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**University Examinations 2014/2015**

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

**BFC 3226 – INTRODUCTION TO FINANCIAL MANAGEMENT**

**DATE: APRIL 2015 TIME: HOURS**

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

**QUESTION ONE**

1. What is agency problem, how does it arise and how is it resolved? (10 Marks)
2. The following is the capital structure of Mbote Ltd.

Shs.

Ordinary shares of Shs. 10 each 800,000

10% preference shares of 10 each 700,000

12% debentures 400,000

14% loan 500,000

2,400,000

**Additional Information**

1. Ordinary shares dividend is paid at the rate of 7%
2. The market value of ordinary shares is shs. 22
3. Market value of preference share is 24 and debentures shs. 98
4. The growth rate for the company is 4%
5. Corporation tax is at the rate of 30%

**Required:**

1. Determine the weighted average cost of capital (WACC) using the market value weights.

(14 Marks)

1. Discuss four factors that influence the capital structure of a firm. (6 Marks)

**QUESTION TWO (20 MARKS**)

1. Discuss four factors that influence the cost of capital in any given economy. (4 Marks)
2. Describe four practical considerations that directors of a company should take into account in determining a dividend policy. (8 Marks)
3. Financial management activities are the back bone of any business organization. Discuss.

(8 Marks)

**QUESTION THREE (15 MARKS)**

1. Briefly explain the approaches that could be used by a company to finance its working capital requirements. (6 Marks)
2. Geda Ltd owns a hardware stores which keeps cement and iron sheets, every year he purchases 100,000 bags of cement and 100,000 pieces of iron sheet each of these items on average costs shs. 500 per piece, the cost of holding each piece in store per annum is shs. 50. The cost of reordering and delivery of a batch is shs. 25,000 regardless of the size of the order.

**Required;**

1. What is the most economical inventory order that will minimize his inventory management cost? (5 Marks)
2. The total cost of inventory management on the assumption that usage is predictable and there is instantaneous replenishment of stock. (5 Marks)
3. What assumptions did you make in your calculations? (4 Marks)

**QUESTION FOUR (20 MARKS)**

A firm is considering the following investment projects

Project Initial cost Expected annual cash flows Project life (years)

Shs ‘000’ Shs’000’

1 50,000 20,000 4

2 100,000 30,000 5

3 120,000 25,000 8

4 180,000 40,000 6

5 200,000 40,000 8

The firms cost of capital is 10%

**Required:**

1. To rank the investment project using Net Present Value and profitability index criteria.

(12 Marks)

1. Suppose the firm’s capital budget is shs. 400,000,000, which projects would be fully undertaken using each of the two criteria above. (4 Marks)
2. Explain the reasons why it may be cheaper for a firm to raise debt finance compared to equity finance. (4 Marks)

**QUESTION FIVE**

1. Describe the various ways a firm can use to improve its negative working capital.(6 Marks)
2. Chaka Enterprises is considering buying a new machine at a cost of sh 30 million with an economic life of 6 years and a residual value of 2 million. The corporation tax rate is 30% and no investment allowance is granted. The expected net profit before tax and depreciation are;

Year Profits

“000”

1. 8,000
2. 10,000
3. 12,000
4. 12,000
5. 13,000
6. 10,000

The company uses straight line method of depreciation.

**Required;**

1. Calculate the expected cash inflows expected for each of the six years. (6 Marks)
2. Calculate the net present value (NPV) at 12% discount rate and recommend whether the machine should be purchased. (8 Marks)