CERTIFIED PUBLIC ACCOUNTANT

INTERMEDIATE LEVEL EXAMINATIONS

I1.1: MANAGERIAL FINANCE

DATE: THURSDAY, 02 DECEMBER 2021

MODEL ANSWER AND MARKING GUIDE

SECTION A

SECTION A

MARKING GUIDE

QUESTION ONE: Kigali Gaz Limited	*Marks*
a) (i) Calculation of Net present values	
Net present value for project D	
Initial investment	0.5
Total present value	1
Net present value	0.5
Maximum marks	**2**
Net present value for project E	
Total Initial investment	0.5
Total present value of cash inflows	1
Net present value	0.5
Maximum marks	**2**
Net present value for project F	
Total Present value of cash outflows	0.5
Total present value of cash inflows	0.5
Net present value	1
Maximum marks	**2**
Net present value for project G	
Total present value of cash outflows	0.5
Total present value of cash inflows	0.5
Net present value	1
Maximum marks	**2**
Net present value for project H	
Cash outlay	0.5
Cash inflow	0.5
Net present value	1
Maximum marks	**2**
Net present value for project I	
Total cash outflow	0.5
Total present value of cash inflows	0.5
Net present value	1
Maximum marks	**2**

Decision (1 mark each, max 2)	**2**
(ii) Calculation	
Net Present Value at 20% or any other rate	2
Internal Rate of Return (1 mark for formula, 1 for calculation)	2
Maximum marks	**4**

b) Reasons for stock listing Kigali Gaz Limited

Reasons (1 mark each, max 4)	4
Maximum marks	**4**

c) Advantages of leasing

Advantages (1 mark each, max 3)	3
Maximum marks	**3**
Total marks	**25**

Detailed Answer

a)

i) Net present Value of Project D

Years	Cash Flow	Discount factor 12%	Present Value (FRW)
0	(30,000,000)	1.000	(30,000,000)
1	8,000,000	0.893	7,144,000
2	10,000,000	0.797	7,970,000
3	12,000,000	0.712	8,544,000
4	6,000,000	0.636	3,816,000
5	13,000,000	0.567	7,371,000
Total Present Values			**34,845,000**
Net Present Value			**4,845,000**

ii) Net present Value of Project E

Year	Equipment (FRW)	Working capital (FRW)	Cash Profit (FRW)	Net cash Flow (FRW)	Discount factor 12%	Present value (FRW)
0	(45,000,000)	(21,000,000)	-	(66,000,000)	1.000	(66,000,000)
1	-	-	20,000,000	20,000,000	0.893	17,860,000
2			26,000,000	26,000,000	0.797	20,722,000
3	5,000,000	21,000,000	12,000,000	38,000,000	0.712	27,056,000
	Total Present Value of cash in flow					**65,638,000**
	Net Present Value					**(362,000)**

iii) Net present Value of Project F

Year	Equipment FRW	Working capital FRW	Cash Profit FRW	Net cash Flow FRW	Discount factor 12%	Present value FRW
0	(51,000,000)	(16,000,000)	-	(67,000,000)	1.000	(67,000,000)
1	-	(6,000,000)		(6,000,000)	0.893	(5,358,000)
1-5			18,000,000	18,000,000	3.605	64,890,000
5		22,000,000		22,000,000	0.567	12,474,000
Total Present Value of cash outflows						**-72,358,000**
Total Present Value of cash inflows						**77,364,000**
Net Present Value						**5,006,000**

iv) Net present Value of Project G

Years	Cash Flow	Discount factor 12%	Present Value
0	(19,000,000)	1.000	(19,000,000)
1	(23,000,000)	0.893	(20,539,000)
2	16,000,000	0.797	12,752,000
3	14,000,000	0.712	9,968,000
4 - 8	6,000,000	2.566	15,396,000
Total Present cash outflows			**(39,539,000)-**
Total present cash inflows			**38,116,000**
Net Present Value			**(1,423,000)**

