CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS
RESIT/SPECIAL EXAMINATIONS

EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 335/337/ BUST 412: FINANCIAL MANAGEMENT I

STREAMS: **TIME: 2 HOURS**

DAY/DATE: MONDAY 23/07/2018 **2.30 P.M – 4.30 P.M**

INSTRUCTION:

- **Answer question one and any other two questions**

QUESTION ONE

(a) Agency problem arises when the agents pursues their own interest rather than the interest of the principal. Discuss the causes of conflicts between shareholders and managers and the solutions to the conflict. [8marks]

(b) Discuss ltd managerial functions of a finance manager in the contemporary business environment. [6marks]

(c) ABC ltd intends to acquire a new asset to replace the existing one. The new asset will cost ksh 120,000 and it will require an installation cost of ksh 3500. The new asset has an economics life of 8 years and a salvage value of 20500. The old asset has a net book value of 20,000 and the market value of the machine is ksh 15,000. The company uses straight line method of depreciation. As a result of this replacement, sales will increase from 190,000 to 218,500. In addition it will reduce cost from ksh 170,000 to ksh 161,000. The company tax rate is 30%.

Required :

Advised the company whether it should replace the asset. [10marks]

(d) Assume a project costing ksh 40,000 yields the following uncertain cash flow with the corresponding certainty equivalent coefficients. Determine the net present value if the cost of capital is 12%. [4marks]

Years	Cash flows	Certainty coefficient

1	20000	0.9
2	15000	0.8
3	10000	0.6
4	8000	0.4

(e) State the advantages of profit maximization as the goal of the firm. [2marks]

QUESTION TWO

(a) ABC limited is considering whether it should purchase a new machine to increase its production and sales. The machine costs ksh 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 of ksh 200,000. For each of the 10 years of usage sales production is expected to be 10,000 units per year. Each unit can be sold at ksh 200 and will incur variable cost of ksh 140 per unit. Fixed costs uncured will be ksh 200,000 per year . Depreciation is on straight line method, tax rate is 30% and the cost of capital is 10%. Determine the NPV of the project and by what percentage change is required in the cost of machine and sales revenue for the project to be undesirable. [7marks]

(b) Bimbo limited is evaluating a new technology for its production. The technology has 2 years and costs ksh 50000. Its impact on the company is subject to uncertainties. In the first year the management estimates that the technology will provide good and normal returns of 30,000 and 20,000 with associated probabilities of 0.4 and 0.6 respectively. If it provides good returns in the first year then the second year cash flows will be 25000, 40000 and 50000 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. Required a decision tree depicting the above information and the expected net present value if the cost of capital is 15%. [7marks]

(c) Discuss the methods of incorporating risks in capital budgeting. [6marks]

QUESTION THREE

(a) Discuss the factors affecting the leverage of a firm. [6marks]

(b) The following information relates to XYZ limited.

Sales volume	10000 units
Variable cost per unit	ksh 70
Selling price per unit	ksh 100
Fixed cost	ksh 100,000

10% debenture	ksh 150,000

Determine the degree of operating, degree of financial and degree of combined leverage. [6marks]

(c) The following information relates to company Y

Economic state	probability	project A
Good	0.5	6000
Normal	0.2	4000
Bad	0.3	2000

Determine the coefficient of variation for project A [4marks]

(d) Discuss the non- financial goals of a firm. [4marks]

QUESTION FOUR

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

(b) The following is the capital structure of Shirandula company.

	Ksh (000)
Ordinary shares (ksh 30 par)	750
12% preference shares (ksh 15 par)	450
10% debentures (ksh 100 par)	400
15% medium term loan	500
Retained earnings	400
	3,000

Additional information

(i) The company has already paid a dividend of ksh 10 per share which is expected to grow at 10%. The current market price of the ordinary shares is ksh 50 and incurs a floatation cost of 10% of the market price.

(ii) The 12% preference shares will mature in 10 years and currently sell for ksh 25.

(iii) The 10% debentures currently sell for ksh 120 and will mature in 20 years.

(iv) The medium term loan currently sell at ksh 400,000.

(v) The tax rate is 30%.

Required

Calculate the weighted average cost of capital (WACC) [14marks]