CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

THIRD YEAR EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 337: FINANCIAL MANAGEMENT 1

STREAMS: BCOM (Y3S2)

TIME: 2 HOURS

DAY/DATE: TUESDAY 6 /07/ 2021 **8.30 AM – 10.30 AM**

INSTRUCTIONS:

- Answer Question ONE and any other TWO Questions.
- Do not write on the question paper

a) ABC Ltd intends to acquire a new asset to replace the existing one. The new asset will cost sh.150,000 and it will require an installation cost of sh.10,000. The new asset has an economic life of 8 years and a salvage value of sh.20,000. The old asset has a net book value of 30,000 and the market value of the machine is sh.20000 with zero scrap value. The company uses straight line method of depreciation. As a result of this replacement, sales will increase from 190,000 to 220,000. In addition it will reduce cost from sh.170000 to sh.165,000. The company tax rate is 30%. Required: advise the company whether it should replace the asset if the cost of capital is 11%. [10 Marks]

b) Discuss the theories that is in line with shareholders' wealth maximization objective. [6 Marks]

c) Assume that a project has the following cash flows. The cost of capital is 12%. Determine the projects expected net present value and advise whether the investment is financially viable if the cost of capita is sh.17,000. [5 Marks]

	Cash flows	Probability
YEAR ONE	5,000	0.3
	7,000	0.4
	10,000	0.3
YEAR TWO	4,000	0.2
	6,000	0.6
	9,000	0.2
YEAR THREE	12,000	0.5
	8,000	0.3
	10,000	0.2

d) Agency problem exists when agents pursues their own interests rather than the interest of their principles. Discuss the causes of conflicts between creditors and shareholders and the solutions to the conflicts. [6 Marks]

e) Distinguish between capital rationing and abandonment decisions. [3 Marks]

QUESTION TWO

a) ABC limited is considering whether it should purchase a new machine to increase its production and sales. The machine costs sh.1,200,000 and has an expected life of 10 years. The machine will be sold at the end of 10 years with a scrap value expected to be 15% of the initial cost. For each of the 10 years of usage sales production is expected to be 10,000 units Each unit can be sold for sh.200 per unit and will incur variable cost of sh.150 per unit. Fixed costs incurred will be sh.200,000. Depreciation is on straight line method, tax rate is 30% and the cost of capital is 15%. Determine the NPV of the project and by what percentage change is required in the cost of machine, scrap value and sales revenue for the project to be undesirable.10 Marks]

b) Describe the factors that affects the cost of finance. [6 Marks]

c) The following information has been extracted from the books of Bimbo limited.

Earnings after tax	10 million
Number of outstanding shares	800,000
Dividend payout ratio	60%
Internal rate of return	10%
Market price per share	100

Calculate the cost of equity for the company. [4 Marks]

QUESTION THREE

a) The following is the balance sheet of Bimbo limited as at 31st December, 2014.

	Sh (000)
<u>Fixed Assets</u>	
Land	5000
Machinery	4000
Equipment	3000
<u>Current Assets</u>	
Cash	500
Debtors	3000
Stock	<u>4500</u>
	<u>20,000</u>
Financed by:	
Ordinary share capital	8500
Retained earnings	3500
15% Long term loan	2500
Creditors	3500
Accrued expenses	<u>2000</u>
	20000

Additional information

- The sales for the year ended 31st December 2014 amounted to sh 30million. The sales will increase by 10% in 2015, 15% in 2016 and 20% in 2017.
- The after tax profit on sales is 15%
- The company's dividend payout ratio is 60%
- Any external financing will be effected through the use of commercial paper
- Required

i) Determine the amount of external financial requirements for the three years. [8 Marks]

ii) Prepare a proforma balance sheet as at 31st December 2017. [7 Marks]

iii) Describe the components of financial planning models. [5 Marks]

QESTION FOUR

a) Highlight the importance of good corporate governance in an organization. [7 Marks]

b) The following data is available for firm A

Quantity	50,000 units
Selling price	sh 80
Variable cost	sh.40
Fixed costs	sh.30,000
10% Debenture	sh.500,000
Preferred dividend	sh 5,000
Tax rate	30%

Required:

i) Determine the degree of operating, financial and combined leverage. [7 Marks]

ii) Discuss the factors affecting the leverage of a firm [6 Marks)

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