Working on Discounting factor 4-8

Discount factor at 12%, year 1 to 8 4.968

Less : Discount factor at 12%, year 1 to 3 2.402
Discount factor at 12%, year 4 to 8 2.566

v) Net present Value of Project H

The cumulative discount factor for perpetuity at 15% is 1/0.15=6.667

Years	Cash Flow	Discount factor 15%	Present Value
0	(35,000,000)	1.000	(35,000,000)
1 - ∞	4,800,000	6.667	32,001,600
Net Present Value			**(2,998,400)**

vi) Net present Value of Project I

Present value (at 15%) of FRW 3,000,000 * 1/0.15 (perpetuity)	20,000,000
Less: Present value of 3,000,000 from year 1 to 10 (5.019)	15,057,000
Present value of 3,000,000 year from 11 in perpetuity	4,943,000
Discounting factor at 15% year 1 to 10	5.019
Less: Discounting factor at 15% year 1 to 5	3.352
Discounting factor at 15% year 6 to 10	1.667

Net present Value of Project I

Years	Cash Flow	Discount factor 12%	Present Value
0	(25,000,000)	1.000	(25,000,000)
1 - 5	6,000,000	3.352	20,112,000
6 - 10	5,000,000	1.667	8,335,000
11 - ∞	3,000,000	See above	4,943,000
Total Present Value			**33,390,000**
Net Present Value			**8,390,000**

Projects D, F, and I have positive net present value and should be undertaken.

Projects E, G and H have negative net present value and should not be undertaken

II) Calculate the Internal rate of Return (IRR) of project D

The internal rate of return for project G is above where NPV is FRW 4,845,000 therefore we will calculate the NPV at 20%

Years	Cash Flow	Discount factor 20%	Present Value
0	(30,000,000)	1.000	(30,000,000)
1	8,000,000	0.833	6,664,000
2	10,000,000	0.694	6,940,000
3	12,000,000	0.579	6,948,000
4	6,000,000	0.482	2,892,000
5	13,000,000	0.402	5,226,000
Net Present Value			**(1,330,000)**

Formula:
IRR= LDR+[(NPVA/NPVa -NPVb)*(b-a)]%

IRR=12%+[4,845,000/4,845,000--1, 330,000)*(20-12)]% =18.27%

b) Reasons why Kigali Gaz Limited management should consider a stock listing for the following reasons.

i) **To allow access to a wider pool of finance:** companies that bear growing faster may need to raise a larger sum of funds that is possible privately. Obtaining a listing widens the potential number of equity investors and may also result in improved credit rating, thus reducing the cost of addition debt finance.

ii) **To improve the marketability of shares:** shares that are traded on the stock market can be bought and sold in relatively small quantity at any time. This means that it is easier for existing investors to realise a part of their holding.

iii) **To allow capital to be transferred to other venture:** funder owner may wish to liquidate the major part of their holding either for personal reasons or for investment in other new business opportunities.

iv) **To improve company image:** quoted companies are commonly believed to be more financially stable, and this may improve the image of the company with its customers and suppliers, allowing it to gain additional business to improve its buying power.

v) **Growth by acquisition is easier:** listed companies are in better position to make a paper offer for a target company than an unlisted one.

c) The advantages of leasing decision

(i) The lessee may not have enough cash to pay for the asset, and would have difficulty in obtaining a bank loan to buy it. If so the lessee has to rent the asset to obtain use of it at all.

(ii) Leasing may be cheaper than a bank loan if the lessor obtains bulk purchase discounts

(iii) If equipment is leased for a shorter period than its expected useful life, in the case of technological equipment, if the equipment becomes out of date before the end of its expected life, the lessee does not have to keep using on it.

(iv) Off-balance-sheet financing: Finally, operating leases provide off-the-books (or balance sheet) financing. In other words, the company's obligation to pay the lease, which is a liability, doesn't reflect on the balance sheet.

QUESTION TWO

MARKING GUIDE **Marks**

Marking Pride Partners Limited

a) Calculations of specific cost of capital

Cost of equity (1 mark for formula, 1 mark for computation)	2
Cost of debt (1 mark for formula, 1 mark for computation)	2
Cost of preferred stock (1 mark for formula, 1 mark for computation, maximum 2)	2
Maximum marks	**6**

b) Computation of weighted average cost of capital (WACC)

