MACHAKOS UNIVERSITY

University Examinations 2021/2022 Academic Year

SCHOOL OF BUSINESS, ECONOMICS AND HOSPITALITY AND TOURISM MANAGEMENT

DEPARTMENT OF BUSINESS ADMINISTRATION AND FINANCE

SECOND YEAR SPECIAL/SUPPLEMENTARY EXAMINATION FOR BACHELOR OF COMMERCE

BAC 204 BUSINESS FINANCE II

DATE: 29/8/2022 **TIME: 2.00-4.00 PM**

INSTRUCTIONS

- Answer question **ONE (Compulsory)** and any other **TWO questions**

QUESTION ONE (30 MARKS)

a) Discuss any three characteristics of long-term investments (6 marks)

b) Eagle Woods Ltd wants to expand its factory to take advantage of the increased demand for its products. It is proposed that this will cost Ksh.100,0000 and generate after-tax cash inflows of Ksh. 235,000, Ksh. For 8 years. You are required to determine Eagle Wood's payback period. (6 marks)

c) Discuss the merits and the demerits of Internal Rate of Return (6 marks)

d) Explain what is meant by the term Time Value of Money. Why is a bird in hand worth two or so in the bush? Which capital budgeting approach ignores this concept? Is it optimal? (6 marks)

e) What is mutually exclusive investment project? What is a dependent project? (6 marks)

QUESTION TWO (20 MARKS)

Briarcliff Store Ltd. Is considering a new product line to supplement its range line. It is anticipated that the new product line will involve cash investment of Ksh. 700,000 at time 0 and Ksh. 1000,000 in year 1. After-tax cash inflows of Ksh. 250,000are expected in year 2 Ksh. 300,000 in year 3, Ksh. 350,000 in year 4, and Ksh. 400,000 each year thereafter through year 10. Though the product line might be viable after year 10, the company prefers to be conservative and all calculations at that time.

a) If the required rate of return is 15%, what is the NPV of the project? (6 marks)

b) What is its IRR? (6 marks)

c) What would be the case if the required rate of return was 10%? (2 marks)

d) What is the project payback period? (6 marks)

QUESTION THREE (20 MARKS)

a) Identify and explain clearly any five factors that determine the capital structure of any firm (5 marks)

b) For each of the following companies described below, state whether and why you would expect it to have high or low dividends payments out ratio:

   i. A company with a large proportion of inside ownership, all of whom are high income individuals (1 mark)

   ii. A growth company with an abundance of good investment opportunities (1 mark)

   iii. A company experiencing ordinary growth that has high liquidity and much unused borrowing capacity (1 mark)

   iv. A dividend-paying company that experience an unexpected drop in earnings from trend (1 mark)

   v. A company with volatile earnings and high business risk (1 mark)

c) A Ltd issues Ksh. 100,000, 9% debenture at a premium of 10%. The costs of floatation are 2%. The tax rate applicable is 50%. You are required to determine the

cost of debt capital
(6 marks)

QUESTION FOUR (20 MARKS)

a) Explain the following Dividend Theories:

i. Trade Off Theory
ii. Bird-In-Hand Theory
iii. Pecking Order Theory
iv. Clientele Effect
v. Signalling Hypothesis (10 marks)
vi. The Balance Sheet of X ltd. For the year ended December 31, 2019 is given below:

Liabilities	Ksh.	Assets	Ksh.
Equity share capital	55000	Fixed assets	35000
Debentures	6000	Stock	15000
Retained earnings	4000	Bills receivable	5000
Bills payable	2000	Debtors	5000
Creditors	3000	Cash and Bank	10000
Total Liabilities	70000	Total Assets	70000

From the above information you are required to calculate the Capital and Financial structures for X Ltd (10 marks).

QUESTION FIVE (20 MARKS)

a) ABC Ltd, needs Ksh 3000000 for the installation of a new factory. The new factory expects to yield annual earnings before interest and tax (EBIT) of Ksh. 500000.In choosing a financial plan, ABC Ltd has an objective of maximizing earnings per share (EPS). The company proposes to issuing ordinary shares and raising debt of Ksh. 300000, Ksh. 1000000 and Ksh. 1500000. The current market price per share is Ksh. 250 and is expected to drop to Ksh. 200, if funds are borrowed in excess of Ksh. 1200000.Funds can be raised at the following rates:

Up to Ksh.300000@ 8%

Over Ksh. 300000 to Ksh. 1500000 @ 10%

Over Ksh. 1500000 @ 15%

Assuming corporation tax rate of 30%, advise the company (12 marks)

b) Why is working capital management important to a firm? (4 marks)

c) What is capital budgeting and is its significance in a firm? (4 marks)