GARISSA UNIVERSITY

UNIVERSITY EXAMINATION 2016/2017 ACADEMIC YEAR <u>ONE</u> <u>FIRST</u> SEMESTER EXAMINATION

SCHOOL OF BUSINESS AND ECONOMICS

FOR THE DIPLOMA BUSINESS MANAGEMENT

COURSE CODE: DBM 019

COURSE TITLE: INTRODUCTION TO FINANCIAL MANAGEMENT

EXAMINATION DURATION: 3 HOURS

DATE: 13/12/17 **TIME: 02.00-05.00 PM**

INSTRUCTION TO CANDIDATES

- **The examination has SIX (6) questions**
- **Question ONE (1) is COMPULSORY**
- **Choose any other THREE (3) questions from the remaining FIVE (5) questions**
- **Use sketch diagrams to illustrate your answer whenever necessary**
- **Do not carry mobile phones or any other written materials in examination room**
- **Do not write on this paper**

This paper consists of FOUR (4) printed pages ***please turn over***

QUESTION ONE (COMPULSORY)

(a) State six advantages of payback period method **[6 marks]**

(b) Cedes limited has the following details of two of the future production plans. Only one of these machines will be purchased and the venture would be taken to be virtually exclusive. The Standard model costs £50,000 and the Deluxe cost £88,000 payable immediately. Both machines will require the input of the following:

i. Installation costs of £20,000 for Standard and £40,000 for the Deluxe
ii. A £10,000 working capital through their working lives.

Both machines have no expected scrap value at end of their expected working lives of 4 years for the Standard machine and six years for the Deluxe. The operating pre-tax net cash flows associated with the two machines are:

Year	1	2	3	4	5	6
Standard	28,500	25,860	24,210	23,410	-	-
Deluxe	36,030	30,110	28,380	25,940	38,500	35,100

The deluxe machine has only been introduced in the market and has not been fully tested in the operating conditions, because of the high risk involved the appropriate discount rate for the deluxe machine is believed to be 14% per annum, 2% higher than the rate of the standard machine. The company is proposing the purchase of either machine with a term loan at a fixed rate of interest of 11% per annum, taxation at 30% is payable on operating cash-flows one year in arrears and capital allowance are available at 25% per annum on a reducing balance basis.

Required

i. For both the Standard and the Deluxe machines, calculate the payback period. [**17 marks]**
ii. Advice the company accordingly [**2 marks]**

QUESTION TWO

(a) Jeremy limited wishes to expand its output by purchasing a new machine worth 170,000 and installation costs are estimated at 40,000/=. In the 4th year, this machine will call for an overhaul to cost 80,000/=. Its expected inflows are:

		a. Shs.
ii.	Year 1	60,000
iii.	Year 2	72,650
iv.	Year 3	35,720
v.	Year 4	48,510
vi.	Year 5	91,630
vii.	Year 6	83,715

This company can raise finance to purchase machine at 12% interest rate. Compute NPV and advise management accordingly. **[11 marks]**

(b) State the advantages of NPV method **[4 marks]**

QUESTION THREE

ABC Ltd. makes cash payments of Shs.10, 000 per week. The interest rate on marketable securities is 12% and every time the company sells marketable securities, it incurs a cost of Shs.20

Required

i. Determine the optimal amount of marketable securities to be converted into cash every time the company makes the transfer. **[4 marks]**
ii. Determine the total number of transfers from marketable securities to cash per year. **[3 marks]**
iii. Determine the total cost of maintaining the cash balance per year. **[3 marks]**
iv. Determine the firm's average cash balance **[5 marks]**

QUESTION FOUR

(a) state the functions of finance manager **[5 marks]**

(b) Explain any three theories on dividend **[10 marks]**

QUESTION FIVE

(a) Explain the major approaches of financing current assets **[8 marks]**

(b) Explain the importance of working capital management **[7 marks]**

QUESTION SIX

The Chuma Ngumu Company needs to finance a seasonal rise in inventories of Sh.4 million. The funds are needed for six months. The company is considering using the following possibilities to finance the inventories:

1. A warehouse loan from a finance company. The terms are 18 per cent annualized with an 80% advance against the value of the inventory. The warehousing costs are Sh.350,000 for the six-month period. The residual financing requirement which is Sh.4 million less the amount advanced will need to be financed by forgoing cash discounts on its payables. Standard terms are 2/10 net 30: however, the company feels it can postpone payment until the fortieth day without adverse effect.
2. A floating lien arrangement from the supplier of the inventory at an effective interest rate of 24 per cent. The supplier will advance the full value of the inventory.
3. A bank loan from the company's bank for Sh.4 million. The bank can lend at the rate of 22%. In addition, a 10% compensating balance will be required which otherwise would not be maintained by the company.

Required:

i. Which is the cheapest option for the company **[15 marks]**