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University Examinations 2013/2014

STAGE III EXAMINATION FOR THE DIPLOMA INFORMATION TECHNOLOGY

CED 0305: FINANCIAL MANAGEMENT

DATE: APRIL 2014 **TIME: 1 $\frac{1}{2}$ HOURS**

INSTRUCTIONS: *Answer all questions*

QUESTION ONE - (30 MARKS)

a) Explain the roles and functions of a finance manager in a firm. (5 marks)

b) Define agency relationship from the context of a public limited company and briefly explain how this arises. (6 marks)

c) Highlight the various measures that would minimize agency problems between the owners and the management. (6 marks)

d) Exactly ten years from now, assume that Kennedy will start receiving a pension of Kshs. 3,000 a year. The payment will continue for sixteen years. How much is the pension worth now, if George's interest rate is 10 per cent? (3 marks)

e) Describe in brief the greatest challenges faced in capital budgeting. (5 marks)

f) A firm finances all its investments by 40 per cent debt and 60 per cent equity. The estimated required rate of return on equity is 20 per cent after taxes and that of the debt is 8 per cent after taxes. The firm is considering an investment proposal costing Ksh 40 million with an expected return that will as forever. What amount in Ksh must the proposal yield per year so that the market price of the share does not change? (show calculations to prove your point) (5 marks)

QUESTION TWO – (20 MARKS)

a) Identify and explain the circumstances under which the Net Present Value (NPV) and the Internal Rate of Return (IRR) methods could rank mutually exclusive projects in a conflicting way. (3 marks)

b) A company is considering the following investment projects.

Cash Flows

(Kshs)

Projects	Co	C_1	C_3	C_4
A	-10,000	10,000		
B	-10,000	7,500	7,500	
C	-10,000	2,000	4,000	12,000
D	-10,000	10,000	3,000	3,000

i. Rank the projects according to each of the following methods: Pay back and Net Present Value (NPV), assuming discount rates of 10% and 30%. (14 marks)

ii. Assuming the projects are independent, which one should be accepted? If the projects are mutually exclusive, which projects is the best? (3 marks)

QUESTION THREE – (20 MARKS)

a) Assume that Safaricom Ltd Company is paying a dividend of Kshs. 2.00 per share. The dividend is expected to grow at a 15 percent annual rate for three years, then at 10 percent for the next three years, after which it is expected to grow at a 5 percent, rate for ever.

i. What is the present value of the share if capitalization rate is 9 percent.(5 marks)
ii. If the share is held for three years, what shall be its present value? (5 marks)

b) Using illustrations, briefly discuss the major sources of business finance. (6 marks)

c) Briefly explain the importance of capital budgeting in a business organization.(4 marks)

QUESTION FOUR – (20 MARKS)

a) List and explain four factors that should be taken into account by a businessman in making the choice between financing by short-term and long-term sources.(8 marks)

b) Outline four limitations of the use of ratios as a basis of financial analysis. (4 marks)

c) ABC Ltd company had the following capital structure as at 30th June 2012

	(Kshs) '000'
Ordinary shares (200,000 shares)	4,000
10% Preference shares	1,000
14% Debentures	3,000

The share of the company sells for shs.20. It is expected that company will pay next year a dividend of shs 2 per share, which will grow at 7 percent forever.

Assume a 50 percent tax rate. You are required to:

i. Computer a weighted average cost of capital based on existing capital structure. (2 marks)

ii. Compute the new weighted average cost of capital if the company raises an additional Ksh 2,000,000 debt by issuing 15 percent debenture. This would result in increasing the expected dividend to shs 3 and leave the growth unchanged, but the price of share will gall to shs.15 per share. (3 marks)

iii. Compute the cost of capital if in (ii) above growth rate increases to 10 percent. (3 marks)