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**GARISSA UNIVERSITY**

**UNIVERSITY EXAMINATION 2019/2020 ACADEMIC YEAR TWO**

**SECOND SEMESTER EXAMINATION**

**SCHOOL OF BUSINESS AND ECONOMICS**

**FOR THE DEGREE OF BACHELOR OF BUSINESS MANAGEMENT**

**COURSE CODE: BBM 231**

**COURSE TITLE: BUSINESS FINANCE**

**EXAMINATION DURATION: 2 HOURS**

**DATE: 16/12/2020 TIME: 09.00-11.00 AM**

**INSTRUCTION TO CANDIDATES**

* **The examination has FIVE (5) questions**
* **Question ONE (1) is COMPULSORY**
* **Choose any other TWO (2) questions from the remaining FOUR (4) questions**
* **Use sketch diagrams to illustrate your answer whenever necessary**
* **Do not carry mobile phones or any other written materials in examination room**
* **Do not write on this paper**

**This paper consists of FOUR (4) printed pages *please turn over***

**QUESTION ONE (COMPULSORY)**

1. Distinguish between the goal of profit maximization and shareholders wealth maximization **[4 marks]**
2. Explain three limitations of the goal of profit maximization **[6 marks]**
3. Karatasi Ltd. had the following capital structure as at 31 December 2008.

|  |  |
| --- | --- |
|  | **“sh. “000”** |
| Ordinary share capital (sh. 20 par value) | 10,000 |
| Retained earnings | 12,000 |
| 12% preference share capital (sh. 10 par value) | 4,800 |
| 10% debentures (sh. 1,000 par value) | 7,200 |
|  | 34000 |

**Additional information:**

1. The current market price per ordinary share, preference share and debenture is sh.. 50, sh. 24 and sh. 1,200 respectively.
2. For the year ended 31 December 2008, the company paid an ordinary dividend of sh. 6.00 per share. Analysts estimate that the company’s earnings and dividends will grow at an annual rate of 15 per cent indefinitely.
3. The corporation tax rate is 30 per cent.

**Required;-**

1. The company’s market weighted average cost of capital **[10 marks]**
2. Shadrack Chando borrowed Sh.80,000 from XYZ commercial bank at an interest rate of 1.25% compounded monthly. The loan is to be amortized using the reducing balance method and be repaid in 12 equal monthly installments payable at the end of each month.

**Required:**

1. A loan amortization schedule **[10 marks]**

**QUESTION TWO**

1. Explain the term agency theory as applied in financial management. **[2 marks]**
2. Wanga Ltd. maintains a minimum cash balance of Sh. 1,500,000. The standard deviation of the daily cash is Sh.800, 000. The annual interest rate is 12%. The transaction cost of buying and selling of marketable securities is Sh.200 per transaction. Assume that one year has 365 days.

**Required:**

Using the Miller-Orr cash management model, determine:

* 1. The return point. **[2 marks]**
  2. Average cash balance. **[2 marks]**
  3. The upper cash limit **[2 marks]**

1. Sally Chemicals Ltd is considering replacing a production machine at its plant in the industrial area. The existing production machine at the plant was bought 3 years ago at a cost of Sh. 50 million with an expected useful life of 8 years with no scrap value at the end of this period. The existing machine could be disposed of immediately with net proceeds of Sh. 35 million after tax. The new machine will cost the company Sh. 80 million with a useful life of 5 years and an expected terminal value of Sh. 5 million. Additional installation cost for the new machine will be Sh. 6 million. With the introduction of the new machine; sales are expected to increase by Sh. 25 million per annum over the next five years. However, electricity costs will increase by Sh. 400,000 per annum. The contribution margin will be 40% and the corporate tax rate is at 30%. The operation of the new machine will also require an immediate investment of Sh. 8 million in working capital which will be recovered at the end of its useful life. The company uses the straight-line method of depreciation. The company's cost of capital is 12%. Ignore capital gains.

**Required:**

1. The initial cash outflow for the replacement decision. **[4 marks]**
2. Using the net present value (NPV) criteria, advise the management of Sally Chemicals Ltd on whether to replace the machine.  **[8 marks]**

**QUESTION THREE**

1. The earnings yields of excel Ltd. is 20% and the current market price per ordinary share is Sh100. Each Share has a par value of Sh.50. The dividend for the current year is expressed as 10% of the par value

**Required:**

1. The earnings per share **[2 marks]**
2. The dividend cover **[2 marks]**
3. The price earnings ratio **[2 marks]**
4. Explain three causes of conflict of interest between shareholders and debt holders **[6 marks]**
5. Describe four ways that could be used to mitigate agency conflict between managers and shareholders **[8 marks]**

**QUESTION FOUR**

1. Explain three factors that might influence the capital structure decision. **[6 marks]**
2. Discuss four functions of the capital markets regulator in your country. **[8 marks]**
3. The following information relates to two potential investments namely; A and B.

|  |  |  |  |
| --- | --- | --- | --- |
| **Investment A** |  | **Investment B** |  |
| **Probability** | **Return** | **Probability** | **Return** |
| 0.3  0.4  0.3 | 20%  8%  -4% | 0.2  0.6  0.2 | 20%  8%  -4% |

**Required:**

1. The standard deviation of each of the two investments **[6 marks]**

**QUESTION FIVE**

1. Citing relevant examples in each case, distinguish between
2. agency costs and financial distress costs **[4 marks]**
3. Primary markets and secondary markets **[4 marks]**
4. Capital markets and money markets **[4 marks]**
5. Brokers and jobbers **[4 marks]**
6. Outline four advantages of paying scrip dividends **[4 marks]**