

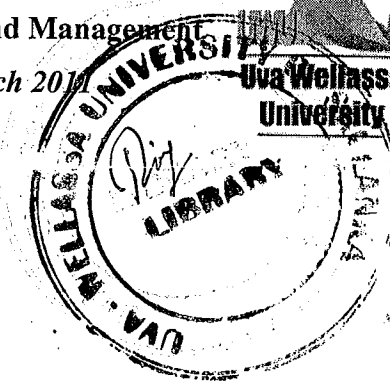
Uva Wellassa University

Faculty of Management

Degree of Bachelor of Business Management in Entrepreneurship and Management

3rd YEAR 1st SEMESTER EXAMINATION – February/March 2011

EMG 302-2 Financial Management



Part C- Essay Questions

Total marks for part C : 50

Answer three questions including question number one

01. i. Comment on the following statement.

(5 Marks)

“The function of financial management is to review and control decisions to commit or recommit funds to new or ongoing uses. Thus, in addition to raising funds, financial management is directly concerned with production, marketing and other functions within an enterprise wherever decisions are made about the acquisition or destruction of assets.”

(Ezra Soloman)

ii. A company is considering the following investment projects.

Projects	Cash Flows (Rs)			
	C ₀	C ₁	C ₂	C ₃
A	-10000	+10000		
B	-10000	+7500	+7500	
C	-10000	+2000	+4000	+12000
D	-10000	+10000	+3000	+3000

Rank the projects according to each of the following method. Your workings should be attached.

- a) Payback
- b) Accounting Rate of Return (ARR)
- c) Internal Rate of Return (IRR)
- d) Net Present Value (NPV) assuming discount rate of 10 percent

(8 Marks)

iii. If the projects are mutually exclusive which project should be accepted? Explain your answer with the help of above calculations.

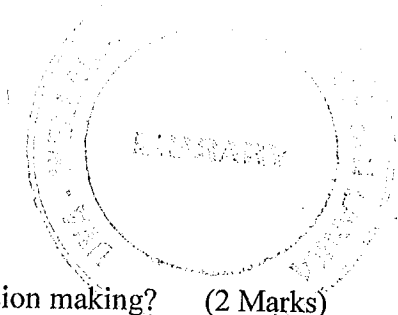
(4 Marks)

iv. “Discounted payback ensures that you don’t accept an investment with negative NPV, but it cannot stop you from rejecting projects with a positive NPV”.

Illustrate and comment the above statement.

(3 Marks)

(Total Marks 20)



02. i. Define Cost of Capital? Explain its significance in financial decision making? (2 Marks)

ii. What is the Capital Asset Pricing Model (CAPM) approach for calculating the cost of equity? What is the difference between this approach and the Constant Growth Approach? (3 Marks)

iii. The Servex Company has the following capital structure on 30th June 2010.

	In Rs "000"
Ordinary Shares (200,000 shares)	4000
10% preference shares	1000
14% debentures	3000
	8000

The ordinary share of the company sells for Rs. 20. It is expected that company will pay next year dividend of Rs 2 per share, which will grow at 7% forever. Assume a 50 percent tax rate.

You are required to,

- Compute a WACC based on the existing capital structure.
- Compute the new WACC if the company raises an additional Rs 2,000,000 debt by issuing 15% debentures. This would result in increasing the expected dividend to Rs.3 and leave the growth rate unchanged, but the price of share will fall to Rs.15 per share.
- Compute the cost of capital if above growth rate increases to 10 percent.

(10 Marks)

(Total Marks 15)

03. i. a) Explain the concept of financial leverage. Show the impact of financial leverage on the earning per share. (2 Marks)

b) Does financial leverage always increases EPS? Illustrate your answer. (2 Marks)

ii. If the use of financial leverage magnifies the earning per share under favorable economic conditions, why do companies not employ very large amount of debt in their capital structures? Explain. (3 Marks)

iii. What is financial distress? How does it affect the value of the firm? (2 Marks)

iv. Consider the following information for Rathna Enterprise.

	(Rs.000)
EBIT	1120
PBT	320
Fixed cost	700

a) Calculate Degree of Operating Leverage (DOL)?

b) Calculate Degree of Financial Leverage (DFL)?

c) Calculate Degree of Total Leverage if sales increased by 5 percent (DTL)?

(6 Marks)

(Total Marks 15)