KIBABII UNIVERSITY COLLEGE
(A Constituent College of MasindeMuliro University of Science Technology)
P.O. Box 1699-50200 Bungoma, Kenya
Tel. 020-2028660/0708-085934/0734-831729
E-mail: enquiries@kibabiiuniversity.ac.ke

UNIVERSITY EXAMINATION 2013/2014

MASTER OF BUSINESS ADMINISTRATION

DEPARTMENT OF BUSINESS

UNIT CODE: MBA 808

UNIT TITLE: FINANCIAL MANAGEMENT

DATE: 13TH AUGUST, 2014 **TIME: 5:00P.M.-8:00P.M.**

INSTRUCTIONS TO CANDIDATES

ANSWER QUESTION ONE AND ANY OTHER TWO QUESTIONS

QUESTION ONE

P. Muli was recently appointed to the post of investment manager of Masada Ltd. a quoted company. The company has raised Sh.8,000,000 through a rights issue.

P. Muli 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 zero salvage value. Their expected cash flows are as follows:

Project	**X**	**Y**
Year	**Cash flows (Sh.)**	**Cash flows (Sh.)**
1	2,000,000	4,000,000
2	2,200,000	3,000,000
3	2,080,000	4,800,000
4	2,240,000	800,000
5	2,760,000	-
6	3,200,000	-
7	3,600,000	-

The amount raised would be used to finance either of the projects. The company expects to pay a dividend per share of Sh.6.50 in one year's time. The current market price per share is Sh.50. Masada Ltd. expects the future earnings to grow by 7% per annum due to the undertaking of either of the projects. Masada Ltd. has no debt capital in its capital structure.

Required:

(a) The cost of equity of the firm. (3 marks)

(b) The net present value of each project. (6 marks)

(c) The Internal Rate of return (IRR) of the projects. (Rediscount cash flows at 24% for project X and 25% for Project Y). (6 marks)

(d) Briefly comment on your results in (b) and (c) above. (2 marks)

(e) Identify and explain the circumstances under which the Net Present Value (NPV) and the Internal Rate of Return (IRR) methods could rank mutually exclusive projects in a conflicting way. (5 marks)

(Total: 22 marks)

QUESTION TWO

a) A firm may adopt a conservative policy or an aggressive policy in financing its working capital needs.

Clearly distinguish between:

i) A conservative policy and (3 marks)

ii) An aggressive policy. (3 marks)

b) The following information relates to the current trading operations of MajiMazuri Enterprises (MME) Ltd:

- Level of annual sales (uniform per month) - Sh.600 million

- Contribution to sales ratio - 15%
- Debtors recovery period:

Percentage of debtors	Average collection period (days)
25	32
60	50
15	80

- Credit sales as a percentage of total sales - 60%
- Required return on investments - 15%
- Level of bad debts (2% of credit sales) - Sh.7,200,000

The management of the company is in the process of reviewing the company's credit management system with the objectives of reducing the operating cycle and improving the firm's liquidity. Two alternative strategies, now being considered by management are detailed as follows:

Alternative A: change of credit terms:
The proposal requires the introduction of a 2% cash discount which is expected to have the following effects:

- 50 per cent of the credit customers (and all cash customers) will take advantage of the 2 per cent cash discount.
- There will be no change in the level of annual sales, the percentage of credit sales and the contribution of sales ratio.
- There will be savings in collection expenses of Sh.2,750,000 per month.
- Bad debts will remain at 2 per cent of total credit sales.
- The average collection period will be reduced to 32 days.

Alternative B: contracting the services of a factor:
The factor would charge a fee of 2% of total credit sales and advance MME Ltd. 90% of total credit sales invoiced by the end of each month at an interest rate of 1.5% per month.

The effects of this alternative are expected to be as follows:

- No change is expected in the level of annual sales, proportion of credit sales and contributions margin ratio.
- Savings on debt administration expenses of Sh.1,400,000 per month will result
- All bad debt losses will be eliminated
- The average collection period will drop to 20 days.

