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University Examinations 2011/2012

THIRD YEAR, FIRST SEMESTER EXAMINATIONS FOR DEGREE OF BACHELOR OF COMMERCE

HBC 2206: FINANCIAL MANAGEMENT

DATE: AUGUST 2011 **TIME: 2 HOURS**

INSTRUCTIONS: *Answer **all** the questions.*

QUESTION ONE – (20 MARKS)

(a) Explain the concept of time value of money. (8 Marks)
(b) Highlight the application of the time value of money concept. (2 Marks)
(c) Explain the following terms used in asset valuation.
  (i) Intrinsic value (2 Marks)
  (ii) Replacement value (2 Marks)
(d) Give two advantages of discounted cash flow method of capital budgeting. (2 Marks)
(e) Differentiate between capital structure and financial structure. (2 Marks)
(f) Distinguish between a deficit budget and a surplus budget. (2 Marks)

QUESTION TWO – (15MARKS)

(a) Explain various conflicts encountered between shareholders and managers of a firm. (3 Marks)
(b) Define the agency relationship from the context of a public ltd company and briefly explain how it arises. (3 Marks)
(c) Highlight to measures that would minimize the agency problem between the owners and managers. (2 Marks)
(d) Hawkers price cool industries has earnings before interest and text of Ksh3 million. The tax rate is 30%. It is able to borrow at an interest rate of 14% whereas without borrowing its cost of equity is 18%. The earnings of the company are not expected to grow and all earnings are paid out its shareholders as dividends. Using the MM assumptions determine the value of the firm.

(i) Without any debt (4 Marks)

(ii) With Ksh7million debt (3 Marks)

QUESTION THREE – (20 MARKS)

Kineenth Ltd is considering the purchase of a new machine. Two alternative Pesi T20 and Upesi M02 will costs Sh6million and Ksh7 million respectively are available in the market. The cash flow after tax of each machine are as follows: Assume market interest

YEAR	PESI T20	UPESI M02
	(Ksh Million)	(Ksh Million)
1	0.6	1.8
2	1.8	2.4
3	2.0	3.0
4	3.0	1.8
5	2.4	1.6

REQUIRED

(a) Compute the net present value of each machine (8 Marks)

(b) Assuming each machine represent a project, compute the return expected from each machine. (8 Marks)

(c) Comment on the result obtained in (a) and (b) above. (4 Marks)

QUESTION FOUR – (15 MARKS)

(a) (i) Fraka Ltd has the following capital structure.

	Shs
Ordinary share capital	300,000
Retained earning	150,000
8% preference share capital	100,000
10% debt finance	50,000
Total Capital Employed	600,000

This company has been paying ordinary dividend of 10% per annum and expect equity to grow at 6% per annum. Tax = 50%. Calculate the weighted average cost capital for this company. (3 Marks)

(ii) Dividends are important in a firm since they are return that shareholders receive for

Their investment and they also affect the capital structure of a firm. Explain the theories by various scholars on the effect of dividend on the value of the firm. (4 Marks)

(b) Marangi Ltd produces paists. It has fixed operating cost of Ksh30million a year. The variable operating cost are Ksh175 per litre of paint and the selling price is Ksh200 per litre.

(i) Explain the term leverage (2 Mark)

(ii) Distinguish between operating and financed leverage. (2 Marks)

(iii) What is the annual break-even point in litres of Marangi Ltd. (2 Marks)

(iv) Show the effect of a decline in variable operating cost to Ksh168 per litre. (1 Marks)

(v) Calculate the firm's degree of operating leverage at the current sales level of 16million litres. (1 Marks)