MACHAKOS UNIVERSITY

University Examinations for 2021/2022 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ACCOUNTING BANKING AND FINANCE

SECOND YEAR SECOND SEMESTER EXAMINATION FOR

BACHELOR OF COMMERCE

BACHELOR OF ECONOMICS

BAC 204: BUSINESS FINANCE 11

DATE: 10/12/2021 **TIME: 11.00-1.00 PM**

INSTRUCTIONS:

Answer Question One and Any Other Two Questions

QUESTION ONE (COMPULSORY) (30 MARKS)

(a) Capital structure refers to the specific mix of long - term debt and equity the firm uses to finance its operations. Explain five factors that should be considered when making this important decision. (5 marks)

(b) Explain how the ABC System of inventory Management operates and how it differs from Economic Order Quantity Model. (5 marks)

(c) P and Q two firms that are operating in the same industry and have the following characteristics.

	Firm A	Firm B
Selling price per unit	Shs.2	Shs.2
Variable cost per unit	Shs.1.6	Shs.1.80
Fixed costs	Shs.40,000	Shs.,65,000

For the year 2019 their level of output had reached 120,000 units and it seems that market conditions for the year 2020 had greatly improved necessitating the output level to be increased to 160,000 units per year.

Required:

(i) Calculate the degree of Operating Leverage for both firms for the year 2020. (6 marks)

(ii) From your results above, which business has a higher business risk and why? (4 marks)

(d) You are a financial analyst of H ltd company. The CEO of the Company has asked you to analyze two proposed capital investments, project X and Y. Each project has a cost of sh.100,000 and the cost of capital for each project is 12%. The projects' expected net cash flows are as follows:

<u>EXPECTED NET CASH FLOWS</u>

YEAR	Project X	Project Y
1	65,000	35,000
2	30,000	35,000
3	30,000	35,000
4	10,000	35,000

Required:

i) Calculate each project's PBP and NPV (6 marks)

ii) Which project or projects should be acceptable if they are independent? (2 marks)

iii) Which project should be accepted if they are mutually exclusive? (2 marks)

QUESTION TWO (20 MARKS)

(a) Fortunate Ltd.s capital structure (taken from the financial statement position) is as follows:

	Millions Shillings
Ordinary shares of Shs.10 each	8
10% preference shares of Shs.20 each	5
12% loan notes	10

The Business pays corporation tax at the rate of 20% and is expected to earn a consistent annual profit before interest and tax of Shs.9Million. The current market prices of the shares are:

Preference Shares	Shs.13
Ordinary Shares	Shs.76

The loan notes are irredeemable and have a market price Value of Shs.2,000 per note and Shs.2,000 nominal value.

Required:

Calculate the Weighted Average Cost of Capital (WACC) (10 marks)

(b) Zee Company is evaluating the following seven investment proposals. The company has capital expenditure ceiling ofKShs 2 000,000 and therefore can accept just enough proposals. Cost of capital is 12%

Project	Cash outlay (Ksh.`000`)	NPV (KSh.`000`)
M	100	18
O	500	80
P	200	40
Q	600	36
R	1 000	250
S	800	180
T	400	90

You are **required:**

i) To rank the proposals according to profitability index and indicate the group of proposals to be accepted. (4 marks)

ii) If projects R and S are mutually exclusive, which group of projects would be accepted and why? (6 marks)

QUESTION THREE (20 MARKS)

(a) Safaricom is one of the leading blue chip companies in Kenya and beyond. Identify and clearly explain any five factors that might be key determinants of its capital structure. (10 marks)

(b) Explain the following Dividend theories:

(i) Signaling Hypothesis

(ii) Bird-In-The-Hand Theory

(iii) Clientele Effect (6 marks)

(c) For each of the following companies described below, state whether and why you would expect to have high or low dividend pay-out:

(i) A company with a large proportion of inside ownership all of whom are high income individuals (2 marks)

(ii) A company with volatile earnings and high business risk. (2 marks)

QUESTION FOUR (20 MARKS)

(a) Explain the following Dividend theories:

(i) Pecking order Theory

(ii) Trade off Theory

(iii) Signaling Theory

(iv) Market Timing Theory (8 marks)

(b) Malili Flyers Ltd. uses a component which it buys from a supplier in its manufacturing process. The estimated annual usage is 23,000 units and these are used fairly steadily throughout the year. It is estimated that the various inventories holding costs amount Shs.1.5 per unit per year. Investigations indicate that it costs about Shs.50 to process each order for the component. Experience shows that delivery always occurs within one week of placing an order.

Required:

(i) Calculate the Economic Order Quantity of the Component. (6 marks)

(ii) Determine what inventories level the order should be placed in order to be confident that delivery would occur before the existing inventories of the components is all used. (6 marks)

QUESTION FIVE (20 MARKS)

(a) The optimum level of inventory should be determined on the basis of a trade-off between costs and benefits associated with the levels of inventory. Horgen, D. F suggested that managing inventories to increase net income requires effective management of costs that fall into the five categories. Explain these five categories. (10 marks)

(b) Paramount products Ltd wants to raise Shs.10,000,000 for diversification project. Current estimates of EBIT from the new project is Shs.2,200,000. P.a.

Cost of debt will be 15% for amounts upto and including Shs.4,000,000; 16% Shs.5,000,000 and 18% for additional amounts above Shs.5,000,000. The equity shares of the company have a face value of Shs.10 and a market value of Shs.40. The market value is expected to fall to Shs.32 if debts exceeding Shs.5,000,000 are raised. The following options are under consideration of the Company:

Option	Debt	Equity
I	50%	50%
II	40%	60%
III	60%	40%

Given a tax rate of 30%, determine the EPS for each option and advise the Company which option it should adopt. (10 marks)