Ser. No. BBM 237/18

GARISSA UNIVERSITY

UNIVERSITY EXAMINATION 2017/2018 ACADEMIC YEAR <u>TWO</u> <u>SECOND</u> SEMESTER EXAMINATION

SCHOOL OF BUSINESS AND ECONOMICS

FOR THE DEGREE OF BACHELOR OF BUSINESS MANAGEMENT

COURSE CODE: BBM 231

COURSE TITLE: BUSINESS FINANCE

EXAMINATION DURATION: 3 HOURS

DATE: 17/04/18 **TIME: 2.00-5.00 PM**

INSTRUCTION TO CANDIDATES

- **The examination has SIX (6) questions**
- **Question ONE (1) is COMPULSORY**
- **Choose any other THREE (3) questions from the remaining FIVE (5) 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 SIX (6) printed pages ***please turn over***

QUESTION ONE (COMPULSORY)

(a) Halima is 20 years old and is the last born in her family. Her father has promised to give her Kshs. 100,000 when she turns 25 years. She has however argued that money received now is more valuable than the same amount received at a later date. Discuss the concept behind Halima's argument citing four reasons to justify the argument. **[6 marks]**

(b) Discuss the agency relationship that exists between shareholders and managers clearly indicating the conflicts that may arise and suggest solutions to those conflicts. **[8 marks]**

(c) The capital structure of Mororo Ltd as 31st December 2017 was as follows

	Shs.
Ordinary share capital (400,000 shares)	20,000,000
10% Preference shares (30,000 shares, issue price, shs100)	3,000,000
14% Bond capital	14,000,000

Additional information

1. The market price of each ordinary share as at 31st December 2017 was shs. 50 while that of bond was shs. 100.
2. The firm paid a dividend of shs. 5 for each ordinary share for the year ended 31st December 2017.
3. The annual growth rate in dividends is 7%
4. The corporation tax rate is 30%

Required:

i. Compute the weighted average cost of capital of the firm as at 31st December 2017 **[5 marks]**

ii. The firm intends to issue a 15% shs. 6 million bond at shs. 100 each during the year ending 31st December 2015. The existing bond will not be affected by this issue. The dividend per share for the year ending 31st December 2015 is expected to be shs. 7 while the average market price per share over the same period is estimated to be sha. 70. The annual growth rate in dividends is expected to be 8%. Compute the WACC as at 31st December 2015 **[3 marks]**

(d) The following information relates to the securities held by Zawadi Ltd

	Security A	Security B	Security C
Expected Return	8%	10%	12%
Capital invested	2,000,000	1,800,000	1,200,000

Required:

i. Determine the expected return of the portfolio **[3 marks]**

QUESTION TWO

(a) Describe any three dividend theories **[6 marks]**

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

Year	Project A	Project B	
1	40,000	60,000	30,000
2	40,000	50,000	30,000
3	60,000	50,000	30,000
4	60,000	40,000	30,000
5	15,000	(10,000)	30,000
6	-	-	30,000

The initial capital outlay for the three projects is as follows

	Capital outlay (shs)
Project A	160,000
Project B	120,000
Project C	100,000

Required

i. If the firms cost of capital is 14% determine the Net Present Value of each project **[7 marks]**

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

QUESTION THREE

(a) Briefly explain any three approaches to financing current assets **[6 marks]**

(b) The following information relates to Madogo Limited.

	Shs.(000)
Purchases of raw materials (all on credit)	3,350
Usage of raw materials	3,250
Sales of finished goods (all on credit)	12,500
Cost of sales (finished goods)	9,000
Average creditors	700
Average raw materials inventory	600
Average work in progress	500
Average finished goods inventory	1,050
Average debtors	2,350

Assuming a 365 days year

Required:

i. Determine the length of the operating cash cycle **[9 marks]**

QUESTION FOUR

a) A firm is considering investing in a project with the following cash flows:

Year	Cash flow
0	(1,500,000)
1	400,000
2	600,000
3	1,000,000

The firms target rate of return is 15%. Determine the Internal Rate of Return of the project and advise the firm's management. **[5 marks]**

b) The expected return on Treasury bill is 10% while the expected return on the market portfolio is 12%. If the beta of the company is 1.2 determine the required return on Company's stock **[5 marks]**

c) Write short notes on the following

i. Diversification **[1 mark]**
ii. Systematic risk **[2 marks]**
iii. Unsystematic risk **[2 marks]**

QUESTION FIVE

The following information represents the financial position and financial results of Mandera Limited for the year ended 31 December 2017

Income statement for the year ended 31 December 2017

	Shs.(000)	Shs.(000)
Sales: Cash : Credit	300,000 600,000	 900,000
Less cost of sales		
Opening inventory	210,000	
Purchases	660,000	
	870,000	
Less closing inventory	(150,000)	720,000
Gross profit		180,000
Less expenses		
Depreciation	13,100	
Directors emoluments	15,000	

General expenses	20,900	
Interest on loan	4,000	(53,000)
Profit before tax		127,000
Corporation tax 30%		(38,100)
Profit after tax		88,900
Preference dividend	4,800	
Ordinary dividend	10,000	(14,800)
Retained earnings		74,100

Mandera Ltd

Statement of Financial position

As at 31st December 2017

	Shs.(000)	Shs.(000)	Shs.(000)
Noncurrent Assets			213,900
Current Assets			
Inventory	150,000		
Debtors	35,900		
Cash	20,000	205,900	
Current liabilities			
Trade creditors	60,000		
Corporation Tax payable	63,500		
Proposed dividend	14,800	(138,300)	67,600
Net Assets			**281,500**
Financed by			
Ordinary share capital (shs. 10 par value)		100,000	
8% Preference share capital		60,000	

Revenue reserves		81,500	
10% Bank loan		40,000	281,500

Additional information:

1. The company's ordinary shares are selling at Sh.20 in the stock market.
2. The company has a constant dividend payout of 10%.

Required:

Determine the following financial ratios:

(i) Acid test ratio. **[2 marks]**

(ii) Inventory holding period **[3 marks]**

(iii) Return on capital employed **[2 marks]**

(iv) Price earnings ratio **[3 marks]**

(v) Interest coverage ratio **[2 marks]**

(vi) Total assets turnover **[3 marks]**