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UNIVERSITY EXAMINATIONS 2023/2024

SECOND YEAR FIRST SEMESTER EXAMINATION FOR DEGREE OF BACHELOR
OF COMMERCE

BFC 3226: INTRODUCTION TO FINANCIAL MANAGEMENT

DATE: APRIL 2024

TIME: 2 HOURS

INSTRUCTIONS: Answer Question ONE and any other TWO questions.

QUESTION ONE (30 MARKS)

- Define agency relationship from the context of a public limited company and briefly explain how this arises. (6 marks)
- Highlight the various measures that would minimize agency problems between the owners and the management. (6 marks)
- Evaluate any three factors that may be responsible for the slow growth in the number of companies seeking listing at the Nairobi Stock Exchange or Stock Exchange in your country. (8 marks)
- Millennium 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:
 - 600,000 fully paid ordinary shares of Sh. 10 each
 - Retained earnings of Sh.4 million
 - 200,000, 10% preference shares of Sh.20 each.
 - 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 is 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:
 - a) Ordinary share capital; (2 marks)
 - b) Debt capital (2 marks)
 - c) Preference share capital. (2 marks)
- (ii) Compute the company's current weighted average cost of capital. (5 marks)

QUESTION TWO(20MARKS)

- a. Discuss various determinants to be considered in arriving at the optimal level of working capita in a manufacturing enterprise (10 marks)
- b. Glyxo Services Ltd., a debt collection agency, has estimated that the standard deviation of its daily net cash flow is Sh.22,750. The company pays Sh. 120 in transaction cost every time it transfers funds into and out of the money market. The rate of interest in the money market is 9.465%. The company uses the Miller-Orr Model to set its target cash balance. The minimum cash balance has been set at Sh.87,500. Required:
 - i. The company's target cash balance. (3 marks)
 - ii. The lower and upper cash limit. (2 marks)
 - iii. Lynx Services Ltd.'s decision rules. (5 marks)

QUESTION THREE(20MARKS)

- a). List and explain five factors that should be taken into account by a businessman in making the choice between financing by short-term and long-term sources (10marks)
- b). Magma Ltd. wishes to make a choice between two mutually exclusive projects. Each of these projects requires Sh.400,000,000 in initial cash outlay. The details of the two projects are as follows:

Project A

This project is made up of two sub-projects. The first sub-project will require an initial outlay of Sh.100,000,000 and will generate Sh.25,600,000 per annum in perpetuity. The second sub-project will require an initial outlay of Sh.300,000,000 and will generate Sh.85,200,000 per annum for the 8 years of its useful life. This subproject does not have a residual value at the end of the 8 years. Both sub-projects are to commence immediately.

Project B

This project will generate Sh.87,000,000 per annum in perpetuity.

The company has a cost of capital of 16%.

Required:

- (i) Determine the net present value (NPV) of each project. (6 marks)

QUESTION FOUR(20MARKS)

- a. Distinguish between an annuity and a perpetuity (4 marks)
- b. Koronya has won a Roton lottery and will receive the following cash inflows:

Year I	Sh 200,000
Year 2	Sh <u>500 000</u>
Total	sh <u>700,000</u>

- i. If interest rate is 6% compounded annually, what is the present value of the Roton earnings? (4 marks)
- ii. If the interest rate is 6% compounded quarterly, what is the present value of the Roton earnings? (4 marks)
- iii. Briefly explain the liquidity — profitability trade — off which a business enterprise may be required to consider in its financial management policies. (4 marks)
- iv. How does a company's working capital policy impact on its liquidity — profitability position? Explain with reference to the strategies available to the firm for financing its working capital. (4 marks)

QUESTION FIVE(20MARKS)

- a) What are the determinants of the price of a bond? (4 marks)

- b) Identify six ways in which a company could make preference shares more attractive to a potential investor. (6 marks)
- c) List and briefly discuss three possible reasons why companies in the same type of business may have different price/earnings (P/E) ratios. (6 marks)
- d) Comment on the view that the price/earnings (P/E) ratio is an "attempt to value a company in terms of its earnings" (4 marks)