Weighted cost (0.5 marks for each source of capital, 1.5 max)	1.5
Weighted Average Cost of Capital (WACC) (0.5 marks for formula, 1 mark for computation, maximum 1.5)	1.5
Maximum marks	**3**

c) Dangers of high level gearing

Business risk (1 mark for meaning and 1 mark per each valid danger maximum 3)	3
Financial risk (1 mark for meaning and 1 mark per each valid danger maximum 3)	3
Maximum marks	**6**

d) Reasons required for independent valuation

Reasons (1 mark each, max 5)	**5**
Total marks	**20**

Detailed Answer

a) Cost of equity

$$K_e = \frac{do(1+g)}{po} + g$$

Where

Ke= Cost of equity
D_o=Dividend in year
P_o= Current share market price
g=growth rate

$$Ke = \frac{2.0(1+\frac{10}{100})}{80} + 0.1 = 12.75\%$$

The after-tax cost 12% debt

$$\text{Kdt} = \frac{\text{I}(1-\text{T})}{\text{mvd}} * 100$$

Where:

K_{dt} =After tax cost of debt
I= Interest
T= Tax
Mvd=Market price of debenture

$$\text{Kdt} = \frac{\frac{12}{100} * 100)(1-0.3)}{90} * 100 = 9.33\%$$

Cost of 10% preferred stock

$$\mathbf{K_p} = \frac{\text{Dp}}{\text{mvp}} * 100$$

Where

K_p= cost of preference stock
D_p = Dividend of preference stock
Mvp = market price of preference share

$$\mathbf{K_p} = \frac{\frac{10}{100} * 20}{30} * 100 = 6.7\%$$

b) Weighted average cost of capital (WACC)

Source	**Market value**	**Amount**	**Market value weight**	**Cost of each item**	**Weighted cost%**
Ordinary share capital	(40,000/100)*80	32,000	0.38	12.75	4.85
Reserve	-	-	-	-	-
12% debenture capital	(25,000/100)*90	22,500	0.27	9.33	2.52
10% preference share capital	(20,000/20)*30	30,000	0.35	6.7	2.35
		84,500	**1**		**9.72**

$$WACC = \frac{Ve}{Ve+Vd+VP} Ke + \frac{VP}{Ve+Vd+VP} \text{ D0/P0} \frac{Vd}{Ve+Vd+VP} Kd(1-T)$$

The Weighted Average Cost of Capital (WACC) = 9.72%

C)

(i) Business risk: the inherent risk of doing a business for a company, refer to the risk of making only low profits, or even losses, due to the nature of the business that the company is involved in. One way of measuring business risk is by calculating company's operating gearing or operational gearing.

$$\text{Operating gearing} = \frac{\text{Contribution}}{\text{Profit before interest and tax (PBIT)}}$$

The contribution of gearing is as follows:

1. **If contribution is high but PBIT is low:** fixed cost will be high and only just covered by the contribution. Business risk as measured by operating gearing will be high
2. **If contribution is not much bigger than PBIT,** fixed cost will be low and fair easily covered. Business risk as measured by operating gearing will be low

(ii) Financial risk: a high level of debt creates financial risk**.** This is the risk of a company not being able to meet other obligations as a result of the need to make interest payments. The proportion of debt finance carried by a company is therefore as significance as the level of business risk. Financial risk can be seen from different points of view

1. **The company as whole.** If the company build up debts that it cannot pay when they fall due, it will be forced to liquidate
2. **Payables** if a company cannot pay its debts, the company will go into liquidation owing payable money that they are unlikely to recover in full

   Ordinary shareholders. A company will not make any distributable profit unless it is able to earn enough PBIT to pay all interest charges and then tax. The lower the profits or the higher the interest- bearing debts, the less they will be, if therefore there is anything at all, for shareholders.

d) Five valid reason when the independent valuation for unquoted company

(i) When the company wishes to go public and must fix an issue of price for its share
(ii) When there is a scheme of merger with another company
(iii) When shares are sold
(iv) When shares need to be valued for the purpose of taxation
(v) When shares are pledged as collateral for loan and the bank need to determine the value to the collateral
(vi) When another company is proposing to take over the unquoted company by making an offer to buy all its shares

QUESTION THREE: KAMAZI Ltd and BWIZA Ltd

Marking Guide		**Marks**
a)	**Calculations**	
(i)	Cost of equity of geared company (1 mark for formula and 1 mark for calculation, max 2)	2
(ii)	The Market Return (1 mark for formula and 2 marks for calculation, max 3)	3
(iii)	The beta value of geared company (1 mark for formula and 2 marks for calculation, max 3)	3
	Maximum marks	**8**
b)	**NYAKABANDA Ltd**	
(i)	Calculations of Risk adjusted cost of equity (2 marks for beta and 1 mark for cost of equity, max 3)	**3**
(ii)	Attractions for a company to convertible debts/bonds Reasons for attractions (1 mark each, max 4)	**4**
	Total marks	**15**

