CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 337: FINANCIAL MANAGEMENT

STREAMS: BCOM Y4S1 **TIME: 2 HOURS**

DAY/DATE: TUESDAY 03/12/2019 **11.30 AM – 1.30 PM**

INSTRUCTIONS:

Answer Question One and any other Two Questions

Question One

(a) The objective of financial management is to maximize the value of the firm. Explain how the achievement of this objective might be compromised by the conflicts which might arise between shareholders and creditors and the solutions to these conflicts. [6 marks]

(b) Discuss the functions that affect the value of the firm. [6 marks]

(c) John deposits sh 180,000 at the end of each year. How much should he withdraw in 18 years at an interest rate of 16%. [3 marks]

(d) ABC limited is evaluating new equipment for its production. The equipment has 2 years and its costs sh 60,000. Its impact is subject to risk. In the first-year management estimates that there is an equal chance that the technology with produce high returns or moderate returns of sh. 50,000 and sh. 40,000. If it generates high returns then second year cashflows will be 60,000, 50,000 and 70,000 with associated probabilities f 0.3, 0.4 and 0.3 respectively. If they generate moderate returns then second year cashflows will be 30,000, 50,000 and 65,000 with probabilities of 0.5, 0.2 and 0.3 respectively.

Required:
A decision tree depicting this information and the expected net present value if the cost of capital is 12%. [8 marks]

(e) A company has invested in a 5 year, 12% sh 40,000 bond. The current market price of the bond is sh 48,000. The cost of capital is 14%. Should the company purchase the bond? [3 marks]

(f) A company is considering investing in a project costing sh 50,000

Years	Cashflow	Certainty coefficients
1	20,000	0.9
2	19,000	0.6
3	25,000	0.8
4	15,000	0.7

The risk-free rate is 10% and risk premium is 5% should the project be undertaken. [4 marks]

Question Two

(a) Mentala plastics company has been dumping in the local waste collection centre some 35,000 kg, 30,000, 40,000kg, 50,000kg and 22,000kg of unusable chemical from year one to year 5 respectively. The residents of a nearby estate have started complaining of bad odor emanating from the company. The company received information that the chemicals can be recycled at a low cost using an equipment. Upon investigation the company decided to sell the chemicals to another firm at an average price of sh 50 per kg. The direct cost/ expenses incurred in recycling is sh 20 per kg. the equipment costs sh 2 million and has a useful life of 5 years. At the end of 5 years the equipment can be sold as a scrap of sh 800,000. The company uses straight line method of depreciation and a tax rate of 30%. The risk-free rate is 10% and risk premiums is 5%. Required NPV, PI and IRR. [14 marks]

(b) Discuss the determinants of working capital needs of a firm. [6 marks]

Question Three

(a) Discuss the following sources of finance. [4 marks]

(i) Lease finance
(ii) Mortgage finance

(b) Explain the factors that affect the cost of finance. [6 marks]

(c) The following is the capital structure of ABC limited

	Sh '000'
Ordinary share capital (sh 80)	10,000
12% preference shares (sh 60)	7,500
15% long term debenture (sh 150)	9,000
20% medium term loan	4,500
Retained earnings	3,000

Additional information:

1. The company expects to pay ordinary shareholders a dividend of sh. 10 per share which is expected to grow at 15%. The ordinary shares are currently selling at sh 120 with a floatation cost of sh 20.
2. The preference shares are currently selling at a discount of 15%
3. The debentures are currently sellingat premium of 20% and will mature in 50 years
4. The medium-term loan is currently selling at sh 7,200,000
5. Tax rate is 30%

   Required: Weighted average cost of capital. [10 marks]

Question Four

(a) A company requires 12,500 units of a component in its manufacturing process which cost sh 200 each. The items are available locally and the lead time is 3 weeks. Each order costs sh 250 and the holding cost is sh 100 to prepare and process. The company considers giving a quantity discount by 20% if a minimum of 1000 units are ordered. Advice whether the quantity discount should be given. [7 marks]

(b) Highlight the reasons for valuation of securities. [3 marks]

(c) A company currently pays an ordinary dividend of sh 20 per share which is expected to grow at 5% for 2 years, 10% for 3 years and 8% for 3 years after which it will fall to a constant rate of 12%. Calculate the intrinsic value of the share If the risk-free rate is 10% and the risk premium is 6%. [10 marks]
