



Uva Wellassa University

Faculty of Management

Degree of Bachelor of Business Management in Entrepreneurship and Management

3rd YEAR 1st SEMESTER EXAMINATION - February/March 2012

EMG 302 -2 Financial Management



Part C- Essay Questions

Answer only three (03) questions including question No.1

Marks allocation: 50 Marks

01. i. What characteristics would management desire in a capital budgeting technique?

(3 Marks)

ii. JFI Corporation is considering investing in either of two competing projects that will allow the firm to eliminate a production bottleneck and meet the growing demand for its products. The firm's engineering department narrowed the alternatives down to two projects called Low Tech (LT) and High Tech (HT). Working with the accounting and finance personnel, the firm's Chief Financial Officer developed the following estimates of the cash flows for LT and HT over the relevant 6-year time horizon. The firm has an 11 percent required return and views these projects as equally risky.

	Project LT	Project HT
Initial Outflow	Rs. 670,000	Rs. 940,000
Year (t)	Cash Inflow	
1	250,000	170,000
2	200,000	180,000
3	170,000	200,000
4	150,000	250,000
5	130,000	300,000
6	130,000	550,000

- Calculate the net present value (NPV) of each project, assess its acceptability, and indicate which project is best using NPV.
- Calculate the internal rate of return (IRR) of each project, assess its acceptability, and indicate which project is best using IRR.
- Calculate the profitability index (PI) of each project, assess its acceptability, and indicate which project is best using PI.
- Which of the two mutually exclusive projects would you recommend for JFI Corporation to undertake? Why?

(15 Marks)

iii. What are the major flaws of the payback and discounted payback approaches? (2 Marks)
(Total Marks 20)

02. i. Why do managers prefer the book value weights for calculating weighted average cost of capital (WACC)? (2 Marks)

ii. "Debt is the cheapest source of funds". Explain. (3 Marks)

iii. Amazon Corporation is estimating its Weighted Average Cost of capital (WACC). Its target capital structure is 20 percent debt, 20 percent preferred stock, and 60 percent common equity. Its bonds have a 12 percent coupon, paid semiannually, a current maturity of 20 years, and sell for Rs.1,000. The firm could sell, at par, Rs.100 preferred stock which pays a 12 percent annual dividend, but flotation costs of 5 percent would be incurred. Amazon is a constant-growth firm which just paid a dividend of Rs.2.00, market price of Rs.27.00 per share, and has a growth rate of 8 percent. The firm's tax rate is 40 percent.

You are required to,

a) Compute the Amazon's component cost of debt.

b) Compute the Amazon's cost of preferred stock.

c) Compute the Amazon's weighted average cost of capital (WACC)

(10 Marks)

(Total Marks 15)

03. i. What is financial risk? How does it differ from business risk? (3 Marks)

ii. "Financial leverage is a double -edged sword". Do you agree? Explain. (4 Marks)

iii. Alfa Ltd. needs Rs.1,000,000 (one million) for expansion. The expansion is expected to yield an annual EBIT of Rs.160,000. In choosing a financial plan, Alfa Ltd. has an objective of maximizing earning per share (EPS). It is considering the possibility of issuing equity shares and raising debt of Rs.100,000, or Rs. 400,000 or Rs.600,000. The

current market price per share is Rs.25 and is expected to drop to Rs. 20 if the funds are borrowed in excess of Rs:500,000. Funds can be borrowed at the rates mentioned bellow.

- Up to Rs.100,000 at 8%.
- Over Rs.100,000 up to Rs.500,000 at 12%
- Over Rs.500,000 at 18%

Assume a tax rate of 50%.

- a) Determine the EPS for the three financing alternatives.
- b) Which alternative would you recommend and why?

(8 Marks)

(Total Marks 15)

04. i. Define the Working Capital Management. (2 Marks)

ii. Why is it important to study the management of working capital as a separate area in financial management? (3 Marks)

iii. Beta Company has made plans for the next year. It is estimated that the company will employ total assets of Rs.800,000. 50% of the assets being financed by borrowed capital at an interest cost of 8% per year. The direct costs for the year are estimated at Rs.480,000 and all other operating expenses are estimated at Rs.80,000. The goods will be sold to customers at 150% of the direct costs. Tax rate is assumed to be 50%.

You are required to calculate;

- a) Net profit margin
- b) Return on assets
- c) Assets turnover
- d) Return on owner's equity

(10 Marks)

