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 TWO

TIME: 3 HOURS

INSTRUCTIONS: ANSWER QUESTION 1 AND ANY OTHER THREE QUESTIONS

QUESTION ONE

Prime shoes Ltd. Manufacturers various types of Shoes. The Company is now considering its working capital policy for 2016.

Fixed assets are projected at sh.30million and current liabilities at sh.27 million. Sales and Earnings before interest and taxes (EBIT) are partially a function of the company's investment in working capital particularly its investment in stocks and debtors. Prime Shoe Ltd**.** is considering the following three different working capital investment policies:

Aggressive policy : Small investment in current assets

Conservative policy : Large investment in current assets

Moderate policy : moderate investment in current assets.

The following information relates to three policies:

Policies	**Aggressive**	**Moderate**	**Conservative**
Investment in:	**Sh: '000'**	**Sh: '000'**	**Sh: '000'**
Current Assets	42,000	45,000	48,000
Project sales	88,500	90,000	91,500
EBIT	8,500	9,000	9,150

Required.

a) Determine the working capital investment policies for each of the following:

i) Rate of return on total assets. **(4marks)**

ii) Net working capital **(4Marks)**

iii) Current ratio **(4Marks)**

iv) Operating margin **(4marks)**

v) Current assets turn over **(4Marks)**

b) Describe the profitability – risk tradeoffs of these three policies. **(5marks)**

QUESTION TWO

(a) Describe in brief the greatest difficulties faced in capital budgeting in the real world. **(10Marks)**

(b) Mumias Milling Company purchased a grinder 3 years ago at a cost of Sh.3.5 million.

The grinder had a life of 8 years at the time of purchase. It is being depreciated at 15% per year on a declining balance. The company is considering replacing it with a new grinder costing Sh. 7 million with an expected useful life of 5 years.

Due to increased efficiency, the profit before depreciation is expected to increase by Sh, 400,000 a year. The old and new grinders will now be depreciated at 2% per year on a declining balance for tax purposes. The Salvage value of the new grinder is estimated at Sh.210, 000. The market value of the old grinder, today, is Sh.40 million.

The salvage value of the new grinder is estimated at Sh.210, 000. The market value of the Old grinder, today, is Sh.4 million. It is estimated to have a zero salvage value after 5 years.

The company's tax is 30% and the after tax cost of capital is 12%.

Required

Should the new grinder be bought? Explain. **(15 marks)**

(Total: 25 marks)

QUESTION THREE

In a company, an agency problem may exist between management and shareholders on one hand and the debt holders (creditors and lenders) on the other because management and Shareholders, who own and control the company have the incentive to enter into transactions that may transfer wealth from debt holders to shareholders. Hence the need for agreements by debt holders in leading contracts.

Required:

(a) State and explain any four actions or transactions by management and shareholders that could be harmful to the interests of debt holders (sources of conflict) **(8Marks)**

(b) Write short notes on any four restrictive covenants that debt holders may use to protect their wealth from management and shareholders raids. **(7Marks)**

(c) List and explain five factors that should be taken into account by a businessman in marking the choice between financing by short term and long term sources**. (10 Marks)**

QUESTION FOUR

Rafiki Hardware Tools Company Limited sells plumbing fixtures on terms of 2/10 net 30. Its financial statements for the last three years are as follows:

	2013	**2014**	**2015**
	Sh'000'	**Sh '000'**	**Sh'000'**
Cash	30,000	20,000	5,000
Receivables	200,000	260,000	290,000
Inventory	400,000	480,000	600,000
Net fixed assets	800,000	800,000	800,000
	1,430,000	**1,560,000**	**1,695,000**
Accounts payables	230,000	300,000	380,000
Accruals	200,000	210,000	225,000
Bank loan, Short term	100,000	100,000	140,000
Long term debt	300,000	300,000	300,000
Common stock	100,000	100,000	100,000
Retained earnings	500,000	550,000	550,000
	1,430,000	**1,560,000**	**1,695,000**
Additional information			
Sales	4,000,000	4,300,000	3,800,000
Cost of goods sold	3,200,000	3,600,000	3,300,000
Net Profit	300,000	200,000	100,000

Required:

(a) For each of the three years, calculate the following ratios:

Acid test ratio, Average collection period, inventory turnover, Total debt/equity, Net Profit margin and return on assets. (12marks)

b) Mabokoni Ltd wishes to expand its output by purchasing a new machine worth 170,000and installation costs are estimated at 40,000/= in the fourth year, this machine will call for an overhaul to cost 80,000/=. Its expected inflows are:

Year	Shs.
1	60,000
2	72,650
3	35,720
4	48,510
5	91,630
6	83,715

This company can raise finance to purchase machine at 12% interest rate.

Required

i) Compute NPV and advise management accordingly. **(8 Marks)**

ii) Discuss the advantages and limitation of this approach **(5 marks).**

QUESTION FIVE

Clean Wash Ltd. manufactures and markets automatic washing machines. Among the hundreds of components which it purchases each year from external suppliers for assembling into the finished articles are drive belts, of which it uses 400,000 units per annum. It is considering converting its purchasing, delivery and stock control of this item to a Just-in-Time (JIT) system. This will raise the number of orders placed but lower the administrative and other costs of placing and receiving orders. If successful, this will provide the model for switching most of its inwards supplies. Into this system.

Details of current and proposed ordering and carrying costs are given below:

	Current	**Proposed**
Ordering cost per order	Sh.10, 000	Sh.2, 500
Purchase cost per item	Sh.25	Sh.25
Inventory holding cost	20%	20%
(as a percentage of the purchase cost)		

To implement new arrangements will require a one-off reorganization costs estimated at Sh.140, 000 which will be treated as revenue item for tax purposes. The rate of corporation tax is 32.5% and Clean Wash Ltd. can obtain finance at an effective cost of 18%. The life span of the new system is 8 years

Required

(a) (i) The economic order quantity with current and proposed arrangements. **(7Marks)**

(ii) New Present Value (NPV) of the new arrangement. Is the new arrangement worthwhile? **(10marks)**

(b) Briefly explain the nature and objectives of JIT purchasing arrangements concluded between components users and suppliers. **(8marks)**

(Total: 25 marks)