KENYA METHODIST UNIVERTISY

END OF SECOND TRIMESTER 2008/2009 EXAMINATIONS

FACULTY	**:**	**BUSINESS STUDIES AND MANAGEMENT**
DEPARTMENT	**:**	**BUSINESS ADMINISTRATION**
COURSE CODE	**:**	**BUSS 321**
COURSE TITLE	**:**	**FINANCIAL MANAGEMENT 1**
TIME	**:**	**2 HOURS**

Instructions:
- ***Attempt section A and any other TWO questions in section B***
- ***Show all your workings***

SECTION A

Question 1

(a) Explain three important decisions that a finance manager needs to consider as he/ she strives to maximize the value of shares. (6 marks)

(b) Nairobi systems ltd has forecasted returns on its shares with the following probability distribution

Return (%)	**probability**
-20	0.05
-10	0.05
-5	0.10
5	0.10
10	0.15
18	0.25
20	0.25
30	0.05

Required:

(i) Calculate expected return

(ii) Variance of return

(iii) Standard deviation

(iv) Mean variance of criterion (8 marks)

Question 2

(a) Highlight circumstances under which the weighted average cost of capital can be used in investment appraisal (5 marks)

(b) Does the dividend growth model or the capital asset pricing model offer the better estimate of the cost of equity of a company? (5 marks)

Question 3

Njunjiri Company has made plans for the next year. It is estimated that the company will employ total assets of ksh 800,000, 50% of the assets being financed by borrowed capital at an interest cost of 8% per year.

The direct costs for the year are estimated at kshs 480,000 and all other operating expenses are estimated at ksh 80,000. The goods will be sold to customers at 150% of the direct costs. Tax rate is assumed to be 50%

Required: Calculate

(a) Net profit margin
(b) Return on assets
(c) Asset turnover
(d) Return on owners equity (8 marks)

SECTION B

Question 4

Kimathi company plan to buy a new machine to meet expected demand for new product T. this machine will cost Ksh 250,000 and last for four years, at the end of which time it will be sold for Ksh 5,000.Kimathi Company expects demand for product T to be as follows:

Year	**1**	**2**	**3**	**4**
Demand (units)	35,000	40,000	50, 0000	25,000

The selling price for product Tis expected to e Kshs 12 per unit and the variable cost of production is expected to be ksh 7.80 per unit. Incremental annual fixed production overheads of Ksh 25,000 per year will be incurred. Selling price and costs are all incurrent price terms.

Selling price of product T: 3% per year
Variable cost of product: 4 % per year
Fixed production overheads: 6%

Additional information
Kimathi company has a real cost of capital of 5.7% and pays tax at an annual rate of 30% one year in arrears. It can claim capital allowance s on a 25% reducing balance basis. General inflation is expected to be 5% per year.

Kimathi Company has a target return on capital employed of 20%. Depreciation is charged on a straight line basis over the life of an asset.

Required:
(a) calculate the NPV of buying the new machine and comment on your findings (work to the nearest ksh 1,000) (10 marks)

(b) calculate the before tax return on capital employed(accounting rate of return) based on the average investment and comment on your findings (5 marks)

(c) discuss the strength and weaknesses of internal rate of return in appraising capital investments (5 marks)

Question 5
James Company has annual sales revenue of ksh 6 million and all sales are on 30 days credit, although customers on average take ten days more than this to pay. Contribution represents 60% of sales and the company currently has no bad debts. Accounts receivable are financed by an overdraft at an annual interest rate of 7%

James Company plans to offer an early settlement discount of 1.5% for payments within 15 days and to extend the maximum credit offered to 60 days. The company expects that these changes will increase annual credit sales by 5%, while also leading to additional incremental costs equal to 0.5% of turnover. The discount is expected to be taken by 30% of customers, within the remaining customers taking an average of 60 days to pay.

Required
(a) Evaluate whether the proposed changes in credit policy will increase the profitability of James company (5 marks)

(b) Ngari company, a subsidiary of james company, has set a minimum cash account balance of ksh 7,500. the average cost to the company of making deposits or selling investments is ksh 18 per transaction and the standard deviation of its cashflows was ksh 1,000 per day during the last year. The average interest rate on investment is 5.11%.

Determine the spread , upper limit and the return point for cash account of Ngari company using the miller orr model and explain the relevance of these values for cash management of the company (5 marks)

(c) Identify and explain the key areas of accounts receivable management (5 marks)

(d) Discuss the key factors to be considered when formulating a working capital funding policy (5 marks)

Question 5

(a) The management of inventory must meet two opposing needs. Which are they and how is a balance brought in these two opposing needs. (3 marks)

(b) The practical approach in determining economic order quantity is concerned with locating a minimum cost range rather than a minimum cost point explain (5 marks)

(c) Explain three general motives for holding inventories (4 marks)

(d) Write short notes on the following
  (i) Hypothecation
  (ii) Pledge
  (iii) Mortgage
  (iv) Modernization (8 marks)