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**GARISSA UNIVERSITY**

**UNIVERSITY EXAMINATION 2018/2019 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: 2 HOURS**

**DATE: 28/11/18 TIME: 09.00-11.00 AM**

**INSTRUCTION TO CANDIDATES**

* **The examination has FIVE (5) questions**
* **Question ONE (1) is COMPULSORY**
* **Choose any other TWO (2) 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)**

1. Distinguish between weighted average cost and marginal cost of capital **[2 marks]**
2. the following was the capital structure of Fahari Ltd as at 31 October, 2007.

|  |  |
| --- | --- |
|  | **Sh** |
| Ordinary Share Capital | 10.0 million |
| 12% Preference share capital (sh. 20 par) | 4.8 million |
| 10% debentures (sh. 1,000 par) | 3.6 million |

**Additional information**

1. The market price per ordinary, preference share and debentures were sh. 45, sh. 30 and sh. 1,200 respectively on 31 October 2007.
2. The dividend per ordinary share for the year ended 31 October 2006 was sh. 8.00. Dividends are expected to grow at an annual rate of 12 percent
3. The rate of corporation tax is 30%

**Required:**

The weighted average cost of capital (WACC) of fahari Ltd. Use market value weights **[8 marks]**

**c).** Wanga Ltd maintain s a minimum cash balance of sh. 1,500,000. The standard deviation of the daily cash is sh. 800,000. The annual interest rate is 12%. The transaction cost of buying and selling of marketable securities is Sh. 200 per transaction. Assume that one year has 365 days.

**Required**

Using the miller-Orr cash management model, determine:

1. The return point **[2 marks]**
2. Average cash balance **[2 marks]**
3. The upper cash limit. **[2 marks]**

**d)**. Highlight four problems that could be faced by a firm with high gearing ratio **[4 marks]**

**e)**. The objective of financial management in corporate sector is to maximize the value of the firm. Explain how the achievement of this objective might be compromised by the conflict which may arise between various stakeholders in an organization. **[10 marks]**

**QUESTION TWO**

1. Davirex Ltd’s share has a nominal value of ksh. 80. The company pays 10% of the nominal value of the share as dividend for the year. The current market price of the share is sh. 160 with 15% earning yield.

**Required:**

* 1. Earnings per share **[2 marks]**
  2. Dividend cover **[2 marks]**
  3. Price – earnings ratio **[1 mark]**

1. 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]**
2. Two firms A and B are identical in all important respects except financial structure. Firm A has Sh 7 million of 8.5% debt, while Firm B uses only equity. Both firms have EBIT of Sh 1,900,000 and the firms are in the same business risk class. Both firms have the same equity capitalization rate of 10%.

**Required**:

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

**QUESTION THREE**

1. Explain four factors that could influence the capital structure of a company  **[4 marks]**
2. ). Highlight five reasons why accounting profit might not be the best measure of a company’s achievement **[5 marks]**
3. Discuss the three main classifications of investment decision **[6 marks]**
4. Explain four (5) fundamental importance of the investment decision **[5 marks]**

**QUESTION FOUR**

1. The payment of dividend by firms is based on various theories. Discuss any four dividend theories **[8 marks]**
2. Aruna ltd is evaluating an investment project which require s the importation of a new machine at a cost of sh. 2,700,000. The machine has a useful life of six years.

**Additional information:**

1. The following additional costs would be incurred in relation to the machine.

|  |  |
| --- | --- |
|  | Shs. |
| Freight | 225,000 |
| Installation and preproduction testing | 375,000 |
| Import duty | 900,000 |

1. The machine is expected to increase the company’s annual cash flows (before tax) as shown below.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Year | 1 | 2 | 3 | 4 | 5 | 6 |
| Increase in cash flows (sh) | 1,760,000 | 1,360,000 | 1,050,000 | 900,000 | 840,000 | 750,000 |

1. The machine is to be fully depreciated over its useful life using the straight line method.
2. The corporate rate tax is 30% while the cost of capital is 12%.
3. The maximum acceptable payback period to the company for all capital projects is four years

Required:

i). payback period of the machine **[3 marks]**

ii). Net present value (NPV) of the machine **[6 marks]**

iii). Advise the company on whether to import the machine based on your results in (b) (i) and (ii) above. **[3 marks]**

**QUESTION FIVE**

**a).** Distinguish between the following sets of terms:

i. Disintermediation and intermediation **[2 marks]**

ii. Mutual funds and hedge funds **[2 marks]**

b). Ismalure 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.

1. Determine optimal size of the company’s transfer of funds from marketable securities to cash. **[3 marks]**
2. 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.What will be the total cost associated with the company’s cash requirement **[3 marks]**

**c).** Company y has issued and financed its investment through equity capital. The treasury bills are currently placed at 9%. The average market return is 20%. The beta of the company share is 1.2

**Required:**

1. Calculate the cost of equity capital using CAPM method. **[4 marks]**
2. Explain two main purpose of financial ratio analysis and why a careful reading of the financial statements is not enough. **[2 marks]**