CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

RESIT/SPECIAL EXAMINATION

EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 337: FINANCIAL MANAGEMENT I

STREAMS: BCOM **TIME: 2 HOURS**

DAY/DATE: WEDNESDAY 03/02/2021 **8.30 A.M – 10.30 A.M.**

INSTRUCTIONS

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

a) ABC ltd intends to acquire a new asset to replace the existing one. The new asset will cost sh 6,000,000 and it will require an installation cost of sh 400,000. The new asset has an economic life of 10 years and a salvage value of sh 800,000. The old asset has a net book value of 600,000 and the market value of the machine is sh 300,000 with a zero salvage value. The company uses straight line method of depreciation. As a result of this replacement, sales will increase from 1,200.000 to 1,700,000. In addition it will increase cost from sh 600,000 to sh 720,000 and commitment of 5 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 12%. Required: advise the company whether it should replace the asset

(12 marks)

b) Briefly explain the functions of a finance manager (8 marks)

c) Agency problem exists when agents pursues their own interests rather than the interest of their principles. Discuss the causes of conflicts between managers and shareholders and the solutions to the conflicts (10 marks)

QUESTION TWO

a) Assume that a project has the following cash flows. The cost of capital is 10%. Determine the projects expected net present value using a decision tree and advise whether the investment is financially viable if the cost of project is sh 100,000 (10 marks)

Year 1		Year 2	
Cash flows	Probability	Cash flow	Probability
16000	0.3	30000	0.2
		40000	0.6
		50000	0.2
24000	0.5	40000	0.1
		60000	0.8
		80000	0.1
20000	0.2	5000	0.2
		8000	0.5
		12000	0.3

b) Assume a project costing sh 40000 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	20000	0.9
2	15000	0.8
3	10000	0.6
4	8000	0.4

c) Briefly explain the methods of incorporating risk in capital budgeting (5 marks)

QUESTION THREE

1) The following is the capital structure of ABC Limited

	Shs
Ordinary shares (sh 25 par)	1000000
8% preference shares (sh 20 par)	600000
10% preference shares (sh 25 par)	1000000
6% debentures (sh 30 par)	900000
10% medium term loan	4000000
Retained earnings	200000
	7700000

Additional information

- The market value of the ordinary shares is sh 45 including sh 5 as floatation cost. Ordinary shareholders expect a cash dividends of sh 5 per share and the dividends are expected to grow at 10% in the foreseeable future
- The 8% preference shares were issued 5 years ago and can be sold at a premium of 10% and an underwriting fee of sh 2 per share Is paid to underwriters
- The 10% preference shares can be sold at a discount of 10%. In addition an underwriting fee of 10% of face value will be incurred in the process.
- The 6% debentures currently sell at sh 40. The debentures will be redeemed after 10 years
- The current market value of the loan is sh 5000000
- Tax rate is 40%

Required: Calculate the WACC (10 marks)

2) A company currently pays a dividend of sh 2 per share and this dividend is expected to grow at 20% for 3 years, 10% for the next 3 years after which it will fall to a constant rate of 7% thereafter. The risk free rate is 7.5% and the risk premium of 4.5% is required to compensate for the risk. Required:
    i) Explain the reasons for valuation of securities (4 marks)
    ii) Determine the intrinsic value of the company's share (6 marks)

QUESTION FOUR

a) Discuss the principles 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 (7marks)

ii) Discuss the factors affecting the leverage of a firm (6 marks)