Detailed Answer

(i) Since the market value of both companies is in equilibrium, the cost of Geared company can be calculated as follow:

$$\text{Cost of equity of geared company} = \frac{\text{d}}{\text{MV}} * 100$$

Where:

D: is a profit after tax = Dividend

MV: Market value of equity for geared company

Therefore, the cost of equity of Geared company $= \frac{2,856,000}{23,400,000} * 100 = 12.2\%$

(ii) The beta of ungeared company is 1.0 which means that the expected return from ungeared is exactly the same as the market returns.

$$\text{Market Return (Rm)} = \frac{\text{P}}{\text{MV}} * 100$$

Where:

P: is a profit after tax

MV: Market value of equity for ungeared company

$R_m = \frac{4,200,000}{39,600,000} * 100 = 10.6\%$

(iii) The beta value of Geared Company

$\beta e = \beta a * \frac{Ve + Vd(1-T)}{Ve}$

$\beta e = 1.0 * \frac{23,400,000 + (25,080,000 * 0.70)}{23,400,000} = 1.75$

βe :Beta equity

βa: Beta Asset

Ve :Value of Equity

Vd : Value of Debt

B)

(i) If $\frac{Vd}{Vd+Ve} = 0.25$

Then, VE = 0.75

So, $\frac{Vd}{Vd+Ve} = \frac{0.75}{1} = 0.75$

Ungearing the equity beta of the new business area gives βa = 0.75*2 =1.5

As NYAKABANDA Ltd is an all -equity financed company, the asset beta of 1.5 does not need regearing.

Therefore,

CAPM= Rf + β(E(rm) – Rf)

Where:

Rf : Risk free rate

β: Equity beta

E(rm): Equity risk premium

The project -specific cost of equity Ke = 5 + (1.5*4) = 11%

(ii) Convertible bonds are attractive for companies due to the following reasons:

i) **Lower rate of interest:** Investors are normally willing to accept the lower coupon rate of interest on convertible bonds, because of additional value offered by the conversion rights. This help to ease the burden on cash flow

ii) **The possibility of not redeeming the date at maturity:** Companies issue convertible bond with expectation that they will be converted. If bonds are converted, this frees the company from cash repayment at redemption**.** The cash advantage **is** further augmented by greater flexibility that equity shares allow in terms of returns

iii) **Availability of finance:** issuing convertible bonds allow greater access to finance, as lender who would otherwise not provide ordinary loan finance may be attracted by the conversion right.

iv) **Impact on gearing:** on conversion, the company's gearing will be reduced not only because of the removal of debt but also because equity replaces the debt. This can send positive signal about company's financial operation

v) **Delayed equity:** The fact that convertible bonds allow issue of shares at predetermined point in the future permits the company to plan the impact on its earnings per share upon conversion.

SECTION B

QUESTION FOUR: PRIME LTD

Marking Guide		**Marks**
a)	**Calculations**	
(i)	Amount required	1
	Profit for 2017	1
	Profit for 2018	1
	Total amount available	1
	Maximum marks	**4**
(ii)	Bonus Issue	
	Bonus shares for 2017	1
	Bonus shares for 2018	1
	Total bonus issue (Amount)	1
	Decision	1
	Maximum marks	**4**
(iii)	Course of action that management of Prime Ltd should take	
	Course of action (1 mark each, max 4)	**4**
b)	**(i) Differences between management accounting and financial accounting**	
	Differences (1 mark each comparison, max 4)	**4**
	(ii) Superiority of wealth maximization over profit maximization	
	Comparison (1 mark each, max 4)	**4**
Total marks		**20**

Detailed Answer

a) i) Is it feasible to maintain a dividend at FRW 3 per share for the next two financial years?

The amount required to pay DPS of FRW 3 for the next 2 years

= FRW 3*2Years*6Million shares = FRW 36,000,000

Prime Ltd can pay dividends from profit either from the current period or retained profit from previous periods.

Profits available for distribution as dividend are for the 2 years.

