MASENO UNIVERSITY

UNIVERSITY EXAMINATIONS 2013/2014

SECOND YEAR FIRST SEMESTER EXAMINATIONS FOR THE DEGREE OF BACHELOR OF BUSINESS ADMINISTRATION, BACHELOR OF ARTS (ECONOMICS), BACHELOR OF EDUCATION (ARTS) AND BACHELOR OF ARTS (BUSINESS STUDIES WITH INFORMATION TECHNOLOGY

(MAIN CAMPUS)

ABA 202: INTRODUCTION TO FINANCE

Date: 26th November, 2013 *Time: 8.30 - 10.30 a.m.*

INSTRUCTIONS:

- **Answer Question ONE and any other TWO questions.**
- **Marks allocated are shown at the end of each question.**
- **Show all your workings.**
- **Do not write on the question paper.**

QUESTION ONE

a) (i) Explain any five actions or transactions by management and shareholders that could be harmful to the interests of debt holders. **(5 marks)**

(ii) Write short notes on any five restrictive covenants that debt holders may use to protect their wealth from management and shareholder raids. **(5 marks)**

(iii) Discuss the significance of financial ratio analysis to its varied users. **(10 marks)**

b) As a portfolio analyst at Runda Limited you are conducting an analysis of four alternative investment projects. Each project has a holding period of one year. The estimated rates of return for three alternative states of the economy are shown in the table below:

State of the Economy	**Probability of each state occurring**	**Rate of return if state occurs**			
		A	**B**	**C**	**M**
		%	%	%	%
Recession	0.2	10	6	22	5
Average	0.6	10	11	14	15
Boom	0.2	10	31	-4	25

Required:

Apply the mean-variance criterion to determine whether any of the alternative projects can be eliminated. **(10 marks)**

QUESTION TWO

a) P. Kurgat was recently appointed to the post of investment manager of Kisumu Ltd. a quoted company. The company has raised Kshs.8, 000,000 through a rights issue.

P. Kurgat 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 (Kshs)	Cash flows (Kshs)
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 Kshs 6.50 in one year's time. The current market price per share is Kshs 50. Kisumu Ltd. expects the future earnings to grow by 7 % per annum due to the undertaking of either of the projects. Kisumu Ltd. has no debt capital in its capital structure.

Required:

a) The cost of equity of the firm. **(4 marks)**

b) The net present value of each project. **(6marks)**

c) The Modified Net Present Value (MNPV) of the projects at 30 % re-investment rate **(8 marks)**

d) Briefly comment on your results in (b) and (c) above. **(2 marks)**

QUESTION THREE

a) The executive director of Pesa Ltd has circulated the following information as part of board paper:

Pesa Ltd.
Financial Performance for the year ended 31 March:

	2012	2011
Return on investment	12%	10%
Gross profit on sales	25%	20%
Number of days credit given	30 days	45 days
Administrative cost of sales	7%	10%

Required:

Brief report on each of the above 4 ratios indicating the reservation, if any, you may have on judging them as improvement in performance. **(10 marks)**

b) Discuss the significance of financial forecasting in a business enterprise. **(10 marks)**

QUESTION FOUR

a) "Financial leverage is variously described a double edged sword" Discuss. **(4 marks)**

b) Differentiate between the following pairs of terms:

(i) Market value and intrinsic value of a share. **(4 Marks)**
(ii) Weighted cost of capital and marginal cost of capital. **(4 Marks)**
(iii)Capital structure and financial structure. **(4 Marks)**

(b) Identify four factors that have limited the development of the venture capital market in your country. **(4 Marks)**

QUESTION FIVE

a) Explain the term overcapitalization of a business and clearly describe its effects on shareholders of a company. **(8 marks)**

b) Assume that ABC Ltd produces two products, product A and B and the following budget has been prepared.

	A	**B**	**Total**
	120,000	40,000	160,000
Sales in units	Kshs	Kshs	Kshs
Sales @5/-, 10/-	600,000	400,000	100,000
Variable cost @ 4/-, 3/-	480,000	120,000	600,000
Contribution @ 1/- 7/-	120,000	280,000	400,000
Total fixed cost			300,000
Profit			100,000

Required:

i. Compute the break-even point in total and for each of the products. **(6 marks)**

ii. The company proposes to change the sales mix in units to 1:1 for products A and B. Advice the Co. on whether this change is desirable. **(6 marks)**