CHUKA UNIVERSITY COLLEGE

UNIVERSITY EXAMINATIONS

FOURTH YEAR EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF EDUCATION (ARTS)

BUST 412: FINANCIAL MANAGEMENT

STREAM: B.ED (ARTS) Y4S1 **TIME: 2 HOURS**

DAY/DATE: THURSDAY 9/12/2010 **2.30 P.M – 4.30 P.M.**

INSTRUCTIONS:

- Answer all questions.
- Do not write anything on this question paper.

QUESTION ONE:

(a) Explain the term Financial Management and discuss the role of a financial manager in the contemporary society [6 marks]

(b) Briefly discuss the following financial goals of the firm

(i) Profit maximization [5 marks]
(ii) Wealth maximization [5 marks]

(c) If you wish to have Sh.2000 five years from now, how much money should you deposit in a savings account today that pays 8% interest per annum. [3 marks]

(d) State the circumstances under which NPV and IRR methods of evaluating investments give conflicting results. [3 marks]

(e) Distinguish between capital structure and financial structure of a firm. [3 marks]

QUESTION TWO:

(a) Distinguish between weighted average cost and marginal cost of capital. [3 marks]

(b) The following was the capital structure of Furaha Ltd as at 31 October 2007.

	Sh.
Ordinary share capital (Sh.10 par)	10.0 million
12% Preference share capital (Sh.20 par)	4.8 million
10% Debentures (Sh.1000 par)	3.6 million

Additional information:

1. The market prices per ordinary share, preference share and debenture were Sh.45, Sh.30 and Sh.1200 respectively on 31 October 2007.

2. The dividend per ordinary share for the year ended 31 October 2006 was Sh.8.00. Dividends are expected to grow at an annual rate of 12 per cent.

3. The rate of corporation tax is 30%.

Required:

(i) The weighted average cost of capital (WACC) of Furaha Ltd. [8 marks]

(ii) The relevance of the WACC computed in (i) above in decision making by Furaha Ltd. [3 marks]

(c) An investor intends to purchase a 20-year Sh.5,000,000 15% bond whose current price is Sh.3,000,000. Estimate the yield to maturity of the bond. [3 marks]

(d) (i) Define the term "intrinsic value" with reference to valuation of shares. [2 marks]

(ii) An investor received a dividend of Sh.1.50 in the current financial year on each of his ordinary shares. The par value per share is Sh.20. The annual growth rate in dividends is 8%. The current market price per share is Sh.150 while the investor's required rate of return is 20%. Calculate the intrinsic value of each ordinary share and advice the investor what he should do with the share. [4 marks]

(e) State the difficulties encountered in the use of Weighted Average Cost of Capital (WACC). [2 marks]

QUESTION THREE:

(a) Distinguish between compounding and discounting. [2 marks]

(b) Chuka Ltd is considering the launch of new product Excel, for which an investment of Sh.6,000,000 in plant and machinery will be required. The production of Excel is expected to last five years after which the plant and machinery would be sold for Sh.1,500,000.

Additional information:

1. Excel would be sold at Sh.600 per unit with a variable cost of Sh.240 per unit.

2. Fixed production costs (excluding depreciation) would amount to Sh.600,000 per annum.

3. The company applies the straight line method of depreciation.

4. The cost of capital is 10% per annum.

5. The units of Excel expected to be sold per annum for the next five years are shown below.

Year	Units expected to be sold
1	8000
2	7000
3	7000
4	5000
5	3000

6. The Corporation tax rate is 30%.

Required:

(i) Calculate the NPV of the project and advise the management on the appropriate course of action. [8 marks]

(ii) Calculate the IRR of the project and advise the management on the appropriate course of action. [5 marks]

(iii) Outline the main drawbacks of the IRR method of investment appraisal.

[3 marks]

(c) Maua Ltd has approached you for advice on an equipment to be purchased for use in a five year project.

The investment will involve an initial capital outlay of Sh.1.4 million and the expected cash flows are given below:

Year	Cash inflows	Cash outflows
	Sh.	Sh.
1	800,000	65,000
2	750,000	80,000
3	900,000	50,000
4	1200,000	55,000
5	1100,000	70,000

The equipment is to be depreciated on a straight line basis over the duration of the project with a nil residual value.

The cost of capital and tax rate are 12% and 30% respectively.

Required:

The net Present Value (NPV) of the project. [7 marks]

QUESTION FOUR:

(a) Distinguish between pure discount bonds and floating rate bonds. [2 marks]

(b) The following is an extract of the balance sheet of Shauri Moyo limited as at December 2005:

	Sh."000"
Capital and liabilities:	
Ordinary share capital: 1 million ordinary shares of Sh.10 each	10,000
Capital reserves	20,000
Revenue reserves	90,000
10% debentures	30,000
	150,000 ======

Additional Information:

1. The profit before interest and tax for the year ended 31 December 2005 was Sh.9,000,000.
2. The dividend payout ratio for the year 2005 was 40%.
3. The market price per share as at 31 December 2005 was Sh.36.
4. The Corporation tax rate is 30%.

Required:

(i) Gearing ratio [2 marks]

(ii) Dividend yield [2 marks]

(iii) Times interest earned ratio [2 marks]

(iv) Return on capital employed [2 marks]

(v) Price earnings ratio [2 marks]

(c) James and Peter have set up a business named JP Enterprises as partners. The firm will venture in the purchase and sale of toy cars with effect from 1 July 2008. The partners intend to inject a total capital of Sh.23 million by 30 June 2008.

The projected sales for the first months and there after are as follows:

Month	Projected Sales (Units)
July	2400
August	3600
September	4800
October and monthly thereafter	9600

Additional information:

1. The selling price per toy car would be Sh.700.
2. All sales would be on credit terms, requiring settlement two months after the date of sale. However, if settlement was made by customers within one month of sale, a 2.5% cash discount would be given.
3. Of the total sales, 60% are expected to be settled two months after the date of sale and 40% (before any discount is deducted) are expected to be settled one month after the date of sale.
4. The purchase cost of each toy car is Sh.490. The firm intends to make purchases at the end of each month in order to maintain sufficient inventory for sale in the following month.
5. Payment for purchases would be made one month in arrears.
6. Non-current assets are expected to cost Sh.17500,000 payable on 1 July 2008.
7. Annual rent is expected to be Sh.1680,000 and would be payable quarterly in advance commencing 1 July 2008.

8. Monthly wages are expected to be Sh.280,000 payable in the month they would be incurred.

9. Other monthly overheads are expected to be Sh.420,000 half of which will be payable in the month they are incurred and the balance one month later.

Required:

A monthly cash budget for JP Enterprises for the month of July, August, September, October and November 2008. [13 marks]
