Ser. No. BBM 032/17

GARISSA UNIVERSITY

UNIVERSITY EXAMINATION 2017/2018 ACADEMIC YEAR THREE FIRST SEMESTER EXAMINATION

SCHOOL OF BUSINESS AND ECONOMICS

FOR THE DEGREE OF BACHELOR OF BUSINESS MANAGEMENT

COURSE CODE: BBM 312

COURSE TITLE: CORPORATE FINANCE

EXAMINATION DURATION: 3 HOURS

DATE: 08/12/17 **TIME: 09.00-12.00 PM**

INSTRUCTION TO CANDIDATES

- **The examination has FIVE (5) questions**
- **Question ONE (1) is COMPULSORY**
- **Choose any other THREE (3) questions from the remaining FOUR (4) 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) Abdi and Marian are considering purchasing a new 30 passenger coach to engage in transport business .They have two alternatives of financing the purchase as shown below.

Alternative 1.

Purchase the vehicle whose current cash price is sh. 4,800,000 through a finance lease from Rana Auto Company. The terms of the lease will require 4 equal payments per year for each of the three years. No deposit is required.

Alternative 2.

Obtain the vehicle through National Bank loan scheme being advertised in the papers. Abdi and Marian will be required to make a down payment of sh .1,800,000 and then make four equal yearly payments of sh. 306, 872 each for the three years.

The market rate of interest is currently 16% per annum.

Abdi and Marian have been informed that as part of your social responsibility, you provide free consultancy service to small-scale businessmen

Required

i. The finance lease payment to be made by Abdi and Marian if they opt for finances from Rana Auto Company Limited **[4 marks]**

ii. The present value of the payment scheme of National Bank **[3 marks]**

iii. The interest expense charged by Rana Auto Company on the third installment **[5 marks]**

iv. Which of the two alternatives (Finance lease or Bank loan scheme) is better in financial terms? Why **[2 marks]**

v. Give a reason why the better alternative may not necessarily be chosen by persons in Abdi and Marian's circumstance **[1 mark]**

(b) Discuss the agency relationship that exists between:

i. Shareholders and auditors

ii. Shareholders and lenders

In each case identity the conflicts that may arise and suggest the solutions to those conflicts

[10 marks]

QUESTION TWO

(a) A company in need of additional funding may issue shares to obtain the funds. Describe any five ways through which shares may be issued **[10 marks]**

(b) Two firms A and B are identical in all important respects except financial structure. Firm A has Sh 8 million of 7.5% debt, while Firm B uses only equity. Both firms have EBIT of Sh 1,800,000 and the firms are in the same business risk class. Both firms have the same equity capitalization rate of 10%.

Required:

Determine the value of each firm and explain the action of the investors. **[5 marks]**

QUESTION THREE

(a) Outline any four assumptions of Economic Order Quantity model **[4 marks]**

(b) Garissa Investments wishes to choose one project among three projects which are mutually independent. The cash flows for each project are estimated to be as follows:

Year	Project A	Project B	Project C
1	80,000	120,000	60,000
2	80,000	100,000	60,000
3	120,000	100,000	60,000
4	120,000	80,000	60,000
5	30,000	(20,000)	60,000
6	-	-	60,000

The initial capital outlay for the three projects is as follows

	Capital outlay (shs)
Project A	320,000
Project B	240,000
Project C	200,000

Required

i. If the firms cost of capital is 14% determine the Net Present Value of each **[9 marks]**

ii. Which project should be undertaken and why **[2 marks]**

QUESTION FOUR

(a) Gamadid Ltd anticipates Sh.300 million in cash outlays during the next year. The outlays are expected to occur equally throughout the year. The company's treasurer reports that the firm can invest in marketable securities yielding 8% and the cost of shifting funds from marketable securities portfolio to cash is Sh.15,000 per transaction. Assume the company will meet its cash demands by selling marketable securities.

i. Determine optimal size of the company's transfer of funds from marketable securities to cash. **[5 marks]**

ii. What will be the company's average cash balance **[1 mark]**

iii. How many transfers from marketable securities to cash will be required during the year **[3 marks]**

iv. Determine the cash conversion cycle **[1 mark]**

(b) What will be the total cost associated with the company's cash requirement **[5 marks]**

QUESTION FIVE

(a) Outline any six features of a sound investment evaluation technique **[6 marks]**

(b) The payment of dividend by firms is based on various theories. Discuss any four dividend theories **[9 marks]**