TECHNICAL UNIVERSITY OF MOMBASA

School of Business

DEPARTMENT OF ACCOUNTING AND FINANCE

UNIVERSITY EXAMINATIONS FOR DEGREE IN

MASTERS OF BUSINESS ADMINISTRATION
MASTERS OF SCIENCE IN HUMAN RESOURCES MANAGEMENT
MASTERS OF SCIENCE IN PROCUREMENT AND SUPPLY CHAIN MANAGEMENT
MASTERS OF SCIENCE IN FINANCE

BFI 5101: FINANCIAL MANAGEMENT

MAIN EXAMINATIONS
SERIES: APRIL 2022
TIME: 3 HOURS

INSTRUCTIONS:
Answer Question **ONE (Compulsory)** and any other **THREE** questions
This paper consists of Four printed pages

QUESTION ONE (Compulsory)

Bakora enterprises is considering the introduction of a new product which will have a life of five years. Two alternatives of promoting the product have been identified:

Alternative 1:

This will involve employing a number of agents. An immediate expenditure of Ksh. 5,000,000 will be required to advertise the product. This will produce net annual cash inflows of Ksh. 3,000,000 at the end of the each of the subsequent five years. However, the agents will have to be paid Ksh. 500,000 each year. On termination of the contract, the agents will have to be paid a lump sum of Ksh. 1,000,000 at the end of the fifth year.

Alternative 2

Under this alternative, the firm will not employ agents but will sell directly to the consumers. The initial expenditure on advertising will be Ksh. 2,500,000. This will bring in cash at the end of each year of Ksh. 1,500,000. However, this alternative will involve out-of-pocket costs for sales administration to the extent of Ksh. 500,000. The firm also proposes to allocate fixed costs worth Ksh. 200,000 per year to this product if this alternative is pursued.

Additional Information

The capital structure of Bakora enterprises is comprised of ordinary shares worth Ksh 10,000,000, 10% debentures worth 8,000,000 and 12% Preference shares worth Ksh 7,000,00. Ordinary shares have a current dividend of Ksh 8.84 per share with a market price of Ksh 40. The dividends are expected to grow at a constant rate of 9%. The company's preference share is usually sold at 80 while 10% debentures is usually sold at par. The corporation tax is charged at a rate of 30%.

Required:

a) Estimate Bakora enterprises' overall cost of capital (9 Marks)

b) Advise the management as to the method of promotion to be adopted. You may assume that the best analysis methods are Net present value (NPV) and profitability Index (PI) (15 Marks)

c) Capital budgeting requires the projection of cash inflow and outflow of the future. The future is always uncertain, estimate of demand, production, selling price, cost and so on, cannot be exact. Briefly describe any FOUR evaluation methods that may be applied in respect of risk and uncertainty in capital budgeting. (16 Marks)

QUESTION TWO

a) Amaco Ltd. needs Ksh 3,000,000 for the installation of a new factory. The new factory expects to yield annual earnings before interest and tax (EBIT) of Ksh 500,000. In choosing a financial plan, Amaco Ltd., has an objective of maximizing earnings per share (EPS). The company proposes to issuing ordinary shares and raising debt of Ksh 300,000 and Ksh 1,000,000 of Ksh 1,500,000. The current market price per share is Ksh 250 and is expected to drop to Ksh 200 if the funds are borrowed in excess of Ksh 1,200,000. Funds can be raised at the following rates.
   - up to Ksh 3,00,000 at 8%
   - over Ksh 3,00,000 to Ksh 15,000,00 at 10%
   - over Ksh 15,00,000 at 15%

   The corporation tax rate is 30%

   Required

   Advise Amaco Ltd on the best financing alternative on the basis of traditional approach (15 Marks)

b) There are two firms 'A' and 'B' which are exactly identical except that A does not use any debt in its financing, while B has Ksh 250,000, 6% Debentures in its financing. Both the firms have earnings before interest and tax of Ksh 75,000 and the equity capitalization rate is 10%.

   Required

   Assuming the corporation tax is 25%, calculate the value of the firm using MM approach. (5 Marks)

QUESTION THREE

Financial management experts rely on the financial statements to make some critical decisions about the company. The financial performance of the organization may be benchmarked upon the industry performance. This requires some degree of skill by the financial analysts.

Required

a) Explain the process of financial statement analysis (8 marks)

b) The following data was extracted from the financial statements Bora Manufacturing Ltd for the year ended 31 December 2016.

Current ratio	1.6:1
Debt-asset ratio	0.6:1
Inventory turnover	6 times
Total assets turnover	1.2 times
Average collection period	40 days
Number of days in a year	365
Additional information	**Ksh**
Cash at hand	137,500
Cash in bank	38,500
Trade payables	110,000
Equity capital	550,000
Total sales	1,980,000
Credit Sales	803,000

Required:

Prepare a Statement of financial position as at 31 December 2016 (12 marks)

QUESTION FOUR

Jamaica limited is interested in assessing the cash flows associated with the replacement of an old machine by a new machine. The old machine bought a few years ago has a book value of Ksh. 900,000 and it can be sold for Ksh. 900,000. It has a remaining life of five years after which its salvage value is expected to be nil It is being depreciated annually at the rate of 20%using reducing balance method. The new machine costs Ksh. 4,000,000. It is expected to fetch Ksh 2,500,000 after five years when it will no longer be required. It will be depreciated annually at the rate of 33 $^{1}/_{3}$ % using reducing balance method. The new machine is expected to bring a saving of Ksh 1,000,000 in manufacturing costs. Investment in working capital would remain unaffected. The tax rate applicable to the firm is 30%.

Required:

a) Find out the relevant cash flow for this replacement decision. Ignore capital gain taxes. (8 Marks)

b) Estimate the Internal Rate of Return (IRR) of the investment (12 Marks)

QUESTION FIVE

a) Financial decision is one of the integral and important parts of financial management in any kind of business concern. A sound financial decision must consider the board coverage of the financial mix (Capital Structure), total amount of capital (capitalization) and cost of capital (Ko). Capital structure is one of the significant things for the management, since it influences the debt equity mix of the business concern, which affects the shareholder's return and risk. Hence, deciding the debt-equity mix plays a major role in the part of the value of the company and market value of the shares. The debt equity mix of the company can be examined with the help of leverage.

Clearly explain any Five features that distinguishes operating leverage from financial leverage (10 marks)

b) Dividend decision of the business concern is one of the crucial parts of the financial manager, because it determines the amount of profit to be distributed among shareholders and amount of profit to be treated as retained earnings for financing its long-term growth. Every divided decision model is based upon some assumptions. Describe the assumptions of the following models

   i. Modigilliani and Miller Approach (5 marks)
   ii. Walter's Model (5 Marks)