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INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA

*Driving Sustainable Performance*

Associate of IFAC

# CERTIFIED PUBLIC ACCOUNTANT

# INTERMEDIATE LEVEL EXAMINATIONS

# I1.1: MANAGERIAL FINANCE

# MONDAY: 9 JUNE 2014

## INSTRUCTIONS:

1. **Time Allowed : 3 hours 15 minutes** (15 minutes reading and 3 hours writing).
2. This examination has two sections; A & B.
3. Section A has **three** Compulsory Questions while B has **three** questions **two** to be attempted.
4. In summary attempt five questions.
5. Marks allocated to each question are shown at the end of the question.
6. Show all your workings

## SECTION A

*Attempt All questions in this section*

## QUESTION ONE

Omega Ltd, a transport company, is considering how to finance the acquisition of new buses which will cost Frw 750,000 with an operating life of five years. Omega Ltd has two financing options:

**Option one**

The buses could be leased for an annual lease payment of Frw 155,000 per year, payable at the start of each year.

**Option two**

The buses could be bought for Frw 750,000 using a bank loan charging interest at a rate of 7% per year. At the end of five years the buses would have a scrap value of Frw 75,000. If the buses are bought a maintenance cost of Frw 20,000 per year would be incurred.

**Required**

(a) Discuss whether Omega Ltd should use leasing or borrowing as a source of financing, explaining the evaluation method you have used. **(8 Marks)**

(b) Discuss the advantages of leasing as source of both short term and long term finance. **(8 Marks)**

(c) Discuss briefly the reasons why interest rates may differ between loans of different maturity. **(4 Marks)**

(d) Explain ways in which the directors of Omega Ltd can be encouraged to achieve the objective of shareholders' ***"wealth maximization***". **(5 Marks)**

**(Total 25 Marks)**

## QUESTION TWO

a) Outline any five factors that could influence the capital structure of a company **(5 Marks)**

b) Ngago Ltd is reviewing investment proposals that have been submitted by divisional managers. The investment funds of the company are limited to Frw 800,000 in the current year. Details of three possible investments, none of which can be delayed, are given below.

**Project 1**

An investment of Frw 300,000 in work station assessments. Each assessment would be on an individual employee basis and would lead to savings in labour costs from increased efficiency and from reduced absenteeism due to work-related illness. Savings in labour costs from these assessments in money terms are expected to be as follows:

| Year | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| Cash flows (Frw 000) | 85 | 90 | 95 | 100 | 95 |

**Project 2**

An investment of Frw 450,000 in individual workstations for staff that is expected to reduce administration costs by Frw 140,800 per annum in money terms for the next five years.

**Project 3**

An investment of Frw 400,000 in new ticket machines. Net cash savings of Frw 120,000 per annum are expected in current price terms and these are expected to increase by 3.6% per annum due to inflation during the five-year life of the machines.

Ngago Ltd has a cost of capital of 12% and taxation should be ignored.

**Required :**

Determine the best way for Ngago Ltd to invest the available funds and calculate the resultant NPV :

i) On the assumption that **each of the three projects is divisible**; **(5 Marks)**

ii) On the assumption that **none of the projects are divisible.** **(5 Marks)**

Discuss the meaning of the term **"relevant cash flows"** in the context of investment appraisal, giving examples to illustrate your discussion. **(5 Marks)**

**(Total 20 Marks)**

## QUESTION THREE

The government of Rwanda established the stock exchange market "Rwanda Stock Exchange" with a head office in Kigali.

**Required :**

(a) Identify and explain the role of stock exchange market in economic development **(4 Marks)**

(b) List five factors to consider in choosing sources of finance. **(5 Marks)**

(c) Identify and explain three sources of equity finance available for business financing. **(6 Marks)**

**(Total 15 Marks)**

## SECTION B

***Attempt two questions from this section***

## QUESTION FOUR

Kigali Security Ltd is a manufacturer and wholesaler of locks and household security fittings. Over the last twelve months the company has encountered increasing problems with late payment by debtors.

The last twelve months credit sales of Frw 67.5 million show an increase of 10% over the previous year, but the company's overdraft, on which it is charged 12% p.a. has also increased (by Frw 1.8 million) over the last year. The company is concerned and intends to reduce its working capital requirements by reducing the debtor collection period.

Kigali Security Ltd's management accountant has extracted an aged debtor's profile which is shown below:

| % of Total debtor payments (by value) | Average Collection Period (days) |
|---|---|
| 5 | 30 |
| 28 | 45 |
| 10 | 60 |
| 30 | 75 |
| 16 | 90 |
| 11 | 120 |

Bad debts currently stand at Frw 2 million per annum.

Kigali Security Ltd is considering the introduction of early settlement discounts. The current invoicing terms require payment to be made within 30 days of the date of issue of the invoice. The management accountant has suggested that a 1% discount be offered to all customers who comply with these payment terms, and he estimates that 50% of total payments (by value) would be on these terms (an average settlement period of 30 days for these payments can be assumed). The discount scheme would be expected to be taken up by customers who already pay in 75 days or less.

As an alternative way of reducing the debtors figure, Kigali Security Ltd could use a recourse debt collection service, which has quoted a price of 1% of sales receipts. It is estimated that using the service will have the effect of reducing debtor days by 20 and eliminating 50% of bad debts.

**Required:**

(a) Calculate the change in working capital requirements and bad debts which would result from:

(i) The introduction of the early settlement discounts **(3 Marks)**

(ii) The use of the debt collection service and **(6 Marks)**

(iii) Recommend which policy should be adopted by Kigali Security Ltd. Your answer should clearly show all workings. **(6 Marks)**

(b) There are a number of methods that can be adopted to assess the credit-worthiness of a potential credit customer. Describe and comment upon two such methods that Kigali Security Ltd could adopt to help reduce the current level of bad debts. **(5 Marks)**

**(Total 20 Marks)**

## QUESTION FIVE

(a) Explain and illustrate (using simple numerical examples) the Accounting Rate of Return and Payback approaches to investment appraisal, paying particular attention to the limitations of each approach. **(10 Marks)**

(b) Explain the differences between NPV and IRR as methods of Discounted Cash Flow analysis. **(10 Marks)**

**(Total 20 Marks)**

## QUESTION SIX

(a) ***"Managers and owners of businesses may not have the same objectives."*** Explain this statement, illustrating your answer with examples of possible conflicts of interest. **(7 Marks)**

(b) In what respects can it be argued that companies need to exercise corporate social responsibility? **(7 Marks)**

(c) Explain the meaning of the term **"Value for Money"** in relation to the management of publicly owned services/utilities. **(6 Marks)**

**(Total 20 Marks)**

**End of question paper**