CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

SECOND YEAR EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE,
BACHELOR OF PURCHASING AND SUPPLIES MANAGEMENT &
BACHELOR OF ENTREPRENEURSHIP AND SMALL BUSINESS MANAGEMENT

BCOM/BBAM/BPSM 230: BUSINESS FINANCE

STREAMS: BCOM/BPSM/BBAM Y2S2 **TIME: 2 HOURS**

DAY/DATE: TUESDAY 13/8/2013 **11.30 A.M. – 1.30 P.M.**

INSTRUCTIONS:

(a) Answer **Question ONE** and any other **TWO** questions.
(b) Show all your workings
(c) Do not write on the question paper.
(d) Mathematics tables have been provided

QUESTION ONE

(a) "…. The function of financial management is to review and control decisions to commit and 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 whenever decisions are made about the acquisition or destruction of assets".

Briefly discuss this statement. [5 marks]

(b) Define agency relationship from the context of a public limited company and briefly explain how this arises. [6 marks]

(c) Highlight the various measures that would minimize agency problems between the owners and the management. [6 marks]

(d) Exactly ten years from now, assume that Kennedy will start receiving a pension of Kshs. 3,000 a year. The payment will continue for sixteen years. How much is the pension worth now, if George's interest rate is 10 per cent? [3 marks]

(e) The following table gives dividend and share price data for ABC manufacturing company.

Year	Div/share	Closing Share Price
1994	2.5	12.25
1995	2.5	14.2
1996	2.5	17.5
1997	3	16.75
1998	3	18.45
1999	3.25	22.25
2000	3.5	23.5
2001	3.5	27.75
2002	3.5	25.5
2003	3.75	27.95
2004	3.75	31.3

You are required to calculate:

(i) Annual rates of return
(ii) The expected (average) rate of return
(iii) The variance and,
(iv) The standard deviations of returns [10 marks]

QUESTION TWO

P. Muli was recently appointed to the post of investment manager of Masada Ltd. a quoted company. The company has raised Sh.8,000,000 through a rights issue. P. Muli has the task of evaluating two mutually exclusive projects with unequal economic lives. Project X has 7 years and Project Y has 4 years of economic life. Both projects are expected to have zero salvage value. Their expected cash flows are as follows:

Project	**X**	**Y**
Year	**Cash flows (Sh.)**	**Cash flows (Sh.)**
1	2,000,000	4,000,000
2	2,200,000	3,000,000
3	2,080,000	4,800,000
4	2,240,000	800,000
5	2,760,000	-
6	3,200,000	-
7	3,600,000	-

The amount raised would be used to finance either of the projects. The company expects to pay a dividend per share of Sh.6.50 in one year's time. The current market price per share is Sh.50.

Masada Ltd expects the future earnings to grow by 7% per annum due to the undertaking of either of the projects. Masada Ltd. has no debt capital in its capital structure.

Required:

(i) The cost of equity of the firm. [3 marks]
(ii) The net present value of each project. [6 marks]
(iii) The internal rate of return (IRR) of the projects. (Rediscount cash flows at 24% for project X and 25% for project Y). [6 marks]

(iv) Briefly comment on your results in (ii) and (iii) above. [2 marks]

(v) Identify and explain the circumstances under which the Net Present Value (NPV) and the Internal Rate of Return (IRR) methods could rank mutually exclusive projects in a conflicting way. [3 marks]

QUESTION THREE

(a) Assume that Safaricom Ltd Company is paying a dividend of Kshs 2.00 per share. The dividend is expected to grow at a 15 per cent annual rate for three years, then at 10 per cent for the next three years, after which it is expected to grow at a 5 per cent, rate forever.

(i) What is the present value of the share if capitalization rate is 9 per cent.
(ii) If the share is held for three years, what shall be its present value? [10 marks]

(b) Using illustrations, briefly discuss the major sources of business finance. [6 marks]

(c) Briefly explain the importance of capital budgeting in a business organization. [4 marks]

QUESTION FOUR

(a) List and explain five factors that should be taken into account by a businessman in making the choice between financing by short-term and long-term sources. [10 marks]

(b) Assume that you are a financial manager in your company and that your company has made plans for next year. It is estimated that the company will employ total assets of $8000,000; 50 per cent of the assets being financed by borrowed capital at an interest cost of 8 per cent per year. The direct costs for the year are estimated at $480,000 and all other operating expenses are estimated at $80,000. The goods will be sold to customers at 150 per cent of the direct costs. Tax is assumed to be 50 per cent.

You are required to calculate:

(i) Net profit margin
(ii) Return on assets
(iii) Asset turn over
(iv) Return on owner's equity [10 marks]

QUESTION FIVE

(a) Define the term "return' and briefly explain the components of total return.
[4 marks]

(b) Outline four limitations of the use of ratios as a basis of financial analysis.
[4 marks]

(c) Stocks A and B have the following historical returns

Year	Stock A's Returns R_a	Stock B's Returns R_b
2000	-18%	-24%
2001	44	24
2002	-22%	-4
2003	22	8
2004	34%	56

(i) Calculate the average rate of return for each of the stock during the 5-year period. Assume that someone held a portfolio consisting of 50 percent Stock A and 50 per of stock B. What would have been realized rate of return on the portfolio in each year and so the average return on portfolio during this period?

(ii) Calculate the standard deviation of returns for each stock and for the portfolio.
[9 marks]

(d) In evaluating investment decisions, cash flows are considered to be more relevant than profitability associated with the project. Explain why this is the case. [3 marks]
