CHUKA **UNIVERSITY**

UNIVERSITY EXAMINATIONS

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

BCOM 337: FINANCIAL MANAGEMENT 1

STREAMS: (Y3S2) ODEL

TIME: 2 HOURS

DAY/DATE: THURSDAY 22 /07/ 2021 **11.30 AM – 1.30 PM**

INSTRUCTIONS:

- Answer Question one(Compulsory) and any other Two.

QUESTION ONE

a) Corporate governance is concerned with the establishment of an appropriate legal, economic and institutional environment that would facilitate and allow business enterprises to grow, thrive and survive as institutions for maximizing shareholders value while being conscious of and providing for the well being of all other stakeholders and society. To achieve this they should adopt certain cannons of good corporate governance. Discuss these cannons. [7 Marks]

b) A company whose cost of capital is 11% and the cost of the project is 5,320,000 is considering investing in a project that has the following information.

Years	Cash flow (000)	Abandonment value (000)
1	2000	1500
2	1750	1800
3	1800	1700
4	1000	500

Required: advise on the optimal time to abandon the project. [8 Marks]

c) Agency problem exists when agents pursues their own interests rather than the interest of their principles. Discuss the cause of conflicts that occurs when auditors pursues their own interest rather than the interest of shareholders and the solutions to the conflicts. [7 Marks]

d) Assume a project costing sh.44,000 yields the following uncertain cash flows with the corresponding certainty equivalent coefficients. Determine the net present value if the cost of capital is 12%. [5 Marks]

Years	Cash flows	Certainity coefficient
1	22,000	0.9
2	18,000	0.8
3	14,000	0.6
4	10,000	0.5

e) Briefly explain the methods of incorporating risk in capital budgeting. [3 Marks]

QUESTION TWO

a) Highlight the steps involved in financial planning. [6 Marks]

b) The following is the balance sheet of Migingo limited as at 31st December 2013

	Sh (000)
Fixed Assets	
Land	15000
Machinery	10000
Equipment	5000
Current Assets	
Cash	4000
Bank	3000
Debtors	8000
Stock	5000
	50000
Financed by:	
Ordinary share capital	25000
Retained earnings	6000
15% Long term debt	7000
Creditors	8000

Accrued expenses	4000
	50000

Additional information

- The sales for the year ended 31st December 2013 amounted to sh.60,000,000. The sales will increase by 10% in 2014 and 15% in 2015
- The after tax profit on sales is 20%
- The company's dividend payout ratio is 80%

iii) Determine the amount of external financial requirements for the next two years. [7 Marks]

iv) Prepare a proforma balance sheet as at 31st December 2015. [7 Marks]

QUESTION THREE

a) Bimbo limited is evaluating a new technology for its production. The technology has 2 years and costs sh.50,000. Its impact on the company is subject to uncertainties. In the first year the management estimates that the technology has an equal chance of generating good and normal returns of 30,000 and 20,000. If it provides good returns in the first year then the second year cash flows will be 25,000, 40,000 and 50,000 with associated probabilities of 0.2, 0.6 and 0.2 respectively. If it provides normal returns in the first year then the second year cash flows will be 40,000, 60,000 and 80,000 with associated probabilities of 0.3, 0.4 and 0.3 respectively. Require a decision tree depicting the above information and the expected net present value if the cost of capital is 13%. [10 Marks]

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

c) The following information relates to a certain company in the year 2020

Total dividends paid	10,000,000
Number of outstanding shares	2,000,000
Share price for 2020	8
Share price for 2019	10

Calculate the cost of equity for the company in the year 2020. [4 Marks]

QUESTION FOUR

a) Suppose a new firm is being formed. The management is expecting a before tax rate of return of 50% on the estimated total investment of sh.10 million. The alternative plans available are:

i) Raising the entire funds by issuing 500,000 ordinary shares at sh.20 per share.

ii) Raising sh.5,000,000 by issuing 250,000 ordinary shares at sh.20 per share and borrow sh.5,000,000 12% debt

iii) Tax rate is 30%

Required:

i) Show the effect of each alternative plan on earnings per share and return on equity.

[6 Marks]

ii) Calculate the gain from financial leverage. [2 Marks]

b) Discuss the factors affecting the leverage of a firm. [6 Marks]

b) Explain any three managerial finance functions [6 Marks]

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