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MAIN EXAMINATION

JANUARY-APRIL 2024

SCHOOL OF BUSINESS

DEPARTMENT OF ACCOUNTING AND FINANCE

EVENING/WEEKEND PROGRAMME

CFI 520: FINANCIAL MANAGEMENT

DATE: APRIL 2024	**Duration: 3 Hours**
INSTRUCTIONS: Answer Any FOUR Questions	

Q1.

a) Describe the role of corporate ethics and social responsibility. Reconcile the need for ethics and social responsibility with shareholder wealth maximization. **(8 Marks)**

b) Foreign Direct investment (FDI) plays a crucial role in revamping less developed economies.

Required:

Write brief notes on the obstacles towards the flow of Foreign Direct Investment (FDI) into the Kenyan economy. **(7 Marks)**

c) Tom Mapesa has sh. 500,000 that he can deposit in any of three savings accounts for a 3 year period. Bank I compounds interest on an annual basis, Bank II compounds interest twice a year, and Bank III compounds interest each quarter. All the three Banks have a stated annual interest rate of 4%.

Required:

(i) Compute the amount in each Bank account at the end of 3 years.

(ii) What is the effective annual rate (EAR) that is earned from each bank.

(iii) In which bank should Tom deposit his money.

(iv) Bank IV is different from the others only in the sense that compounding is done continously. What would be the amount at end of 3 years it it was deposited in Bank IV. **(10 Marks)**

Q2.

a) Literature has been shown that in the absence of taxes and other market imperfections firm value will be unaffected by dividend policy (Modigliani & Miller 1962). Explain the logic behind this conclusion. **(8 Marks)**

b) The republic of Korong has just liberalised its market and is now permitting foreign investors. Mango manufacturing has analysed starting a project in the country and has determined that the project has a negative NPV. Why might the company go ahead with the project anyway? What type of real option do you think is most likely to add value to this project? **(5 Marks)**

c) Mercy Nyasuguta has been finding problems understanding the term risk. She is aware that you are studying Financial Management (CFI 520) at CUEA. While on her way home, she heard somebody wondering loudly: 'We routinely assume that investors are risk-averse return seekers; i.e. they like returns and dislike risk.' If so, why do we contend that only systematic risk and not total risk is important? Please, assist her understand this very important concept.

(7 Marks)

d) In the context of risk and return measurement, what does the phrase "No pain, No gain mean**?** **(5 Marks)**

Q3.

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 relatedly less debt capital. **(5 Marks)**

b) 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 s 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, 10% long term loan 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:

Compute the component cost of:

i) Ordinary share capital;

ii) Debt capital

iii) Preference share capital;

iv) Compute the company's current weighted average cost of capital

(20 Marks)

Q4.

A company is considering developing and raising two apartment complexes for MMUST staff, WA and HA. The following estimate of annual cash flows have been generated for each apartment.

	WA		**HA**
Probability	**Annual cash flows**	**Probability**	**Annual cash flows**
0.1	1,000,000	0.2	1,500,000
0.2	1,500,000	0.3	2,500,000
0.4	3,000,000	0.4	3,500,000
0.2	4,500,000	0.1	4,500,000
0.1	5,000,000		

Required:

i) Find the expected cash flows from each apartment complex.

ii) What is the coefficient of variation for each department complex?

iii) Which apartment complex has more risk? **(15 Marks)**

a) The company in the preceding question uses the Build Recover and Surrender business model (BRS) and will hold the apartments for 10 years and either apartment complex would cost Sh. 10,000,000. The company estimates the cost of capital to be 12%. Should the company use the model above using NPV? If yes which apartment complex is ideal? Show all the necessary workings. **(10 Marks)**

Q5.

a) Explain the meaning of the following: pecking order theory, trade off theory and market timing theory as applied in capital structure decisions **(15 Marks)**

b) What relationship between the required rate of return (RRR) and coupon rate will cause the bond to sell

i) At a discount,

ii) At a premium? and

iii) At par value? Explain using numerical example of your choice. **(10 Marks)**

END