



COLLEGE OF BUSINESS, PEACE, LEADERSHIP AND GOVERNANCE

FINANCIAL MANAGEMENT – MFN 501

END OF SEMESTER EXAMINATIONS

NOVEMBER 2019

LECTURER: N. E CHIRIMA

DURATION: 3 HRS

INSTRUCTIONS

ANSWER **ALL** QUESTIONS

MARKS ARE SHOWN AT THE END OF EACH QUESTION

ALL WORKING IS TO BE SHOWN CLEARLY IN THE AFRICA UNIVERSITY ANSWER BOOKLET. ANYTHING WRITTEN IN PENCIL IS DEEMED TO BE WORKING.

CREDIT WILL BE AWARDED FOR NEATLY PRESENTED WORK

START EACH QUESTION ON A NEW PAGE.

QUESTION 1

Either:

Mr. Johnson is considering investing in either NF Ltd or P Ltd and, on hearing that you are business graduand, has approached you for financial advice. You have managed to gather the information tabled below.

		<u>Rate of Return</u> %	
<u>State of the Economy</u>	<u>Probability of Occurrence</u>	<u>NF</u>	<u>P</u>
Boom	0,30	16	40
Normal	0,50	11	10
Recession	0,20	6	-20

You are required to:

- Advise C Ltd on which company to invest in, clearly stating your reasons and computations. [15 marks]
- Explain the “portfolio concept” to Mr. Johnson; outlining how he can make use of it as an investor to maximise his wealth. [10 marks]

Or:

- A Finance manager makes financial decisions while a Financial Accountant prepares financial reports which are one of the important sources of financial information pertaining to a company. To what extent can the financial reports be of use to the Finance Manager in making decisions. [9 marks]
- A Finance Manager’s objective is to maximise shareholders wealth as he makes investment, financing and dividend decisions. Illustrate how the Finance Manager is able to meet his objective through each of these decisions. [9 marks]
- A company is held together by a set of agent – principle relationships. Analyse the importance of these relationships in relation financial management, indicating the possible causes of the relationships not being upheld. [7 marks]

QUESTION 2

Either:

J Ltd wishes to raise additional capital through a rights offer to its shareholders. The following information about the company has been compiled:

Paid up equity (1 000 000 shares of \$10 each)	\$10 000 000
Retained earnings	\$20 000 000
Earnings before interest and taxes	\$12 000 000
Interest	\$2 000 000
Profit before taxes	\$10 000 000
Taxes (50%)	\$5 000 000
Profit after taxes	\$5 000 000
Earnings per share	\$5
Market price per share (P/E ratio of 8 assumed)	\$40
Number of additional shares proposed to be issued as rights shares	200 000
Proposed subscription price	\$20

You are required to compute:

- i. the Theoretical Ex-Right Price [5 marks]
- ii. the value of a right [2 marks]
- iii. Marj; one of J Ltd's shareholders, has not been able to take up their rights offer due to personal financial challenges.
 - a. As a financial advisor, clearly explain to her the effect of her actions on her wealth as a shareholder? [9 marks]

- b. How should the rights shares that she has been unable to take up, be handled by the company secretary? [4 marks]
- iv. Compare and contrast a rights issue and a public issue. [5 marks]

Or:

- a) Discuss whether the dividend growth model or the capital asset pricing model offers the better estimate of the cost of equity of a company. [7 marks]
- b) Distinguish between weak form, semi-strong form and strong form stock market efficiency. [6 marks]
- c) Discuss the significance to a listed company if the stock market on which its shares are traded is shown to be semi strong form efficient. [4 marks]
- d) Sol Ltd, a listed company whose share has been stable on the market for the past fifteen years, published its annual report, which reflected a favorable position at year end as well as above average performance for the year ended 31 December 2018, at the beginning of March 2019. During the month of March, its share maintained a steady increase from \$5 end of February 2019 to \$5, 10 by end of March 2019. In June 2019, there were reports of the company having been adversely affected by a cyclone, with a number of “near maturity” plantations being destroyed. By end of June 2019, Sol Ltd’s share was trading at \$3, 20.
- a. In your opinion, what efficiency form is the securities market Sol Ltd is listed on? [4 marks]
- b. In the above scenario, how would expect a bull and a bear participating on the market to react to the changes in the share prices of Sol Ltd. [4 marks]

QUESTION 3

Either:

- a. Briefly explain three methods of analyzing risk in capital budgeting. [3 marks]
- b. Given below are details in respect of two machines to be acquired by Tonto Ltd.

