africa. This decision rule also ignores return. If return is expected to be very high, a relatively low score might be acceptable to Umurava Investment Ltd.
- iii. The factors considered by the consultant might not be the only relevant factors when assessing political risk. Others could include the extent of capital flight from the country, the legal infrastructure, availability of local finance and the existence of special taxes and regulations for multinational companies.
- iv. The weightings of the factors might not be relevant to Umurava Investment Ltd
- v. Scores such as these only focus on the macro risk of the country. The micro risk, the risk for the actual company investing in a country, is the vital factor. This differs between companies and between industries. A relatively hardware company might be less susceptible to political actions than, for example, companies in extractive industries where the diminishing bargain concept may apply.
- vi. There is no evidence of how the scores have been devised and how valid they are.

- e) Prior to investing Umurava Investment Ltd might negotiate an agreement with the local government covering areas of possible contention such as
 - i. Dividend remittance,
 - ii. Transfer pricing, taxation,
 - iii. The use of local labour
 - iv. Capital structure related laws
 - v. Exchange rate controls.

The problem with such negotiations is that governments might change, and a new government might not honor the agreement.

The logistics of the investment may also influence political risk:

- a) If a key element of the process is left outside the country it may not be viable for the government to take actions against a company as it could not produce a complete product.
- b) Financing locally might deter political action, as effectively the action will hurt the local providers of finance.
- c) Local sourcing of components and raw materials might reduce risk.
- d) It is sometimes argued that participating in joint ventures with a local partner reduces political risk, although evidence of this is not conclusive.
- e) Control of patents and processes by the multinational might reduce risk, although patents are not recognised in all countries.

Governments or commercial agencies in multinationals' home countries often offer insurance against political risk.

f)

Memo

From: Tuyizere & Sons (Consultants)
To: Board, Ntamunozza Ltd
Date: X-X-20XX
Subject: Brief notes on Corporate Finance concepts

1. Capital Asset Pricing Model (CAPM)

Capital Asset Pricing Model assess investments from the viewpoint of well diversified shareholders and consider that when companies invest in projects, they must accept that the majority of their shareholders are well diversified institution.

It provides the return that would be required by a well diversified, risk averse investor. The formula can be expressed in the following way:

$$E(r_i) = R_f + \beta_j(E(r_m) - R_f)$$

Where:

- R_f:** The risk-free rate of interest
- R_m:** The average market return
- β:** Index which compares the systematic risk of investment and systematic risk of portfolio

Limitations of CAPM

- It is based on some unrealistic assumptions such as Existence of Risk-free assets; All assets being perfectly divisible and marketable (human capital is not divisible); Existence of homogeneous expectations about the expected returns; Asset returns are normally distributed.
- CAPM is a single period model—it looks at the end of the year return.
- CAPM cannot be empirically tested because we cannot test investors' expectations.
- CAPM assumes that a security's required rate of return is based on only one factor (the stock market - beta). However, other factors such as relative sensitivity to inflation and dividend payout, may influence a security's return relative to those of other securities.

Assumptions of CAPM

- Investors are rational and they choose among alternative portfolios on the basis of each portfolio's expected return and standard deviation.
- Investors are risk averse.
- Investors maximise the utility of end of period wealth. Thus, CAPM is a single period model.
- Investors have homogeneous expectations with regard to asset return. Thus, all investors will perceive the same efficient set.
- There exist a risk-free asset and all investors can borrow and lend at this rate.
- All assets are marketable and perfectly divisible.
- The capital market is efficient and perfect.

2. Problems associated with acquisitions

- Acquisitions are usually expensive and complex
- Strong resistance by Directors/senior employees of the target company
- Potential loss of customers of the target company as a result of the hostile acquisition
- Compatibility problems around products, services, operations, etc. which could create management overload
- Legal complexities – acquisitions are highly regulated

3. Foreign Direct Investment (FDI)

FDI involves the investment in the form of a controlling ownership in a business/company in one country by an entity based in another country.

Advantages of FDI:

- Eliminates or reduces shipping costs and import duties.
- Shorter lead-time in getting goods to market.
- May be advantages to the business environment in the foreign country (fewer regulations, lower taxes, cheaper raw materials).
- Eliminates the commission/cut taken by an agent or wholesaler.

