UNIVERSITY EXAMINATIONS

MAIN EXAMINATIONS

2020/2021 ACADEMIC YEAR

FOURTH YEAR SECOND SEMESTER

FOR THE DEGREE OF BACHELOR OF COMMERCE

COURSE CODE: BCF 440E

COURSE TITLE: STRAEGIC FINANCIAL MANAGEMENT

DATE:13TH OCTOBER,2021 **TIME: 2.00PM – 4.00PM**

INSTRUCTIONS TO CANDIDATES

Answer Question ONE (compulsory) and ANY OTHER TWO questions

QUESTION ONE

a) **ABC LTD Income statements for the past two years are shown below;**

	2020 KES 000	2019 KES 000
Operating profit	6500	5500
Interest expense	1000	900
Profit before Tax	5500	4600
Tax	1375	1150
	4125	3450

1. The allowance f or doubtful debts was KES 300,000 at 1 January 2019, KES 250,000 at 31 December 2019 and KES 350,000 at 31 December 2020.
2. Research and development costs of KES500,000 were incurred during each of the years 2019 and 2020 on Project Z. These costs were expensed in the income statement, as they did not meet the requirements of financial reporting standards for capitalisation. Project Z is not complete yet.
3. At the end of 2018, the company had completed another research and development project, Project X. Total expenditure on this project had been KES 1,500,000, none of which had been capitalised in the financial statements. The product developed by Project X went on sale on 1 January 2019, and the product was a great success. The product 's life cycle was only two years, so no further sales of the product are expected after 31 December 2020.
4. The company incurred non-cash expenses of KES 15,000 in both years.
5. Capital employed (equity plus debt) per the statement of financial position was KES 33,500 at 1 January 2019, and KES 37,000 at 1 January 2020 .
6. The pre - tax cost of debt was 5% in each year. The estimated cost of equity was 12% in 2009 and 14% in 2020. The rate of corporate income tax was 25% during both years.
7. The company's capital structure was 60% equity and 40% debt.
8. There was no provision for deferred tax.

Required

Calculate Economic Value Added (EVA) and give a comment on performance of the company in the years 2019-2020. (10 marks).

b)

Discuss the meaning of shareholder wealth maximization and reasons why profitability is not an objective of strategic financial management. (10 marks)

c)

Altman's original Z score equation is given as:

$$Z = 0.012X_1 + 0.014X_2 + 0.33X_3 + 0.006X_4 + X_5$$

Where:

X_1 = working capital/total assets

X_2 = retained earnings/total assets

X_3 = profit before interest and tax/total assets

X_4 = market value of equity/book value of debt

X_5 = sales/total assets

Required ;Evaluate the likelihood of failure of the firm the following financial statements;

Income Statement KES 000Balance Sheet KES 000

Sales	3100	**Current assets**	4000	Current capabilities	750
Costs	2600	PPE	3000	Long term	1250
Taxable income	500			Equity	3000
Taxes (34%)	170				
Net Income	330	**Total**	7000		7000

(10 marks)

QUESTION TWO

a)Discuss **FIVE** reasons of business failure (10 marks)

b) A company has reported operating profits of KES 30 million. This was after charging KES 10 million for the development and launch costs of a new product that is expected to generate profits for 5 years. Taxation is paid at the rate of 30% of the operating profit. The company has a risk-adjusted weighted average cost of capital of 15% per annum and is paying interest at 10% per annum on a substantial long-term loan. The company's non-current asset value is KES 50 million and the net current assets have a value of KES 20 million.

Required;

Calculate the company's EVA for the period. (10 marks)

QUESTION THREE

a)

Outline FIVE motivations for mergers and acquisitions. (10 marks)

b)

The following two new businesses are trying to raise finance to fund development.

(i)

KIPCHOGE, a trained sports physiotherapist and personal trainer, is setting up a sports consultancy business where amateur and professional athletes can come for advice on prevention and treatment of injuries. Nick is also considering offering consultancy services on sports kits and training regimes. He is planning to rent small premises until his business becomes established.

The location of the business is in a town with excellent sports facilities but with little if any sports consultancy services. He is looking for approximately KES 30M to develop his business, recruit two members of staff and set up a consultancy website. He is hoping that the funds will also help him to go round sports centres and gyms to give presentations on the services his business can offer.

Research carried out so far has shown that there are an encouraging number of interested partiesin the area. Nick has invested KES 5M of his own money so far on market research and initial advertising but does not have a great deal of previous business knowledge.

(ii)

Paula Donnelly is setting up a small hat shop, selling both formal and casual hats. She has considerable experience of making these goods herself and has produced a number of 'one off' hats for private clients. She now wants to expand her expertise into business and has been busy producing inventory for the shop. She has already invested KES 20M of her own money in obtaining

and fitting out suitable premises, buying materials, building up inventory and marketing. There are no such shops in the area and research has shown Paula that ladies looking for hats have to travel a considerable distance. She has made contact with two shops in the area that specialise in formal ladies wear for weddings, race meetings, balls etc and the owners have agreed to recommend her shop based on their existing knowledge of the quality of her 'one off' creations.

Required;

Using the information above, which type(s) of finance do you think will be most suitable for each of the new businesses? Give reasons for your recommendations. (10 marks)

QUESTION FOUR

a)

Naivas Supermrket ltd has plans to acquire Tuskys Supermarket ltd by exchanging stock. Naivas will issue 1.5 shares of its stock for each share of Tuskys. Financial information for the two companies is as follows;

	Naivas	Tuskys
Net income	KES 400,000	KES 100,000
Shares outstanding	200,000	25,000
EPS	2.00	4.00
Market price of stock	40.00	48.00

Naivas expects a P/E ratio of the combined company to be 15.

Required;what is the expected share price after acquisition. (10 marks)

b)

A firm currently has a debt/equity ratio of 0.12 and a return on equity equal to 16.2%. However, the optimal debt ratio is much lower than the optimal level, since it can raise the debt/equity ratio up to 0.30 without increasing the risk of bankruptcy. The firm plans to borrow and repurchase stock to get to this optimal ratio. The interest rate is expected to increase from 7% to 8%. The tax rate is 25% and the retention rate is 50%. Find the impact of the increase in debt on the growth rate.

(10 marks)

QUESTION FIVE

a)

Assume you are Finance Director of a large multinational company, listed on a number of international stock markets. The company is reviewing its corporate plan. At present, the company focuses on maximising shareholder wealth as its major goal. The Managing Director thinks this single goal is inappropriate and asks his co-directors for their views on giving greater emphasis to the following.

i.Cash flow generation

ii.Profitability as measured by profits after tax and return on investment

iii.Risk-adjusted returns to shareholders

iv.Performance improvement in a number of areas, such as concern for the environment, employees'

v.Remuneration and quality of working conditions and customer satisfaction

Required

Provide the Managing Director with a report for presentation at the next board meeting which:

Evaluates the argument that maximisation of shareholder wealth should be the only true objective of a company.

(10 marks)

b)

Show **FIVE** advantage of spin-offs and curve outs.

(10 marks)