The expected before tax operating cash flows for the machines are as follows:

Year	1	2	3	4	5
Machine A	20 500	22 860	24 210	23 410	35 100
Machine B	32 000	26 100	25 400	26 000	38 600

Other relevant details are as follows:

	Machine A	Machine B
Cost	\$50 000	\$88 000
Terminal Value	\$5 000	\$8 000
Relevant Discount Rate reflecting risk	12%	14%*

*Machine B will use new untested technology that management deems to be more risky.

Both the machines would require investment in working capital of \$10 000 at the beginning of the investment period, to be recovered immediately after the end of the productive life of respective machine. Capital allowances are at a rate of 25% on a reducing balance basis and tax is at a rate of 35% payable one year in arrears.

Required:

- Determine the discounted payback period for each machine. [4 marks]
- Determine the NPV for each machine. [10 marks]
- Advise the company on which machine to buy. [5 marks]
- Briefly, explain the factors you would take into account before deciding on the 'cost of capital' to apply in appraising an investment project. [3 marks]

Or:

- Compare and contrast the Net Present Value investment appraisal techniques with the Internal Rate of Return investment appraisal technique. [5 marks]
- Specify which of the two methods mentioned in (a) will, in your opinion; take precedence should the two methods have conflicting results. Explain. [5 marks]

e) Explain the difference between risk and uncertainty in the context of investment appraisal. [5 marks]

f) Describe four investment risk analysis techniques, highlighting the advantages as well as disadvantages of each. [10 marks]

QUESTION 4

The value of a company is the present value of future dividends. Is this inconsistent with the proposition that dividends are irrelevant? Explain. [10 marks]

T Ltd is operating in a hyper – inflationary economy where investor confidence has been eroded due to the unstable currency negatively affecting returns on investments. 70% of its shares are held by investment institutions while the remaining 30% is held by individuals, most of who are in the high income earning bracket and hold significant investments in other companies within the same country. Company policy is to retain 40% of the profits each year and distribute the rest to shareholders. During the current year, the company has been profitable but realises it is not liquid enough to pay the dividend. Advise the Finance Director on the proposal to be tabled before the shareholders at the upcoming Annual General Meeting. [15 marks]

END OF PAPER

FORMULA SHEET

Value of a Right

Current Market Price – Expected Market Price

Earnings Per Share

EAIT/ Number of Ord Shares

Theoretical Ex – Right Price

{(Current Shares held x market price/ share) + (rights shares x rights issue price)}/ Current shares +rights shares

PRESENT VALUE FINANCIAL TABLES

Present Value of a lump sum									
Periods	4%	5%	6%	8%	9%	10%	11%	12%	14%
1	.96154	.95238	.94340	.92593	.91743	.90909	.90090	.89286	.8772
2	.92456	.90703	.89000	.85734	.84168	.82645	.81162	.79719	.7695
3	.88900	.86384	.83962	.79383	.77218	.75132	.73119	.71178	.6750
4	.85480	.82270	.79209	.73503	.70843	.68301	.65873	.63552	.5921
5	.82193	.78353	.74726	.68058	.64993	.62092	.59345	.56743	.5194
6	.79031	.74622	.70496	.63017	.59627	.56447	.53464	.50663	.4556
7	.75992	.71068	.66506	.58349	.54703	.51316	.48166	.45235	.3996
8	.73069	.67684	.62741	.54027	.50187	.46651	.43393	.40388	.3506
9	.70259	.64461	.59190	.50025	.46043	.42410	.39092	.36061	.3075
10	.67556	.61391	.55839	.46319	.42241	.38554	.35218	.32197	.2697
11	.64958	.58468	.52679	.42888	.38753	.35049	.31728	.28748	.2366
12	.62460	.55684	.49697	.39711	.35554	.31863	.28584	.25668	.2076
13	.60057	.53032	.46884	.36770	.32618	.28966	.25751	.22917	.1821
14	.57748	.50507	.44230	.34046	.29925	.26333	.23199	.20462	.1597

15	.55526	.48102	.41727	.31524	.27454	.23939	.20900	.18270	.1401
16	.53391	.45811	.39365	.29189	.25187	.21763	.18829	.16312	.1229
17	.51337	.43630	.37136	.27027	.23107	.19785	.16963	.14564	.1078
18	.49363	.41552	.35034	.25025	.21199	.17986	.15282	.13004	.0946
19	.47464	.39573	.33051	.23171	.19449	.16351	.13768	.11611	.0829
20	.45639	.37689	.31180	.21455	.17843	.14864	.12403	.10367	.0728