Disadvantages of FDI:

- Expensive set-up costs – therefore high risk.
- Involves book-keeping as well as dealing in foreign currencies.
- Lack of knowledge of regulations, culture and local ethics etc. which are local to the foreign country.

SECTION B

QUESTION TWO

Marking guide

Sub question	Requirement	Marks
a	Computed cost of equity	1
	Computed cost of preference shares	1
	Post tax cost of loan	1
	Computed market value of equity	1
	Computed market value of preference shares	1
	Computed total market value	1
	Computed WACC	1
	Maximum	7
b	1 mark for each well explained source of finance, maximum, 4 marks	4
	c	2 marks for each well explained method, maximum 6 marks
d	2 marks for each well explained method, maximum 8 marks	8
	Total maximum	25

Model answers

a)

$$\text{Cost of equity} = \frac{Do(1 + g)}{Po} + g = \frac{375(1.05)}{1500} + 0.05 = 31.25\%$$

$$\text{Cost of pref. shares} = \frac{6}{80} = 7.5\%$$

Post tax cost of loan = 13% x 0.7 = 9.1%

Market values FRW'000

Equity	135,000,000 ((45Bn/500)*1500)
Preference shares	531,200 ((664M/100)*80)
Long term loan	9,680,000
Total	145,211,200

$$\text{WACC} = \frac{Ve}{Ve + Vp + Vd} Ke + \frac{Vp}{Ve + Vp + Vd} Kp + \frac{Vd}{Ve + Vp + Vd} Kd(1 - T)$$

$$WACC = \frac{135,000,000,000 \times 31.25\%}{145,211,200,000} + \frac{531,200,000 \times 7.5\%}{145,211,200,000} + \frac{9,680,000,000 \times 9.1\%}{145,211,200,000} = 29.68\% = \sim 30\%$$

WACC = 30%

b) Source of finance

Sources of short-term finance:

1. Overdrafts

Overdrafts arise when payments from a current account exceed income to the current account – the deficit is financed by an overdraft. They can be arranged relatively quickly and offer a degree of flexibility. Interest is only charged when the current account is overdrawn.

2. Short-term loans

This is a loan of a fixed amount for a specified period of time. The capital is received immediately and is repaid either at a specified time or in instalments. Interest rates and capital repayment structure are often predetermined.

3. Trade credit

This is one of the main sources of short-term finance for businesses, as they can take advantage of credit periods granted by suppliers. It is particularly useful during periods of high inflation.

4. Leasing

Leasing is a popular source of finance and is a useful alternative to purchasing an asset. The two main types of leases are operational lease and finance lease. The difference between the two types of leases lies with the extent of responsibility the lessee has for the leased asset (maintenance etc).

Sources of long-term finance:

1. Debt

The choice of debt finance depends on the size of the business (a public issue of bonds is only available to large companies); the duration of the loan; whether a fixed or floating interest rate is preferred and the security that can be offered

2. Bonds

Bonds are long-term debt capital raised by a company for which interest is paid, usually half-yearly and at a fixed rate. Bonds can be redeemable or irredeemable and come in various forms, including floating rate, zero coupon and convertible.

Bonds have a nominal value (the debt owed by the company) and interest is paid at a stated ‘coupon’ on this amount. The coupon rate is quoted before tax (ie gross).

3. Equity

Equity finance is raised through the sale of ordinary shares to investors via a new issue or a rights issue. Holders of equity shares bear the ultimate risk as they are at the bottom of the creditor hierarchy in the event of liquidation. As a result of this high risk, equity shareholders expect the highest return of long-term finance providers. The cost of equity is always higher than the cost of debt.

c)

1. Cash dividends: This is the most common way of paying dividends by corporations. These dividends are paid in cash, usually quarterly. Companies can declare both regular and 'extra' dividends. Regular dividends usually remain unchanged in the future, but 'extraordinary' or 'special' dividends are unlikely to be repeated.

2. Dividends in the form of shares are paid instead of cash dividends by allocating to existing shareholders shares of equivalent value. Shareholders receive new shares in the corporation as a form of a dividend. Like a 'share split', the number of shares increases, but no cash changes hands

3. Share repurchases is an alternative to distribute cash to its shareholders. The firm buys back its own shares. This can be done **on the open market, by tender offer or by buying stock from major shareholders.**

d)

• **Pegging/attaching managerial compensation to performance**

This will involve restructuring the remuneration scheme of the firm in order to enhance the alignments/harmonization of the interest of the shareholders with those of the management e.g. managers may be given commissions, bonus etc. for superior performance of the firm.