Earnings Per Share = Profit after tax (Earnings)/Number of shares

	FRW 000”
Retained profit from previous period	10,000

Profit for 2017 (FRW 2*6M Shares)	12,000
Profit for 2018 (FRW 2.20*6M Shares)	13,200
Total amount available	**35,200**

It is therefore not possible to maintain a dividend of FRW 3 per share because the amount required to pay the dividends is FRW 36 Million and the total amount available for distribution is 35.2 Million.

ii) Should company replace the cash dividend with a bonus issue for one share for every four-ordinary share?

First determine the number of bonus shares to be issued

	Bonus shares
Year 2017 ¼ x 6,000,000	1,500,000
Year 2018 ¼ x (6,000,000+1,500,000)	1,875,000
Total bonus issue	**3,375,000**
Total bonus issue in amount (3,375,000*10)	**33,750,000**

Decision

Total amount available for distribution =FRW 35,200,000

It is therefore possible to replace cash dividends with bonus issue as the total amount available for distribution is more than the amount of money to be spent on bonus issue

iii) The course of action that management of Prime Ltd should take in the light of declining projection in dividend payments

i) The management should look on new market areas in order to increase sales volume that may lead to the increase in the profit of the firm
ii) Diversification of the operation of the firms that will minimize business risk because the company will be holding portfolio
iii) The management should change the company's dividend policy from the ratio of 50%to a lower dividend pay-out ratio.
iv) Disposal of non-profitable assets
v) Cost cutting measures eg. retrenchment of unproductive employees

(b) Presents the key differences between management accounting and financial accounting;

Financial Account	**Management Account**
Limited companies must, by law prepare financial accounts	There is no legal requirement to prepare management accounts
Most of financial accounting information is of a monetary nature	Management accounts incorporate non-monetary measures
Financial accounting focuses on history; reports on the prior quarter or year	Managerial accounting focuses on the present and forecasts for the future
Financial accounts are to disclose the end results of the business, and the financial condition of the business on a particular date	Managerial accounts are to help management by providing information that is used to plan, set goals and evaluate these goals.
Financial accounts are reported in a specific format, so that different organizations can be easily compared.	Format is informal and is on a per department/company basis as needed.
Rules in financial accounting are prescribed by standards such as GAAP or IFRS. There are legal requirements for companies to follow financial accounting standards.	Managerial accounting reports are only used internally within the organization; so they are not subject to the legal requirements that financial accounts are.

b) Profit maximization refers to a process in which a firm analyses its market so that they can determine the best prices and output levels that they can set, which will maximize its returns.

Wealth maximization refers to the ability of a firm to increase the market value of its shares in order to make the shareholders as rich as possible

Profit Maximization	**Wealth maximization**
Profit Maximization is based on the increase on increase in sales and accounting profit	Wealth maximization is based on the cash flow into the organisation
It emphases on short term goals	Its emphases on long-term goals
It ignores time value of money	It considers time value of money
It led to exploitation of employees and consumers	It serves the interest of suppliers, employees, Management and society
The objectives of profit maximization, hence	The objectives are to produce quality at the

the quality may not be maintained	lowest price
The profit maximization ignores risk and uncertainty	The wealth maximization considers risk and uncertainty

In summary, the wealth maximization as an objective to financial management and other business decisions enables the shareholders to achieve their objectives and therefore is superior to profit maximization. For financial managers, it is a decision criterion being used for all the decisions

QUESTION FIVE: BETTER FUTURE GROUP LTD

Marking Guide	**Marks**
a) Loan amortization schedule Computation	4
(Principal, interest, beginning and closing balance, 1 mark each)	
Maximum marks	**4**
b) BFG Ltd	
(i) Amount of money in investment account	
Amount (1 mark each year, max 5)	**5**
(ii) Percentage of interest earned	
Percentage of interest earned	1
Maximum marks	**1**
c) Report to the BFG Ltd shareholders	
Identification and definition of each method	4
(1 mark each, 2 max)+Presentation of Report 2 marks	
Bank loan	3
(Advantage, disadvantage and risk, 1 mark each)	
Overdraft (Advantage, disadvantage and risk, 1 mark each)	3
Maximum marks	**10**
Total marks	**20**

Detailed Answer

a) Loan amortization schedule

$PVIFA_{r,t} = \frac{1-(1+r)-n}{r}$ n= 12 months, r = 1.25%

$PVIFA = \frac{1-(1+r)^{(-n)}}{r}$ $PVIFA = \frac{1-(1+0.0125)^{(-12)}}{0.0125} = 11.07931196$

