MASENO UNIVERSITY

UNIVERSITY EXAMINATIONS 2016/2017

THIRD YEAR FIRST SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF BUSINESS ADMINISTRATION WITH INFORMATION TECHNOLOGY

CITY CAMPUS – EVENNING

ABA 303: FINANCIAL MANAGEMENT

Date: 12th June, 2017 | Time: 5.30 - 8.30pm

INSTRUCTIONS:

- Answer Question ONE and any other THREE Questions.
- Marks allocated are shown at the end of each question
- Show all your workings
- Do not write on the question paper

QUESTION 1

A CASE STUDY

Choices have Consequences Ltd. (CCL), a manufacturer of edible oils, is contemplating the purchase of a new oil processing machine to replace the existing one. The existing machine was acquired two years ago at a cost of Sh.4, 000,000. The useful life of this machine was originally expected to be five years with no salvage value, but after a critical analysis, the financial analyst has now estimated that the machine will have an economic life of ten years with a salvage value of Sh.500, 000. The new machine is estimated to cost Sh.8, 000,000 and Sh.400, 000 would be incurred in installing the machine. The new machine is estimated to have a useful life of ten years. An expert in asset valuation estimates that the existing machine can be sold at Sh.2, 500,000 in the open market. The new machine is expected to lead to increased sales. To support the increased sales, debtors would increase by Sh.320, 000, stock by Sh.140, 000 and creditors by Sh.300, 000. The estimated profit before depreciation and tax over the next ten years for the two machines is as given below.

Year	**New machine Sh.**	**Old Machine Sh.**
1	350,000	280,000
2	400,000	300,000
3	420,000	320,000
4	410,000	340,000
5	410,000	340,000
6	380,000	320,000
7	380,000	310,000
8	350,000	280,000
9	300,000	260,000
10	280,000	240,000

The company's cost of capital is 14.5 %. Corporation tax applicable is 30%. The company uses the straight-line method of depreciation.

Required:

(i) Using appropriate computations, advice management on the initial investment required for the replacement of the old machine. **(6 marks)**

(ii) Conduct an evaluation of whether it is worthwhile for the company to undertake the replacement of the machine. **(12 marks)**

(iii) Advice management on the proposal based on your answer in (ii) above. **(2 marks)**

(iv) Comment on any other qualitative considerations that could influence this decision. **(5 marks)**

QUESTION 2

a) For the past 5 years, the market price per share (MPS) and Dividend per share (DPS) for XYZ Ltd were as follows:

	2009	2010	2011	2012	2013
	Shs.	Shs.	Shs.	Shs.	Shs.
MPS as at 31st Dec	40	45	53	50	52
DPS for the year	-	3	4	3	-

An investor has approached you as a securities analyst and contracted you to advice on the shareholders percentage yield for each of the years involved.

Required: Using relevant computations, advise the investor. **(5 Marks)**

b) The following is the capital structure of XYZ Ltd as at 31/12/2002.

	Kshs. Millions
	400
Ordinary share capital Kshs.10 par value	200
Retained earnings	100
10% preference share capital Kshs.20 par value	200
12% debenture Sh.100 par value	900

Additional information:

1. Corporate tax rate is 30 %.
2. Preference shares were issued 10 years ago and are still selling at par value MPS = Par value.
3. The debenture has a 10 year maturity period. It is currently selling at Kshs.90 in the market.
4. Currently the firm has been paying dividend per share of Kshs.5. The DPS is expected to grow at 5% p.a. in future. The current MPS is Kshs.40.

Required:

a) Determine the WACC of the firm and comment on its appropriateness as discounting rate in a market where cost of money is skyrocketing. **(8 marks)**

b) Explain why market values and not book values are used to determine the weights. **(2 marks)**

QUESTION 3

a) Explain the implications of the following concepts/theories as used in financial management:

i. Traditional theory of capital structure **(2 marks)**

ii. Trade off theory of capital structure **(2 marks)**

iii. Net operating Income **(2 marks)**

iv. Corporate governance **(2 marks)**

v. Agency problems **(2 marks)**

b) The financial manager of ABC Ltd expects earnings before interest and taxes of Kshs 50,000 in the current financial year and pays interest of 10% as long-term loan of Kshs 200 000. The company has 100 000 ordinary shares and the tax rate is 30%. The finance manager is currently examining 2 scenarios.

- A case where EBIT is 25% less than expected.
- A case where EBIT is 25% more than expected.

Required:

Compute the EPS under the 3 cases and analyze the degree of financial gearing for both scenarios 1 and 2. **(5 marks)**

QUESTION 4

a) The executive director of Pesa Ltd has circulated the following information as part of board paper:

Pesa Ltd.

Financial Performance for the year ended 31 March:

		2013	**2012**
i)	Return on investment	12%	10%
ii)	Gross profit on sales	25%	20%
iii)	Number of days credit given	30 days	45 days
iv)	Administrative cost of sales	7%	10%

Required:

Brief report on each of the above 4 ratios indicating the reservation, if any, you may have on judging them as improvement in performance. **(5 Marks)**

b) Given that the expected market return of a security is 15%, the risk-free rate is 5.7% and the security's beta is 1.3. Calculate the expected return of the security using the Capital Asset Pricing Model (CAPM) and comment on the feasibility of the investment given that the investor's required rate of return is 10%. **(5 Marks)**

c) Discuss any FIVE factors that govern the pattern of capital structure of a company. **(5 Marks)**

QUESTION 5

a) Discuss the reasons motivating the increasing interest in corporate governance. **(5 Marks)**

b) John Litner, a financial analyst for Carroll Company, has prepared the following sales and cash

Disbursement estimates for the period February-June of the current year.

Month	**Sales (Kshs '000')**	**Cash Disbursement (Kshs '000')**
February	500	400
March	600	300
April	400	600
May	200	500
June	200	200

John notes that historically, 30 percent of sales have been for cash. Of credit sales, 70 percent are collected 1 month after the sale, and the remaining 30 percent are collected 2 months after the sale. The firm wishes to maintain a minimum ending balance in its cash account of Ksh.25, 000. Balances above this amount would be invested in short-term government securities (marketable securities), whereas any deficits would be financed through short-term bank borrowing (notes payable). The beginning cash balance at April 1 is Ksh.115, 000.

Required:

i) Prepare a cash budget for April, May and June. **(8 Marks)**

ii) How much financing, if any, at a maximum would Carroll Company require to meet its obligations during this 3-month period? **(2 Marks)**