



STRATHMORE UNIVERSITY BUSINESS SCHOOL
BACHELOR OF FINANCIAL SERVICES
BFS 2104: INTRODUCTION TO FINANCIAL MANAGEMENT I
END OF SEMESTER EXAMINATION

Date: Monday, 24th July, 2023

Time: 2 Hours

Instructions: Answer Question ONE (COMPULSORY) and any other TWO questions.

QUESTION ONE **(TOTAL 30 MARKS)**

- a) Mali Mingi Ltd., a publicly traded company specializing in the manufacturing and sale of electronic gadgets. The company has demonstrated strong performance and garnered a loyal customer base in recent years. In order to finance its expansion plans, the company has opted to raise capital by issuing corporate bonds. However, bondholders have voiced concerns regarding potential agency issues that may arise between themselves and the shareholders. **Required:**
- i. Explain agency conflict and how this arises between bondholders and shareholders. **(5 Marks)**
 - ii. Highlight four measures that would minimize agency problems between the two parties **(5 Marks)**
- b) Madaraka Ltd. has approached you for advice on an equipment to be purchased for use in a five-year project. The investment will involve an initial capital outlay of Shs. 1.4 million and the expected cash flows over the five-year period are given below:

Year	Cash inflows Shs.	Cash outflows Shs.
1	800,000	65,000
2	750,000	80,000
3	900,000	50,000
4	1,200,000	55,000
5	1,100,000	70,000

The equipment is to be depreciated on a straight-line basis over the duration of the project with a nil residual value. The cost of capital and the tax rate are 12% and 30% respectively. Using this information, Madaraka Ltd. seeks your advice on the feasibility of the investment. Assess the cash flows and provide your recommendation based on the following appraisal techniques. **Required:**

- i. Compute the Payback period **(5 Marks)**
- ii. Compute the Accounting rate of return **(4 Marks)**
- iii. Compute the Net present value (NPV) of the investment. **(5 Marks)**
- iv. Compute Internal rate of return (IRR) **(6 Marks)**

QUESTION TWO

(TOTAL 20 MARKS)

- a) Meet Kamau and Waka, two hilarious stand-up comedians venturing into the world of finance. Despite having no background in finance, they have contrasting investment preferences.
- b) Kamau, the daredevil dreamer, is drawn to the excitement of the capital market, while Waka, the quick-witted pragmatist, delves into the money market. As a finance expert, help these comedians understand at least two differences between these markets and their investment choices. **(4 Marks)**
- c) The role of a finance manager in a modern organization is pervasive in all activities of any business firm. In light of the above statement, highlight four managerial roles of a finance manager in any organization using examples. **(5 Marks)**
- d) The total of the net working capital and fixed assets of Zawadi Ltd. as at 30 April 2020 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.

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 2021 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. Compute the cost of equity **(2 Marks)**
- ii. Compute the cost of debenture **(3 Marks)**
- iii. Compute the cost of preference share capital **(2 Marks)**
- iv. Compute the weighted average cost of capital of the company **(4 Marks)**

QUESTION THREE

(TOTAL 20 MARKS)

- a) Lulu, a 40-year-old professional with dreams of a retirement filled with beachside lounging and exotic vacations, is seeking your expertise in financial management. She's received some intriguing news that five years from now, her retirement dreams will kick into high gear with an annual pension payout of Kshs 100,000 for the following 5 years. However, being a self-proclaimed financial novice, Lulu needs your help to determine the current value of her pension, factoring in her 10% interest rate per annum. **(5 Marks)**
- b) Zahara recently received a significant inheritance from her grandmother. She is considering investing a portion of her funds in bonds as a way to generate stable income and preserve capital. Zahara is risk-averse and prefers a conservative investment approach. She has done some research and gathered information about two different bonds: Bond A and Bond B. Zahara understands that the state of the

economy can affect bond returns. Based on her research, she has identified three potential states of the economy and their corresponding probabilities as shown below:

State of the economy	Probability	Bond A return (%)	Bond B return (%)
Boom	0.2	12	15
Moderate	0.3	8	8
Recession	0.5	3	5

Required:

- i. Calculate the expected return for both bonds. **(4 Marks)**
- ii. Calculate the variance and standard deviation for both bonds. **(10 Marks)**
- iii. Advise Zahara on the better investment option, considering her risk aversion **(1 Mark)**

QUESTION FOUR

(TOTAL 20 MARKS)

- a) Adana, a dynamic food entrepreneur, is eager to transform her family's pickle, jam, and squash business. With dreams of expanding into chocolates and candies, she needs your input-on financing. The stock market is bullish, and she requires around KES 5,000,000 for the project. Which finance source should Adana avoid for her expansion? Share your reasons **(5 Marks)**
- b) Hola Ltd. is a small manufacturing business that has recently experienced a significant increase in sales and profitability. The company's financial statements show a healthy profit margin and positive net income. However, despite the positive profit figures, the business finds itself facing a cash flow crisis. Explain three reasons to the company why cash flow is considered to be more relevant than profitability when evaluating investment decisions. **(6 Marks)**
- c) Centuries ago, rich families in Kiambu established a fund to further welfare and education. From this fund, only the interest revenue was allowed to be spent, in order to keep the principal unattached. Assume the fund has amounted to Kes 12 million and market interest rate (i) is 6% annually. What would be the present value of the fund endowed to the society? **(4 Marks)**
- d) Suppose you borrowed a 3-year loan of Kshs. 200,000 at 12% from a local bank. If the bank requires 4 equal end of year repayments, prepare your loan repayment schedule **(5 Marks)**

QUESTION FIVE

(TOTAL 20 MARKS)

- a) Jamila Enterprises, a leading retail company in the cosmetic sector, is at a crossroads when it comes to defining its primary goal. The management team is divided between two approaches: shareholder wealth maximization and profit maximization. Explain three differences between profit maximization and shareholder wealth maximization to the management. **(3 Marks)**
- b) Kilifi Traders Ltd., a manufacturing company operating in a coastal town, has set sail on a mission to optimize its working capital management. Highlight three ways the businesses can use to improve their cash conversion cycle. **(3 Marks)**
- c) Mapato Tech Limited sells computer hardware's fixtures on terms of 2/10 net 30. Its financial statements for the last three years are as follows:

2018	2019	2020
Sh."000"	Sh."000"	Sh."000"

Cash	30,000	20,000	5,000
Accounts receivable	200,000	260,000	290,000
Inventory	400,000	480,000	600,000
Net fixed assets	<u>800,000</u>	<u>800,000</u>	<u>800,000</u>
	1,430,000	1,560,000	1,695,000
Accounts payable	230,000	300,000	380,000
Accruals	200,000	210,000	225,000
Bank loan, short term	100,000	100,000	140,000
Long term debt	300,000	300,000	300,000
Common stock	100,000	100,000	100,000
Retained earnings	<u>500,000</u>	<u>550,000</u>	<u>550,000</u>
	1,430,000	1,560,000	1,695,000
Additional information:			
Sales	4,000,000	4,300,000	3,800,000
Cost of goods sold	3,200,000	3,600,000	3,300,000
Net profit	300,000	200,000	100,000

Required:

1. Determine the following financial ratios:

- i. Current ratio
- ii. Quick ratio **(2 Marks)**
- iii. Creditors turnover **(2 Marks)**
- iv. Gross profit margin **(2 Marks)**
- v. Debtors turnover **(2 Marks)**
- vi. Return on Assets **(2 Marks)**

2. From part (a) above, comment on the liquidity and profitability of the company. **(4 Marks)**