80,000,000 =A*11.07931196

$A = \frac{80{,}000{,}000}{11.0793}$ = 7,220,665

Month	Beginning	Installment	Interest (1.25%)	Principal	Ending balance
1	80,000,000	7,220,665	1,000,000	6,220,665	73,779,335
2	73,779,335	7,220,665	922,242	6,298,423	67,480,912
3	67,480,912	7,220,665	843,511	6,377,154	61,103,758
4	61,103,758	7,220,665	763,797	6,456,868	54,646,890
5	54,646,890	7,220,665	683,086	6,537,579	48,109,311
6	48,109,311	7,220,665	601,366	6,619,299	41,490,013
7	41,490,013	7,220,665	518,625	6,702,040	34,787,973
8	34,787,973	7,220,665	434,850	6,785,815	28,002,157
9	28,002,157	7,220,665	350,027	6,870,638	21,131,519
10	21,131,519	7,220,665	264,144	6,956,521	14,174,998
11	14,174,998	7,220,665	177,187	7,043,478	7,131,521
12	7,131,521	7,220,665	89,144	7,131,521	0

b)

i) The amount of money in the investment account by the end of 2020

Let the amount at the end of 1st, 2nd and subsequent year be Year 1, Year 2, Year 3 Respectively

Compounded interest =15%

Year 1 (2016); Amount in the investment account = 1,000,000x1.15 = FRW 1,150,000

Year 2 (2017); Amount in the investment account = (1,150,000+500,000) x1.15) = FRW 1,897,500

Year 3 (2018); Amount in the investment account = (1,897,500+500,000) x1.15) = FRW 2,757,125

Year 4 (2019); Amount in the investment account = (2,757,125+500,000) x1.15) = FRW 3,745,694

Year 5 (2020); Amount in the investment account = (3,745,694+500,000) x1.15) = FRW 4,882,547

ii) Total investment = FRW 1,000,000+(500,000x4)
= FRW 3,000,000
The total amount after 5 years = **FRW 4,882,547.8**
Percentage interest (%) = $\frac{4{,}882{,}547.8-3{,}000{,}000}{3{,}000{,}000}$ x100

$$\text{Percentage interest (\%)} = \frac{1{,}882{,}547.8}{3{,}000{,}000} \text{ x}100$$

$$= \mathbf{62.75\%}$$

c)

To: Shareholders in BFG Ltd

From: Management Accountant/Financial Analyst

Date: 1/20/2022

Subject: Various methods of financing current assets

The manufactures of quality household products will need to make an additional significant permanent investment in current assets (in the form of additional inventory and account receivables). There will also be an additional temporary element which fluctuates with the level of sales. This will increase the amount of money needed by the company finance to finance the assets. There are a number of different sources of finance that could be considered

Bank loan

A bank loan is an extension of credit by a bank to a customer or business; it has to be paid along with interest. A bank loan would normally be for a **fixed amount of money** for a fixed term and at a fixed rate of interest. The **size of the loan** and quality of security available will be the key in determining whether the bank is willing to make a further advance to cover the investment in current assets.

Advantage of Bank loan

(i) It can be easily secured.
(ii) It can be used for short-term as well as medium-term financing.
(iii) Interest paid on a bank loan is a tax-deductible expenditure.

The disadvantages of bank loans are:

(i) Some bank loans carry prepayment penalty.
(ii) Borrowing too much as a bank loan can lead to decreased cash flow.
(iii) In most cases, the bank does not disburse the whole amount of loan applied for, it pays cash lower than the loan demanded.

Risks of Bank Loans

(i) Extra Financial Strain. A bank loan adds extra debt.
(ii) Lower Credit Score. If you end up in a situation where you begin to miss payments, it will negatively affect your credit score.
(iii) Personal Property Loss. If you secure your loan with an asset, you run the risk of losing that asset if the loan goes bad.

Overdraft

Bank overdraft is the overdraft facility provided by the banks under which customers or business can withdraw money more than their account balance. An overdraft is a form of lending that is **repayable on demand**. The bank grants the customer a facility up to a certain limit, and the customer or business can take advantage of this necessary. Overdrafts are essentially short -term finance but are renewable and may become a near -permanent source.

Advantages of an overdraft

(i) An overdraft is flexible - you only borrow what you need at the time which may make it cheaper than a loan.
(ii) It's quick to arrange.
(iii) There is not normally a charge for paying off the overdraft earlier than expected.

