**GARISSA UNIVERSITY**

UNIVERSITY EXAMINATION 2020/2021 ACADEMIC YEAR **FOUR SECOND** SEMESTER EXAMINATION

SCHOOL OF BUSINESS AND ECONOMICS

FOR THE DEGREE OF BACHELOR OF BUSINESS MANAGEMENT

**COURSE CODE: BBM 414**

**COURSE TITLE: FINANCIAL MANAGEMENT**

**EXAMINATION DURATION: 2HOURS.**

**DATE: TIME:**

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**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 answers where necessary
* Do not carry mobile phones or any other written materials in the examination room
* Do not write on this paper

**This paper consists of FIVE (5 printed pages *Please turn over***

QUESTION ONE

CASE STUDY

GEORGE OKOTH & COMPANY

INTEREST RATE DETERMINATION

MacDonald Mariga is a professional football player, and your firm manages his money. He has asked you to give him information about what determines the level of various interest rates. Your boss has prepared some questions for you to consider.

1. What are the four most fundamental factors that affect the cost of money, or the general level of interest rates, in the economy? [8Marks]
2. What is the real risk-free rate of interest (r\*) and the nominal risk-free rate (rRF)? How are these two rates measured? [4Marks]
3. Define the terms:
4. Inflation premium (IP) [2Marks]
5. Default risk premium (DRP) [2Marks]
6. Liquidity premium (LP), and [2Marks]
7. Maturity risk premium (MRP). [2Marks]
8. What is the term structure of interest rates? [2Marks]
9. What is a yield curve? [2Marks]
10. What is the pure expectations theory? [3Marks]
11. What does the pure expectations theory imply about the term structure of interest rates? [3Marks]

QUESTION TWO

a) Outline four differences between Funds Flow and Cash Flow Statement [**8Marks]**

1. The following is a balance sheet of **Ecopost Industries Ltd**., as 31st March 2020.

|  |  |  |  |
| --- | --- | --- | --- |
| **Assets** | **Ksh.** | **Liabilities** | **Ksh.** |
| Fixed assets (**less** depreciation sh.10,000) | 26,000.00 | Equity Share Capital | 10,000.00 |
| **Current Assets:**  Cash  investments (10%  Sundry debtor.  Stock | 1,000.00  3,000.00  4,000.00  6,000.00 | 7% Preference Share Capital | 2,000.00 |
|  |  | Reserves and Surplus | 8,000.00 |
|  |  | 6% Mortgage Debentures | 14,000.00 |
|  |  | **Current Liabilities:**  Creditor.  Bills payable  Outstanding expenses | 1,200.00  2,000.00  200.00 |
|  |  | Tax Provision | 2,600.00 |
|  | **40,000.00** |  | **40,000.00** |

You are provided with the following additional information:

1. Net sales Sh. 60,000.00

2. Cost of goods sold Sh. 51,600.00

3. Net income before tax Sh. 4,000.00

4. Net income after tax Sh. 2,000.00

**Required:**

Calculate the following ratios:

1. Short-term solvency ratios **[2Marks]**
2. Long-term solvency ratios **[3Marks]**
3. Activity ratios **[4Marks]**
4. Profitability ratios **[3Marks]**

QUESTION THREE

1. The current market price of the shares of A Ltd. is Sh. 95. The floatation costs are Sh. 5 per share amounts to Sh. 4.50 and is expected to grow at a rate of 7%.

You are required to calculate the cost of equity share capital. **[2Marks]**

1. A company has on its books the following amounts and specific costs of each type of capital:

|  |  |  |  |
| --- | --- | --- | --- |
| **Type of Capital** | **Book Value(sh.)** | **Market Value(sh.)** | **Specific Costs (%)** |
| Debt  Preference  Equity  Retained Earnings | 400,000  100,000  600,000  200,000  1,300,000 | 380,000  110,000  900,000  300,000  1,690,000 | 5  8  15  13 |

**Required:**

Determine the weighted average cost of capital using:

**(i).** Book value weights, and **[5Marks]**

**(ii).** Market value weights. **[5Marks]**

1. ABC Ltd. has the following capital structure.

**Ksh.**

Equity (expected dividend 12%) 1,000,000

10% preference 500,000

8% loan 1,500,000

Required:

Calculate the weighted average cost of capital, assuming 50% as the rate of income-tax, before and after tax **[8Marks]**

QUESTION FOUR

1. Discuss four merits and three demerits of **Net Present Value** [7Marks]
2. Discuss the Accounting Rate of Return and state its merits and demerits [4Marks]
3. From the following information, calculate the **Net Present Value** of the two projects and suggest which of the two projects should be accepted at discount rate of the two.

|  |  |  |
| --- | --- | --- |
|  | **Project X** | **Project Y** |
| Initial Investment  Estimated Life  Scrap Value | Sh. 20,000  5 years  sh. 1,000 | sh. 30,000  5 years  sh. 2,000 |

The profits before depreciation and after taxation (cash flows) are as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Year 1** | **Year 2** | **Year 3** | **Year 4** | **Year 5** |
| Sh.  **Project X** 5,000  **Project Y** 20,000 | Sh.  10,000  10,000 | Sh.  10,000  5,000 | Sh.  3,000  3,000 | Sh.  2,000  2,000 |

**Note: The following are the present value factors @ 10% p.a**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Year | 1 | 2 | 3 | 4 | 5 | 6 |
| Factor | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 | 0.564 |

[9Marks]

QUESTION FIVE

1. Discuss the various factors affecting the capital structure. [8Marks]
2. A Company expects a net income of Ksh. 100,000. It has Ksh. 250,000, 8% debentures. The equality capitalization rate of the company is 10%.

**Required:**

1. Calculate the value of the firm and overall capitalization rate according to the net income approach (ignoring income tax). [6Marks]
2. If the debenture debts are increased to Ksh. 400,000. What shall be the value of the firm and the overall capitalization rate? [6Marks]