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University Examinations 2013/2014

THIRD YEAR, FIRST SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF COMMERCE

HBC 2206: FINANCIAL MANAGEMENT

DATE: DECEMBER 2013 **TIME: 2 HOURS**

INSTRUCTIONS: *Answer question **One** and any other **Two.***

QUESTION ONE (30 MARKS)

a) Highlight the various measures that would minimize agency problems between the owners and the management. (8 marks)

b) Umoja Limited wishes to raise funds amounting to Shs.10 million to finance a project in the following manner:
- Shs.6 million from debt
- Shs.4 million from floating new ordinary shares

The current capital structure of the company is made up as follows:

- 600,000 fully paid ordinary shares of Shs.10 each
- Retained earning of Shs.4 million
- 200,000; 10% preference shares of Shs.20 each
- 40,000; 6% long term debentures of Shs.150 each

The current market value of the Company's ordinary shares is Shs.60 per share. The expected ordinary shares dividends in a year's time is Shs.2.40 per share. The average growth rate in both dividends and earnings have been 10% over the past ten years and this growth rate is expected to be maintained in the foreseeable future.

The company's long term debentures currently change hands for Shs.100 each. The debentures will mature in 100 years. The preference shares were issued 4 years ago and still change hands at face value.

Required:

a) Compute the component cost of :
   i) Ordinary share capital (3 marks)
   ii) Debt capital (3 marks)
   iii) Preference share capital (3 marks)

b) Compute the company's current weighted average cost of capital. (5 marks)

c) Compute the company's marginal cost of capital if it raised the additional Shs.10 million as envisaged. (Assume a tax rate of 30%). (8 marks)

QUESTION TWO (20 MARKS)

a) Describe FOUR factors that should be considered in establishing an effective credit policy. (8 marks)

b) Explain some difficulties managers face when making capital budgeting decisions. (6 marks)

c) Why would an investor prefer current income rather than income at some point in future. (6 marks)

QUESTION THREE (20 MARKS)

a) Mutunga has invested in a venture that promises Shs.2,000,000 at the end of year one and Shs.5,000,000 at end of year five.
   i) Given that his discounting rate is 6% compounded annually, calculate the present value of his earnings. (4 marks)
   ii) If the interest is 6% compounded semi-annually, what is the present value of the earnings. (4 marks)

b) A company is considering two mutually exclusive projects requiring initial cash outlay of Shs.1,000,000 each and a useful life of 5 years. The required rate of return is 10% and the appropriate corporate tax rate is 50%. The company follows straight line method of depreciation. The expected before depreciation and tax cashflows are:

Year	Project X (Shs.)	Project Y (Shs.)
1	4,000,000	6,000,000
2	4,000,000	3,000,000
3	4,000,000	2,000,000
4	4,000,000	5,000,000
5	4,000,000	5,000,000

Required:

Calculate for each project:

i) The NPV (Net Present Value) (4 marks)
ii) Profitability Index. (3 marks)
iii) Accounting Rate of Return (3 marks)
iv) Which one should be taken? Justify your answer. (2 marks)

QUESTION FOUR (20 MARKS)

a) Describe various sources of debt capital available to a company. (10 marks)
b) Why would Debt Finance be considered as a cheaper source of finance as compared to Equity. (10 marks)

QUESTION FIVE (20 MARKS)

Wakulima Limited made cash payment of Shs.10,000 a week. The interest rate of marketable securities is 12%. Every time the company sells marketable securities, it incurs Shs.20.

Required:

a) Determine the optimal amount of marketable securities to be converted into cash every time the company makes the transfer. (5 marks)
b) Determine the total number of transfers from marketable securities to cash per year. (5 marks)
c) Determine the total cost of maintaining the cash balance per year. (5 marks)
d) Determine the firms' average cash balance. (5 marks)