Disadvantages of an overdraft

(i) If business has overdraft, there is a need to pay an arrangement fee.
(ii) Bank could charge you if you exceed your overdraft limit without authorization.
(iii) The bank has the right to ask for repayment of your overdraft amount at any time, although this is unlikely to happen unless you get into financial difficulties.
(iv) Overdrafts may be secured against business assets.

Risks of Bank Loans

- The amount of money you can access through your overdraft tends to be lower than with a personal loan.
- Fees and interest charged on overdrafts can be high even more so if you go over your agreed limit making it an expensive way to borrow

QUESTION SIX Working Capital Management

Marking Guide	**Marks**
a) Conflict among the objectives of working capital management	
Discussion of the conflict (2marks for liquidity, 2 marks for profitability)	4
Maximum marks	**4**
b) Factors that determine the level of investment in working capital	
Factors (2 marks each, 6 max)	6
Maximum marks	**6**
c) (i) Two types of factoring	
Types (2 mark each, max 4)	**4**
(ii) Benefits of factoring	
Benefit (1 mark each, max 3)	**3**
Disadvantages of factoring	
Disadvantages (1 mark each, max 3)	**3**
Total marks	**20**

Detailed Answer

a) The conflict that might arise among the objectives of working capital management

The objectives of working capital management are profitability and liquidity. Profitability support shareholders wealth maximization objectives. Liquidity ensures that firms are able to meet their liabilities as they fall due

However, funds held in cash do not earn return; while near liquid assets such as short-term investment earn only a small return. Meeting the objectives of liquidity will therefore conflict with the objectives of profitability, which is met by investing over the longer term in order to achieve higher returns

Good working capital management, therefore, needs to achieve a balance between profitability and liquidity if shareholders wealth is to be maximized.

b) Discuss THREE factors which determine the level of company's investment in working capital

A company's working capital investment is equal to sum of its inventories and its account receivables less its account payables.

Nature of the industry and the length of working capital cycle

Some business has long production process which inevitably leads to long working capital cycles and large investments in working capital. House building for example, requires the building company to acquire land, gain government permission to build, build houses and when complete, sell them to customers. This process can often take more than a year require larger investment in work-in-progress and therefore in working capital

Working capital investment policy Some companies take a conservative approach to working capital investment, offering long period of credit to customers (to promote sales), carrying high level of inventory (to protect against stock-outs), and paying suppliers promptly (to maintain good relationships) this approach offers many benefits, but it necessitates a large investment in working capital

Efficiency of management and terms of trade

If management of the components of working capital is neglected, then the investment in working capital can increase. For example, a failure to apply credit control procedures such as warning letters or stop list can result in high level account receivable. Failure to control inventory by using EOQ model, or JIT inventory management principles, can lead to high level of inventory.

c) (i) Two types of factoring of sales invoicing

1.Recourse factoring: this is a type of factoring where the factor provides all kinds of facilities except debt protection. This means that the client is responsible for any bad debts arising from insolvency of the client's customers

2.Non- recourse factoring: this is also known as full servicing factoring. It is the most comprehensive type of factoring arrangement offering all kinds of services, namely: finance, sales ledger administration, collection, debt protection and advisory services. The most important characteristic of this type of factoring service is that it gives protection against bad debts to the client. In other words. In case the client fails to pay the debts, the factor will absorb the losses arising from insolvency or bankruptcy of the client's customers

(iv) Benefit of factoring

The benefits of factoring for a business customer include the following

1) The business can pay its suppliers promptly, and so can take advantage of any early payment discount that is available.
2) **Optimum inventory** levels can be maintained, because the business will have enough cash to pay for the inventories it needs
3) **Growth** can be **financed** through sales rather than by injecting fresh external capital.
4) The business gets financed linked to its volume of sales. In contrast, overdraft limit tends to be determined by historical statements of financial position
5) Managers of the business do not have to spend their time on the problems of slow - paying accounts receivable.
6) The business does not incur the costs of running its own sales ledger department

Disadvantages of factoring

1) The main disadvantage of factoring is that it is a relatively expensive form of finance compared to loan finance.
2) Some business will also find it undesirable for customer relations if the administration of debt collection is passed to a third party.
3) Factoring may not be of much use where companies or agents have one time sales with the customers.
4) The image of the client may suffer as engaging a factoring agency is not considered a good sign of efficient management.