Required:

i) Evaluate the annual financial benefits and costs of each alternative (Assume 360 –day year) (8 marks)

ii) Advise MME Ltd. management on the alternative to implement. (2 marks)

iii) Explain briefly other factors that should be considered in reaching the decision in (ii) above. (4 marks)

(Total: 20 marks)

QUESTION THREE

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

(b) The total of the net working capital and fixed assets of Faida Ltd as at 30 April 2003 was Sh.100,000,000. The company wishes to raise additional funds to finance a project within the next one year in the following manner.

Sh.30,000,000 from debt
Sh.20,000,000 from selling new ordinary shares.

The following items make up the equity of the company:

	Sh.
3,000,000 fully paid up ordinary shares	30,000,000
Accumulated retained earnings	20,000,000
1,000,000 10% preference shares	20,000,000
200,000 6% long term debentures	30,000,000

The current market value of the company's ordinary shares is Sh.30. The expected dividend on ordinary shares by 30 April 2004 is forecast at Sh.1.20 per share. The average growth rate in both earnings and dividends has been 10% over the last 10 years and this growth rate is expected to be maintained in the foreseeable future.

The debentures of the company have a face value of Sh.150. However, they currently sell for Sh.100. The debentures will mature in 100 years.

The preference shares were issued four years ago and still sell at their face value.

Assume a tax rate of 30%

Required:

(i) The expected rate of return on ordinary shares. (2 marks)

(ii) The effective cost to the company of:
- Debt capital (2 marks)
- Preference share capital (2 marks)

(iii) The company's existing weighted average cost of capital. (4 marks)

(iv) The company's marginal cost of capital if it raised the additional Sh.50,000,000 as intended.
(4 marks)

(Total: 20 marks)

QUESTION FOUR

(a) Outline four limitations of the use of ratios as a basis of financial analysis. (4 marks)

(b) The following information represents the financial position and financial results of AMETEX Limited for the year ended 31 December 2002.

AMETEX Limited
Trading, profit and loss account for the year ended 31 December 2002

	Sh."000"	Sh."000"
Sales – Cash		300,000
- Credit		600,000
		900,000
Less: cost of sales		
Opening stock	210,000	
Purchases	660,000	
	870,000	
Less: closing stock	(150,000)	720,000
Gross profit		180,000
Less expenses:		
Depreciation	13,100	
Directors' emoluments	15,000	
General expenses	20,900	
Interest on loan	4,000	
		(53,000)
Net profit before tax		127,000
Corporation tax at 30%		(38,100)
Net profit after tax		88,900
Preference dividend	4,800	
Ordinary dividend	10,000	14,800
Retained profit for the year		74,100

AMETEX Limited
Balance Sheet as at 31 December 2002

	Sh."000"	Sh."000"	Sh."000"
Fixed Assets			213,900
Current Assets:			
Stocks	150,000		
Debtors	35,900		
Cash	20,000	205,900	
Current Liabilities:			
Trade creditors	60,000		
Corporation tax payable	63,500		
Proposed dividend	14,800	138,300	67,600
			281,500
Financed by:			
Ordinary share capital (Sh.10 par value)		100,000	
8% preference share capital		60,000	
Revenue reserves		81,500	
10% bank loan		40,000	
			281,500

Additional information:

1. The company's ordinary shares are selling at Sh.20 in the stock market.
2. The company has a constant dividend pay out of 10%.

Required:

Determine the following financial ratios:

(i)	Acid test ratio.	(2 marks)
(ii)	Operating ratio	(2 marks)
(iii)	Return on total capital employed	(2 marks)
(iv)	Price earnings ratio.	(2 marks)
(v)	Interest coverage ratio	(2 marks)
(vi)	Total assets turnover	(2 marks)

(c) Determine the working capital cycle for the company. (4 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Distinguish between the following terms as used in the management of working capital:

(i) Overtrading and overcapitalization. (4 marks)

(ii) Factoring and pledging of debtors (4 marks)

(b) The following information relates to Mafuta Safi Limited:

	Shs. '000'
Purchase of raw materials	6,700
Usage of raw materials	6,500
Sale of finished goods (all on credit)	25,000
Cost of sales (finished goods)	18,000
Average creditors	1,400
Average raw materials stock	1,200
Average work in progress	1,000
Average finished goods stock	2,100
Average debtors	4,700

Assume a 365 days year.

Required:

The length of the operating cash cycle (12 marks)

(Total: 20 marks)