• **Threat of firing**

This is where there is a possibility of firing the entire management team by the shareholders due to poor performance. Management of companies have been fired by the shareholders who have the right to hire and fire the top executive officers.

• **The Threat of Hostile Takeover**

If the shares of the firm are undervalued due to poor performance and mismanagement, shareholders can threaten to sell their shares to competitors. In this case the management team is fired and those who stay on can lose their control and influence in the new firm. This threat is adequate to give incentive to management to avoid conflict of interest.

• Managers should have voluntary code of practice, which would guide them in the performance of their duties.

• **Direct Intervention by the Shareholders**

Shareholders may intervene to insist on a more independent board of directors; by sponsoring a proposal to be voted at the AGM and by making recommendations to the management on how the firm should be run.

QUESTION THREE

Marking Guide

Sub question	Requirement	Marks
a	Computation of any of the following (Increase in Revenue, increase in total current assets, increase in receivables, Increase in Inventory, Increase in Bank overdraft, Increase in total current liabilities, etc. – 0.5 marks for each correct computation – Maximum of 5 marks	5
	Computation of any of the following (Inventory days, Receivables' days, Payables' days, Net profit margin, Current ratio, Quick ratio, etc – 0.5 marks for each correct computation – Maximum of 8 marks	8
	Detailed explanation of symptoms of overtrading using computed ratios – 1 mark for each well explained symptoms, maximum of 4 marks	4
	Conclusion	2
	Maximum Marks	19
b	Expansionary fiscal policy (1 Mark for each explained impact), maximum of 3 marks	3
	Expansionary monetary policy (1 Mark for each explained impact), maximum of 3 marks	3
	Maximum Marks	6
	Total	25

Model answers

a)

COMPUTATIONS	31-Dec-20	31-Dec-19	Formula
Increase in Revenue	40%		n/a
Increase in total current assets	101%		n/a
Increase in receivables	85%		n/a
Increase in Inventory	127%		n/a
Inventory days	83	58	Inventory/Cost of sales*365
Receivables' days	77	59	Receivables/Revenue*365
Payables' days	96	86	Trade payables/Cost of sales*365
Net profit margin	15%	21%	Net profit/Revenue*100%
Increase in Bank overdraft	500%		n/a
Increase in total current liabilities	131%		n/a
Current ratio	1.3	1.5	Current assets/current liabilities
Quick ratio	0.7	0.9	(Current Assets- Inventory)/current liabilities

Symptoms of Overtrading:

- **Turnover increases rapidly**

IC Ltd's revenues increased by 40% in 2020 from 2019. The rapid increase in revenue is a major sign of overtrading.

- **The volume of current assets increases faster than sales**

The company's total current assets doubled with a 101% increase in 2020 from FRW3.3Bn in 2019 to FRW6.8Bn in 2020 while sales only increased by 40%.

The increase in receivables was 85% in 2020 while the inventory has more than double at 127% in the same year.

- **Increase in stock days**

IC Ltd.'s inventory days increased to 83 days in 2020 from 58 days in 2019. This means that the inventory turnover has significantly reduced which can affect the company cash flows.

- **Increase in debtor days**

IC Ltd.'s debtor days/receivables days increased to 77 days in 2020 from 59 days in 2019. The recovery process is slow, and this has a direct impact on the company cash receipts.

- **Reduced profitability**

IC Ltd.'s has recorded reduced profitability in 2020 where the profit margin reduced to 15% from 21% in the previous year of 2019.

- **Increase in short term financing**

The company short term financing has significantly increased by 500% in 2020 due to new bank overdrafts.

- **Increase in current liabilities**

The company's total current liabilities have also doubled in 2020 with 131% increase from Frw2.2Bn in 2019 to Frw5.2Bn in 2020. The company is finding it difficult to pay its payables – the payables days have increased from 86 days in 2019 to 96 days in 2020.

- **The current and quick ratios declined**

The company's liquidity position is deteriorating with the current ratio decrease from 1.5 times in 2019 to 1.3 times in 2020.

