CHUKA **UNIVERSITY**

UNIVERSITY EXAMINATIONS

THIRD YEAR EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF EDUCATION ARTS

BCOM 337: FINANCIAL MANAGEMENT

STREAMS: Y4S1

TIME: 2 HOURS

DAY/DATE : TUESDAY 28 /09/ 2021 **8.30 AM – 10.30 AM**

INSTRUCTIONS TO CANDIDATES:

- Answer Question One and any other Two Questions.
- DO NOT WRITE ANYTHING on the question paper

QUESTION ONE

a) Agency problem exists when agents pursues their own interests rather than the interest of their principles. Discuss the causes of conflicts that occurs when auditors pursues their own interest rather than the interest of shareholders and the solutions to the conflicts. [6 marks]

b) Discuss the managerial finance functions [4 Marks]

c) Shukrani limited is considering investing in an equipment that costs sh.300,000. The equipment is expected to produce 2,100, 1,800, 1,500, 1,400 and 1,300 units from year one to year five respectively. Each unit can be sold at sh 100 and incurs a variable cost of 40% of sales revenue and the fixed cost incurred each year is sh 20,000. Cost of capital is 10%, tax rate is 30%, depreciation is on straight line method and the scrap value is sh.80,000. Required NPV, P1 and IRR [11 Marks]

d) Humble limited intends to acquire a new asset to replace the existing one. The new asset will cost sh.7,000,000 and it will require an installation cost of sh.1.000,000. The new asset has an economic life of 8 years and a salvage value of sh 1,000,000. The old asset has a net book value of 2,000,000 and the market value of the machine is sh.2,500,000 with a salvage value of sh.500,000. The company uses straight line method of depreciation. As a result of this replacement, sales will increase from 2,000,000 to 3, 200,000. In addition it will reduce cost from sh 1,200,000 to sh. 1,000,000 and commitment of 4 million in raw materials, 1.5 million in debtors and 4.5 million in creditors. The company tax rate is 30% and the cost of capital is 11%. Required: advise the company whether it should replace the asset or not. [9 Marks]

QUESTION TWO

a) The following data is available for firm A

Quantity	50,000 units
Selling price per unit	Sh.130
Variable cost per unit	Sh.74
Fixed cost	Sh.800,000
10% debenture	Sh.4,000,000
Tax rate	30%
Number of outstanding shares	1000

Required:

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

ii) Discuss the factors affecting the leverage of a firm. [5 Marks]

b) Company A is evaluating a new technology for its production. The technology has 2 years and costs sh.95,000. 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 50,000 and 70,000. If it provides good returns in the first year then the second year cash flows will be 40,000, 50,000 and 60,000 with associated probabilities of 0.3, 0.5 and 0.2 respectively. If it provides normal returns in the first year then the second year cash flows will be 60,000, 70,000 and 80,000 with association 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 10%. [8 Marks]

QUESTION THREE

a) The following is the capital structure of Shikuku company.

	Sh (000)
Ordinary shares (sh 80 par)	16,000
15% Preference shares (sh 60 par)	9,000
18% Debentures (sh 120 par)	6,000
12% Medium term loan	5,000
Retained Earnings	4,000
	40,000

Additional information

i) The company expects to pay a dividend of sh 15 per share which is expected to grow at 8%. The current market price of the ordinary shares is sh.120 including sh.20 as floatation cost

ii) The 15% preference shares were issued 10 years ago and currently sell at sh.75

iii) The 18% debentures currently sell for sh.180 and will mature in 100 years

iv) The tax rate is 30%

v) The medium term loan is currently selling at sh.6,000,000

Required Calculate the Weighted average cost of capital (WACC) [10 Marks]

b) Explain the factors that influence the cost of finance. [5 Marks]

c) Explain the sources of funds [5 Marks]

i. Debentures

ii. Mortgage

iii. Venture capital

QUESTION FOUR

a) A company currently pays a dividend of 18 per share. The dividend is expected to grow at 10% for 3 years, 15%for 3 years and 20% for 2 years after which it will fall to a constant rate of 11%. Calculate the intrinsic value of the share if the risk free rate is 6% and the risk premium is 9%. [10 Marks]

b) State the reasons for valuation of securities [4 Marks]

c) A company is considering investing in a project that promises profit before depreciation and tax of sh.40,000 each year for 4 years. The cost of the project is sh.120,000 with sh.20,000 as the scrap value. Tax rate is 30%, depreciation is on straight line method.

Required

i. Accounting rate of return [4 Marks]

ii. State the disadvantages of accounting rate of return. [2 Marks]

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