



## MERU UNIVERSITY COLLEGE OF SCIENCE & TECHNOLOGY

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### University Examinations 2011/2012

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

#### HBC 2206: FINANCIAL MANAGEMENT

DATE: APRIL 2012

TIME: 2 HOURS

INSTRUCTIONS: Answer question *one* and any other *two* questions

#### QUESTION ONE (30 MARKS)

- Explain any two agency relationship in a corporation, source of conflicts and show such conflicts are resolved (3 Marks)
- Ujenzi Ltd has become increasingly concerned over its liquidity position in recent months.

The most recent set of final accounts for the business how the following profit and loss account for the period ended 31<sup>st</sup> December 2005 profit and loss account for the period ended 31<sup>st</sup> December 2005.

	Sh.	Sh.
Sales		550,000
Less cost of sales	170,000	
Opening stock	<u>465,000</u>	
Purchases	<u>635,000</u>	
Closing stock		<u>(470,000)</u>
Gross profit		80,000
Expenses		<u>(90,000)</u>
		<u>(10,000)</u>

#### Balance sheet as at 31 December 2005

Sh.	Cost.	Cum. Dep'n.	NBV
Fixed assets	610,000	(300,000)	310,000
Premises	85,000	(40,000)	45,000
Fixtures and fittings	<u>105,000</u>	<u>(35,000)</u>	<u>70,000</u>
Motor vehicles	<u>800,000</u>	<u>(375,000)</u>	<u>425,000</u>
<b>Current assets</b>			
Stocks			152,000

Debtors		<u>183,000</u>
		335,000
Current liabilities		
Creditors		<u>146,000</u>
Bank overdrafts		<u>174,000</u>
		<u>320,000</u>
Working capital		<u>15,000</u>
Long term liabilities		440,000
Loans	<u>(160,000)</u>	
Net assets	<u>280,000</u>	
Financed by:		
Capital	120,000	
Retained profit	<u>160,000</u>	
	<u>280,000</u>	

The debtors and creditors were maintained at a constant level throughout the year, and all transactions were on a credit basis.

**Required:**

- i. Explain using appropriate ratios, why the business is concerned with its liquidity position (6 Marks)
  - ii. Explain the term “operating cash cycle” and state why this concept is important in the financial management of a business? (3 Marks)
  - iii. Calculate the operating cash cycle for Ujenzi Ltd based on the information given (assume a 365 day year) (3 Marks)
  - iv. State what steps might be taken to improve the operating cash cycle of the company (3 Marks)
- c. Maji Ltd and Fire Ltd provided you with the following information:

Sales (shs in million)	variable costs (shs in million)	fixed costs (shs in million)
Firm A	450	900
Firm B	750	375

**Required:**

Calculate:

- i. Profit to sales ratio (3 Marks)
- ii. Break even points (3 Marks)
- iii. Degree of operating leverage (3 Marks)
- iv. If sales increased by 20% what will be the impact on profitability of the two firms (3 Marks)

**QUESTION TWO (20 MARKS)**

- a. Discuss the factors that determine the capital structure of a firm (10 marks)

- b. A p/c and B p/c are identical with except that B p/c has £60,000 debt outstanding. The cost of the debt is 5%. Both the firms have a net operating income of sksh.20, 000. the cost of equity (ke) in a p/c is 15% and in b p/c is 16.5%

**Require:**

- i. Determine the value of the firm using MMI approach (5 Marks)
- ii. Suppose Muthoni owns 10% of firm B, demonstrate arbitrage process (5 Marks)

**QUESTION THREE (20 MARKS)**

- a. Discuss various factors that determine the source of finance the company should use (4 Marks)
- b. Money link Ltd has the following capital structured as on 31 December 2009

Ksh.(000)	
200,000 ordinary shares of 10 each	4,000
10% preference shares	1,000
14% debentures	3,000
<u>8000</u>	

The company's share sells for ksh.20 each. It is expected that the company will pay a dividend of sh. 2 next year, which will grow at 7% forever.

Assuming 50% tax rate.

**Required:**

- i. Compute the weighted average cost of capital based on the existing capital structured (8Marks)
- ii. Compute the new weighted average cost of capital if the company would raises an additional sh. 2,000,000 debt by issuing 15% debenture. This would result in increasing the expected dividend to sh. 3 and leave the growth unchanged, but the price of share will fall to sh.15 per share. (6 Marks)
- iii. Compute the cost of capital in (ii) above, growth rate increases to 10% (4 Marks)

**QUESTION FOUR (20 MARKS)**

- a. Discuss various factors that influence the payment of dividends by a company (4 Marks)
- b. Write short notes on the following theories of dividends:
  - i. MMs irrelevance theory of dividends (4 Marks)
  - ii. Bird in hand theory (4 Marks)
- c. The following data shows the earnings per share for Ushirika group of companies for the year ended 31 December 2004,k 2005, 2006,2007

<u>Year</u>	<u>earnings per share</u>
2007	0.5
2006	1.75
2005	-1.50
2004	2.00
2003	4.50

**Required:**

- i. If the firm has a policy of paying out 40% of its earnings in cash dividends, calculate the dividends per share for the company for the year 2003-2007 (4 Marks)
- ii. What are the limitations of such a policy adopted by the firm? (4 Marks)

**QUESTION FIVE (20 MARKS)**

- a. A firm is considering a project with the following cashflows:

Year	0	1	2	3	4
Cash flows	-10,000	3000	3000	3000	3000

The above cash inflows are subject to an inflation of 7%. The required rate of return for the company is 19%.

**Required:**

**Determine** (i) the net present value of the project

(ii) the internal rate of return for the project

- b. A company is currently paying a dividend of sh. 2 per share. The dividend is expected to grow at 15% annual rate for three years. Then at 10% rate for the next three years, after which it is expected to grow at a 5% rate forever.

**Required:**

- i. What is the present value for the share if the capitalization rate is 9%.
- ii. If shares will be held for three years, what will be its present value?

