

**KABARAK**



**UNIVERSITY**

**EXAMINATIONS**

**2008/2009 ACADEMIC YEAR**

**FOR THE DEGREE OF BACHELOR OF COMMERCE**

**COURSE CODE: FNCE 220**

**COURSE TITLE: BUSINESS FINANCE**

**STREAM: Y2S2**

**DAY: WEDNESDAY**

**TIME: 9.00 – 11.00 A.M.**

**DATE: 25/03/2009**

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**INSTRUCTIONS:**

1. Attempt question **ONE** and any other **TWO** questions.
2. Question one carries **30 marks** and the rest **20 marks** each.
3. Show all your workings clearly.

**PLEASE TURN OVER**

## QUESTION ONE

a) Write brief explanatory notes on the following concepts as used in business finance.

- (i) Risk and Return (2 Marks)
- (ii) Diversification (1 ½ Marks)
- (iii) Capital Structure (1 ½ Marks)
- (iv) Having staggered boards (1 ½ Marks)
- (v) Multiple directorships (1 ½ Marks)
- (vi) Agency costs (1 ½ Marks)
- (vii) Profitability Index (1 ½ Marks)

b) Respond to the following comments: -

- (i) Profits are the same as cash flows (2 Marks)
- (ii) Capital structure is the same as financial structure (2 Marks)
- (iii) Harry Markowitz was just another non-Kenyan (2 Marks)

c) (i) Briefly explain the following methods of investment appraisal:

- (i) Payback period (2 Marks)
- (ii) Net present value. (3 Marks)

c) (ii) A company that specializes in the manufacturing of chemicals now wants to diversify into the fertilizer business. It requires a new plant to help in the production of fertilizers. Two plants, being promoted by different vendors, have been identified with the following cash flows.

End of Year	Net Cash Flows (Kshs. '000)	
	Machine A	Machine B
0	24,000	5,000
1	18,000	9,000
2	15,000	10,000
3	12,000	13,000
4	10,000	15,000
5	5,000	20,000
6	2,000	28,000

Assess the suitability of the capital project using the following methods: -

- (a) Payback period. (2 Marks)
- (b) Net present value method. (3 Marks)
- (c) Profitability index (3 Marks)

[Total: 30 Marks]

## **QUESTION TWO**

(a) Briefly explain the following forms of financing the acquisition of a capital asset.

(i) Leasing. (3 Marks)

(ii) Hire Purchase. (3 Marks)

(b) Explain the main differences between a sale-or-lease back and an asset purchase.

(4 Marks)

(c) Janet is considering investing in a corporate bond with possible one-year returns distributed as follows:

<b>Returns</b>	6%	9%	11%	13%	16%
<b>Probability</b>	0.15	0.20	0.30	0.20	0.15

### **Required:**

(i) Determine the expected return and standard deviation of the above security.(6 Marks)

(ii) Suppose that Janet now wants to form a portfolio of Kshs. 1 Million, with Kshs. 400,000 invested in the above bond, denoted B. If the rest of the funds are invested equally in the stocks K and C of two companies, determine the expected return of the portfolio given the following information.

<b>Security</b>	<b>Expected Return %</b>
K	10
C	12

(4 Marks)

## **QUESTION THREE**

(a) What is the difference between profit maximization and wealth maximization

(5 Marks)

(b) Using knowledge of agency theory, discuss how to resolve the potential conflicts arising between:

(i) Shareholders and management (7 ½ Marks)

(ii) Lenders and owners (7 ½ Marks)

#### **QUESTION FOUR**

(a) In a recent seminar held in Nairobi, a financial analyst stated that “There is no doubt that compared to large firms, small firms are at considerable disadvantages in financial markets”.

**Required:**

(i) Discuss the above statement, giving details of the ways in which small firms encounter disadvantages when it comes to raising finance. (8 Marks)

(ii) Does the above statement imply that there is a bias in the financial system against small firms? Explain. (4 Marks)

(b) The valuation of ordinary shares is more complicated than the valuation of bonds and preference shares. Explain the factors that complicate the valuation of ordinary shares. (6 Marks)