KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2014/2015

DIGITAL SCHOOL OF VIRTUAL AND OPEN LEARNING

SECOND SEMESTER EXAMINATION FOR DIPLOMA IN BUSINESS MANAGEMENT

BAC 030: FUNDAMENTALS OF FINANCIAL MANAGEMENT

DATE: Thursday, 30th April 2015 **TIME:** 8.00 a.m. – 10.00 a.m.

INSTRUCTIONS:

- **Answer ALL questions**
- **Marks allocated are shown at the end of each question.**

Question One

(a) Explain why the weighted average cost of capital of a firm that was relatively more debt capital is generally lower than that of a firm that uses relatively less debt capital. (5 marks)

(b) The total of the net working capital and fixed assets of Faida Ltd. as at 30th April 2014 was Kshs 100 Million. The company wishes to raise additional funds to finance a project within the next one year jin the following manner;

Kshs 30 M from debt

Kshs 20 M from selling new ordinary shares

The following items make up the equity of the company:

	Kshs 000
3M fully paid up ordinary shares	30,000
Accumulated retained earnings	20,000
1M 10% preference shares	20,000
0.2M 6% long term debentures	30,000

The current market values of the company's ordinary shares is Kshs 30. The expected dividend on ordinary shares by 30th April 2015 is forecast is Kshs 1.20 per share. The average growth rate in both earnings and dividends has been 10% over the last 10 years and this growth is expected to be maintained into the foreseeable future. The debentures of the company have a face value of Kshs 150. However they currently sell for Kshs 100. The debentures will mature in 100 years. The preference shares were issued four years ago and still sell at this face value. Assume a tax rate of 30%.

Required

(i) The effective cost to the company of:

(a) Debt capital (2 marks)

(b) Preference share capital (2 marks)

(c) Ordinary share capital (2 marks)

(ii) The company's existing weighted average cost of capital. (5 marks)

(iii) The company's marginal cost of capital if it raised the additional Kshs 50M as intended. (4 marks)

Question Two

J. Korir was recently appointed to the post of investment manager of Makao Ltd. a quoted company. The company has raised Kshs 8M through a rights issue. J. Korir has the task of evaluating two mutually exclusive projects with unequal economic lives. Project X has 7 years and project Y has 4 years of economic life. Both projects are expected to have a zero salvage value. Their expected cash flows are as follows:

Year	X Cash flows Kshs 000	Y Cash flows Kshs 000
1	2,000	4,000
2	2,200	3,000
3	2,080	4,800
4	2,240	800
5	2,760	–
6	3,200	–
7	3,600	–

The company's cost of capital is 20%.

Required

(a) The Net Present Value of each project. (6 marks)

(b) The IRR of each project (Re discount cash flows at 24% for project X and 25% for project Y). (6 marks)

(c) Briefly comment on your results in (a) and (b) above. (3 marks)

(d) Identify the main disadvantages of the NPV method. (5 marks)

Question Three

(a) Identify any four factors that have limited the development of the venture capital market in Kenya. (4 marks)

(b) Distinguish between compounding and discounting of cash flows. (3 marks)

(c) Define the term agency relationship in the context of corporate management. (4 marks)

(d) An investor wants to purchase an annuity of Kshs. 100,000 for the next three years. If a bank is prepared to pay an interest rate of 6% p.a. how much should be invested today? (4 marks)

Question Four

(a) Identify the main advantages of budgeting to organizations. (4 marks)

(b) State and explain the assumptions underlying the cost volume profit analysis. (5 marks)

(c) A company makes a single product with a sales price of Kshs 10 and a variable cost of Kshs 6. Fixed costs are Kshs. 60,000 p.a.

Required

Calculate;

(i) The number of units to break even. (2 marks)

(ii) The sales at the break even point. (2 marks)

(iii) Number of units to be sold to achieve a profit of Kshs 20,000 p.a. (2 marks)