TECHNICAL UNIVERSITY OF MOMBASA

SCHOOL OF BUSINESS STUDIES

DEPARTMENT OF ACCOUNTING AND FINANCE

UNIT CODE: BMF 5101 UNIT TITLE: FINANCIAL MANAGEMENT

SERIES: SEP/DEC SERIES

TERM PAPER ONE

TIME: 3 HOURS

INSTRUCTIONS: ANSWER QUESTION 1 AND ANY OTHER THREE QUESTIONS

QUESTION ONE

(a) Explain the meaning of the term "cost of capital" and explain why a company should Calculate its cost of capital with care. **(4 marks)**

(b) Identify and briefly explain three conditions which have to be satisfied before the use of the weighted average cost of capital (WACC) can be justified. **(6 Marks)**

(c) Biashara Ltd. has the following capital structure:

	Shs '000
Long term debt	3,600
Ordinary Share Capital	6,500
Retained earnings	4,000

The finance manager of Biashara Ltd. has a proposal for a project requiring Sh.45 million.

He has proposed the following method of raising the funds:

i. Utilize all the existing retained earnings

ii. Issue ordinary shares at the current market price.

iii. Issue 100,000 10% preference shares at the current market price of Sh.100 per Share which is the same as the par value.

iv Issue 10% debentures at the current market price of Sh.1, 000 per debenture.

Additional information:

1. Currently, Biashara Ltd. pays a dividend of Sh.5 per share which is expected to grow at the rate of 6% due to increased returns from the intended project. Biashara Ltd.'s Price /earnings (P/E) ratio and earnings per share (EPS) are Sh 5 and Sh 8 respectively.

2. The ordinary shares would be issued at a floatation cost of 10% based in the market price.

3. The debenture par value is Sh.1, 000 per debenture.

4. The corporate tax rate is 30%.

Required:

Biashara Ltd.'s weighted average cost of capital (WACC). **(15 Marks)**

Question 2

Although profit maximization has long been considered as the main goal of a firm, Shareholder wealth maximization is gaining acceptance amongst most companies as the Key goal of a firm.

Required:

(i) Distinguish between the goals of profit maximization and shareholder wealth Maximization. (8 Marks)

(ii) Explain three limitations of the goal of profit maximization. (6 Marks)

(b) Explain three key roles of a capital markets regulator in your country. (6 Marks)

(c) Highlight the importance of the following terms in investment appraisal:

(i) Internal rate of return (IRR) (3 Marks)

(ii) Payback period. (2 Marks)

Question 3

Mwongozo Limited has approached you for advice on an equipment to be purchased for use in a five year project.

The investment will involve an initial capital outlay of Shs. 1.4 million and the expected cash flows are given below:

Year	Cash inflows	Cash outflows
	Shs.	**Shs.**
1	800,000	65,000
2	750,000	80,000
3	900,000	50,000
4	1,200,000	55,000
5	1,100,000	70,000

The equipment is to be depreciated on a straight line basis over the duration of the Project with a nil residual value.

The cost of capital and the tax rate are 12% and 30% respectively.

Required:

The net present value (NPV) of the investment. **(10 marks)**

(b) Beta Leather Company Limited is considering acquiring an additional leather processing machine at a cost of Shs. 18 million. The machine is expected to generate after tax savings of Sh. 3,600,000 per year over an eight year period.

The policy of the company is to finance capital investments with a 50% debt. The company is able to borrow Shs. 9 million at 10% per annum to finance the purchase of the machine in part. The loan principal is to be paid in equal annual instalments of Shs. 1,125,000 payable at the year end. The company's required rate of return is 13% and the company is in the 30% tax bracket.

Required:

(i) The net present value (NPV) of the machine if fully financed by equity to acquire the machine. Advise the management on whether to finance it by equity or loan. **(5 marks)**

(ii) The net present value (NPV) of „the machine with part debt financing. Would your advice to the management in (b) (i) above change? **(10Marks)**

Question 4

a) In the context of capital budgeting, explain the difference between “hard rationing” and “soft rationing”. (**5Marks)**

b) If you deposit Sh. 100,000 in a bank, which was paying a 15% rate of interest on a ten-year time deposit, how much would the deposit grow at the end of ten years? **(5Marks)**

c) Suppose that a firm deposits Sh. 50,000 at the end of the year for four years at 8 percent rate r of interest. How much would this annuity account at the end of the fourth year?(**5Marks)**

d) Write briefly on the following Capital Structure theories:-

i) The Trade-off Theory **(4Marks)**

ii) Information costs theories **(6Marks)**

Questions 5

(a) What is meant by the term “matching approach” in financing fixed and current assets? **(5Marks)**

(b) Briefly explain how the Miller-Orr cash management model operates.**(5Marks)**

(c) Dawamu Ltd., which operates in the retail sector selling a single product, is considering

a change of credit policy which will result in an increase in the average collection period of debts from one to two months. The relaxation of the credit policy is expected to produce an increase in sales in each year, amounting to 25% of the current sales volume. The following information is available:

1. Selling price per unit of product – Sh.1, 000.
2. Variable cost per unit of product – Sh.850.
3. Current annual sales of product – Sh.240, 000,000
4. Dawamu Ltd. required rate of return on investments is 20%.
5. It is expected that increase in sales would result in additional stock of Sh.10, 000,000 and additional creditors of Sh.2, 000,000.

Required:

Advise Dawamu Ltd. on whether or not to extend the credit period offered to customers, if:

(i) All customers take the longer credit period of two months. **(7 marks)**

(ii) Existing customers do not change their payment habits and only the new customers will take a full two month's credit. **(8Marks**