

CHUKA



UNIVERSITY

UNIVERSITY EXAMINATIONS

EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 337: FINANCIAL MANAGEMENT I

STREAMS: BCOM Y3S2

TIME: 2 HOURS

DAY/DATE: WEDNESDAY 08/04/2020

11.30 A.M. – 1.30 P.M.

INSTRUCTIONS:

- **Answer question ONE and any other TWO questions.**

QUESTION ONE

(a) The objectives of financial management is to maximize the value of the firm. Explain how the achievement of this objective might be compromised by the conflict which may arise between manager and shareholders in the organization. (6 marks)

(b) Mgenya limited intends to replace an old machine with a new one. The old machine has a useful life of 3 years with a net book value of 2,950,000 with a current market price of 3,700,000 and a salvage value of 850,000. The new machine costs Sh. 10,000,000 and requires an installation cost of 1,000,000 and has a salvage value of 3,500,000. As a result of this replacement the following will occur:

- Sales would increase by Sh. 1,200,000
- Expenses would decrease by Sh. 1,200,000
- Stocks and creditors would increase by 3,000,000 and 1,000,000 respectively.
- Cost of capital is 12% and tax rate is 30%

Required:

Using suitable computations, advice the management of Ugenya limited on whether the old machine should be replaced. (9 marks)

(c) Explain the importance of good corporate governance in an organization. (6 marks)

(d) The following information has been extracted from the books of XYZ limited.

Earnings after tax.	12,000,000
Number of outstanding shares	1,500,000
Internal rate of return	20%
Dividend payout ratio	60%
Market price of a share	100

Calculate the cost of equity. (4 marks)

(e) Assume a company has 2 assets A and B
 Asset A has a probability of 50% of generating a return of Sh. 20 and 50% of generating
 a return of Sh. 10

Asset B has a probability of 40% of generating a return of Sh. 16 and 60% of generating a return
 of Sh. 12. Required: Calculate the expected utility of each asset and advise on which asset to
 invest in. (5 marks)

QUESTION TWO

(a) ABC limited is evaluating new equipment for its production. The equipment has two
 years and it costs Sh. 240,000. In the first year the equipment has an equal chance of getting
 high returns and moderate returns with associated cashflows of Sh. 153, 000 and 120,000
 respectively. If it generates high returns then the second year cashflows will be 122,000,
 140,000 and 180,000 with associated probabilities of 0.2, 0.3 and 0.5 respectively. If they
 generate moderate returns then second year cashflows will be 200,000, 220,000 and
 250,000 with associated probability of 0.6, 0.2 and 0.2 respectively.

Required:

A decision tree depicting this information and the expected net present value if the cost of
 capital is 12% (8 marks)

(b) Explain the functions that affect the value of the firm. (6 marks)

(c) A ten year bond with a face value of Sh. 1,000 has a coupon rate of 9%. The market
 interest rate is 12% the bond is redeemable after 5 years. Calculate the duration of the
 bond. (6 marks)

QUESTION THREE

(a) Assume the following information

	2018	2019
Sales volume (units)	100,000	120,000
Selling price per unit	60	80

Variable cost per unit	25	35
Fixed cost	1,000,000	1,400,000
Tax rate	30%	30%
10% Sh 5,000,000 debentures		

Required:

- Degree of operating, financial and combined leverage. (8 marks)
- (b) Explain the factors that affect the leverage decision of a firm. (6 marks)
- (c) A company is considering investing in a project costing Sh. 60,000
- | Years | Cashflows | Certainty coefficient |
|-------|-----------|-----------------------|
| 1 | 20,000 | 0.9 |
| 2 | 25,000 | 0.6 |
| 3 | 19,000 | 0.8 |
| 4 | 15,000 | 0.7 |
| 5 | 10,000 | 0.5 |

The risk free rate is 10% and the risk premium is 5% should the project be undertaken?

- (4 marks)
- (d) Explain the term bond duration. (2 marks)

QUESTION FOUR

- (a) Explain the factors that affect the cost of finance. (4 marks)
- (b) Discuss the various components of financial planning model. (4 marks)
- (c) The management of ABC limited wants to establish the amount of financial needs for 3 years.

	Sh “000”
Fixed assets	
Land	16,000
Plant and machinery	72,000
Equipment	52,000
Current assets	
Stock	60,000
Debtors	40,000
Cash	<u>10,000</u>
	<u>250,000</u>
Financed by:	
Ordinary share capital	95,000
Retained earnings	55,000
10% bond	30,000
Trade creditors	50,000

Accrued expenses	<u>20,000</u>
	<u>250,000</u>

Additional information

- (i) Sales amounted to 300 million on 31st Dec 2015. The firm's projected that sales will increase by 10% in 2016, 15% in 2017 and 20% in 2018.
- (ii) The after tax return on sales has been 15%
- (iii) Dividend payout ratio is 70%

Required:

Determine the amount of external finance needed for three years. (8 marks)

- (d) A company is considering investing in the following project

Economic state	Probability	Project A
Good	0.5	9,000
Normal	0.2	6,000
Bad	0.3	5,000

Determine the coefficient of variation for project A. (4 marks)