The quick ratio also declined from 0.9 times in 2019 from 0.7 times in 2020. The company is relying on short term finance such as bank overdrafts to finance short term activities.

Conclusion

Based on the above symptoms, we can conclude that IC Ltd is overtrading.

b)

Expansionary fiscal policy

A fiscal policy influences the Government taxation and spending.

- The company may pay lower taxes due to the introduction of lower taxes by the Government
- The company may benefit from available higher government subsidies
- The company may be impacted by higher interest rates and higher inflation which are both effects of introduced expansionary fiscal policy when the economy is booming

Expansionary monetary policy:

A monetary policy influences the supply of money, the availability of Credit and interest rates.

- The company may pay lower interest rates on loans which is an effect of the introduced expansionary monetary policy to encourage borrowing and investment, and to discourage saving.
- The company may benefit from increased availability of credit loans which is an effect of the introduced expansionary monetary policy by Government to encourage spending and the stimulation of demand in an economy
- The company may benefit from higher demand from customers

QUESTION FOUR

Marking Guide

Sub question	Requirement	Marks
a	Forward market hedge, computed receipt from forward contract	1
	Money market hedge, computed 4 Months USD borrowing rate	0.5
	Money market hedge, computed 4 Months FRW deposit rate	0.5
	Computed USD to be borrowed Now	1
	Computed amount to be converted into FRW Now	1
	Computed amount to invest Now	1
	Computed difference	1
	Conclusion	1
	Maximum Marks	7
b	Difference between systematic and unsystematic risks well explained	2
c	Business risk well explained	2
	Non business risk well explained	2
	Maximum Marks	4
d	Transaction risks well explained	2
	Translation risks well explained	2
	Economic risks well explained	2
	Maximum Marks	6
e	Credit risks well explained	2
	Liquidity risks well explained	2
	Cash management risks well explained	2
	Maximum Marks	6
	Total maximum	25

Model answers

a)

Available information	
Expected receipt	\$ 650,000
Forward rate	0.0011
Spot rate	0.0010

Forward market hedge	
Receipt from forward contract	FRW 590,909,091 (650,000/0.0011)

Money market hedge	
4 Months USD borrowing rate	5.3% (16%*4/12)
4 Months FRW deposit rate	4.0% (12%*4/12)
USD to be borrowed Now	USD 617,284 (650,000/1.053)
Convert into FRW Now	FRW 617,283,951 (617,284/0.001)

Invest Now	FRW 641,975,308.64 (617,283,951 x 1.04)
Difference	FRW 51,066,218 (641,975,308.64-590,909,091)

The receipt from the money market hedge is higher and so should be used

b) Difference between systematic and unsystematic risks:

- **Market or systematic risk** is risk that cannot be diversified away.
- **Non-systematic or unsystematic risk** applies to a single investment or class of investments and can be reduced or eliminated by diversification.

c) Difference between business and non-business risks:

- **Business risks** are threats to the net profits of an organisation and are borne by both debt and equity holders. The level of business risk depends on the decisions an organisation makes in relation to its products or services.
- **Non-business risks** are threats to profits that are not influenced by the products or services the organisation supplies.

d) Three foreign currency risks which could affect K Ltd

- **Transaction Risk** - This risk exists because of the time lag between the initiation of the transaction and the actual payment/receipt of the foreign currency, allowing, potentially, the occurrence of adverse exchange rate movements in the course of normal international trading transactions.
- **Translation Risk** - The risk of profits and losses arising from the conversion of foreign currency assets and liabilities from one Balance Sheet date to the next. Translation losses can result, for example, from restating the book value of a foreign subsidiary's assets at the exchange rate on the statement of financial position date.

- **Economic Risk** - This exists where there is the possibility that the value of the company will change due to unexpected changes in exchange rates. Unexpected currency fluctuations can affect both the future cash flows and their riskiness. Both are likely to result in a change in the value of the company.

e) Three financial risks which could affect K Ltd

- **Credit risk** – the possibility of payment default by the customer.
- **Liquidity risk** – the risk of being unable to finance the credit, arising from cash restrictions or the need for more cash.
- **Cash management risk** – risks relating to the security of cash, risks arising from unpredictable cash flows.

END OF MARKING GUIDE AND MODEL ANSWER