The Co-operative University of Kenya

END OF SEMESTER EXAMINATION DECEMBER-2016

EXAMINATION FOR THE DEGREE OF BACHELOR OF CO-OPERATIVE BUSINESS/ BACHELOR OF COMMERCE
(BCOB YR III SEM I/ II/ BCOM YR II SEM I)

UNIT CODE: HCOB 2305/ HBC 2202

UNIT TITLE: FINANCIAL MANAGEMENT I/ INTRODUCTION TO FINANCIAL MANAGEMENT

DATE: 15TH DECEMBER, 2016 **TIME: 2:00 PM – 4:00 PM**

INSTRUCTIONS:

- Answer question **ONE (compulsory)** and any other **TWO** questions

QUESTION ONE

a) Distinguish between the following terms as discussed in financial management:-
   i) Weighted average cost of capital and marginal cost of capital. (4 Marks)
   ii) Finance lease and operating lease. (4 Marks)

b) Kibibi PLC is contemplating to invest in a project to boost their income. The following information relates to the two mutually exclusive projects that the firm can invest in:

	Project A	Project B
Initial Investment	Sh 10 Million	Sh 12 Million
Cash inflows	Sh 3.6 Million per year for 6 years	Sh 4.0 Million per year for 3 years

The two project are subject to straight line of depreciation and the corporation tax is 30%. The return for each project is 15%.

Required

Advice the Management of Kibibi PLC on which Project to invest in under each of the following appraisal method (give reasons on each choice):-
   i. Payback period (3 Marks)
   ii. Net Present Value (3 Marks)
   iii. Internal Rate of Return (4 Marks)

c) Discuss three measures that would minimize agency problems between the owners and the management. (6 Marks)

d) Mr. Simba has just retired and he has been paid a handsome pension. A local bank is aware of this and the Bank Manager has advised Mr. Simba to invest a certain amount of money at 16%. The bank promises to pay him, Kes 2.5Million after five years. Advice Mr. Simba on the amount of money he is required to invest now by the bank in order to achieve the bank promise. (6 Marks)

QUESTION TWO

a) Explain why there is preference for money now rather than in future. (4 Marks)

b) Mr. Deni wishes to borrow Kes 1 Million from ABC Bank Ltd. The loan will be repaid for 5 years with an interest rate of 12% per annum compounded quarterly. Prepare an amortization schedule, showing the total interest payable. (10 Marks)

c) After clearing training and obtaining a Degree in Commerce, you successfully got a job as a Finance Assistant in CUK Sacco Ltd. The gross salary is Kes. 25,000 and due to your training, you know that if you invest in a savings account, you will have enough money for your dream house. You opened a savings account in Okoa Nyumba Bank Ltd and you deposit Kes 120,000 every year end and will continue to save for the next 10 years. If your dream house will cost Kes 2 million after 10 years;
Will you have met the target? (6 Marks)

QUESTION THREE

a) Discuss TWO factors that determine the cost of finance to a business. (4 Marks)

b) Future Investments Ltd. wishes to raise funds amounting to Sh.10 million to finance a project in the following manner:

Sh.6 million from debt; and

Sh.4 million from floating new ordinary shares.

The present capital structure of the company is made up as follows:

1. 600,000 fully paid ordinary shares of Sh.10 each
2. Retained earnings of Sh.4 million
3. 200,000, 10% preference shares of Sh.20 each.
4. 40,000 6% long term debentures of Sh.150 each.

The current market value of the company's ordinary shares is Sh.60 per share. The expected ordinary share dividends in a year's time are Sh.2.40 per share. The average growth rate in both dividends and earnings has been 10% over the past ten years and this growth rate is expected to be maintained in the foreseeable future.

The company's long term debentures currently change hands for Sh.100 each. The debentures will mature in 100 years. The preference shares were issued four years ago and still change hands at face value.

Required:

i) Compute the component cost of:

- Ordinary share capital (4 Marks)
- Debt capital (3 Marks)
- Preference share capital. (3 Marks)

ii) Compute the company's current Weighted Average Cost of Capital. (6 Marks)

QUESTION FOUR

a) Highlight two reasons why Venture capital is not a common source of funds in Kenya (2 Marks)

b) The following information was extracted from the financial statements of Kikambala PLC:

	Kes
Issued Share capital: 100,000 Ordinary shares of Sh 10 each fully paid	1,000,000
Issued Loan capital: 10% Loan stock	1,500,000
Reserves: Capital	2,000,000
Revenue	8,000,000

Profit for the year after income tax but before payment of loan stock interest and dividends is Kes 600,000.

Ordinary dividend rate is 40%.

The current market value of ordinary shares is Kes 36 and loan stock is selling at Kes 90 per Kes 100 units.

Required

Calculate the following, briefly explaining the meaning of each:-

i) Return on capital employed (3 Marks)

ii) Earnings per share (3 Marks)

iii) Price Earnings ratio (3 Marks)

iv) Dividend Payout ratio (3 Marks)

v) Gearing ratio (3 Marks)

vi) State THREE limitations of the above ratios when used in decision making. (3 marks)

QUESTION FIVE

Shirika Ltd has four categories of debtors; A, B, C and D. The average collection period and the percentage of bad debts for each category of debtors is shown below:

Category	**Average collection period (days)**	**Bad debts (%)**
A	15	0.5
B	20	2.5
C	30	5.0
D	40	9.5

The profit per unit of the company's product is shown below:

	Shs.	**Shs.**
Selling price		25
Less: materials	10	

Wages	9.5	
Variable costs	3	
Fixed costs	0.5	23
Profit		2

The company has the opportunity to increase its sales by Shs. 10,000,000 per annum, split between categories C and D of the debtors in the proportion 2:3 respectively. The company borrows at an interest rate of 11.5% per annum (assume a year has 365 days).

Required:

i) Calculate the additional contribution to be realized from the increased sales. (8 Marks)

ii) Calculate the bad debts expense arising from the increased sales for each category of debtors. (4 Marks)

iii) Compute the net profit or loss realized from the increased sales. (8 Marks)