JARAMOGI OGINGA ODINGA UNIVERSITY OF SCIENCE AND TECHNOLOGY
SCHOOL OF BUSINESS & ECONOMICS
UNIVERSITY EXAMINATION FOR THE DEGREE OF BACHELOR OF BUSINESS ADMINISTRATION WITH IT
3RD YEAR 1ST SEMESTER 2016/2017 ACADEMIC YEAR
KISUMU CAMPUS

COURSE CODE : ABA 303
COURSE TITLE : FINANCIAL MANAGEMENT

TIME: 2 HOURS

Instructions:

1. **Answer Question ONE (COMPULSORY) and ANY other 2 questions**
2. **Candidates are advised not to write on the question paper**
3. **Candidates must hand in their answer booklets to the invigilator while in the examination room**

QUESTION ONE

a.) Does the firm's profit maximization strategy have to be the same with its wealth maximization programme? Explain. (10 marks)

b.) Explain the relationship between an investor's required rate of return and the cost of capital (5 marks)

c.) A zero coupon bond with a ten year maturity and a face value of Kshs. 10,000/- is issued by Otonglo Enterprises for subscription. Calculate the bond market value if the market returns for similar bonds is 12%. (5 marks)

d.) ABC Company dividends are expected to grow perpetually at 6% and the dividend per share is also expected to be Kshs. 8/- at the end of the first period. The appropriate discount rate with this type of security is at 14%. Calculate the share price (5 marks)

e.) The following are important milestones in the understanding of finance theory. Discuss.
   i.) Security market line (SML)
   ii.) Capital Asset Pricing Model (CAPM)
   iii.) Efficient Market Hypothesis (EMH) (5 marks)

QUESTION TWO

a.) Define risk and return relationship. How can this be redefined through portfolio diversification? (5 marks)

b.) What are the basic components of risk? How do they affect an investor's business decision? (5 marks)

c.) Suppose XYZ Company has invested in the following stocks (securities) :

	Amount Invested (Kshs)	Expected Return	Beta
Security A	50,000	8%	.80
Security B	100,000	12%	.95
Security C	300,000	15%	1.10
Security D	500,000	18%	.40

Required:

i.) Calculate the expected return of this portfolio (5 marks)

ii.) Does this portfolio have more or less systematic risk than an average asset? Explain. (5 marks)

QUESTION THREE

a.) "The importance of capital budgeting cannot be over-emphasized." Do you agree? Why? (5 marks)

b.) What are the steps involved in capital budgeting process? (5 marks)

c.) A project costs Kshs. 160,000/- and is expected to generate cash flows of Kshs. 80,000/-, Kshs. 70,000/- and Kshs. 60,000/- over its life of 3 years. Calculate the project's internal rate of return (5 marks)

d.) Explain capital rationing rationalization (5 marks)

QUESTION FOUR

a.) Distinguish between time series and cross sectional analysis of financial statements. Explain their unique application to the understanding of company performance. (5 marks)

b.) The total sales (all credit) of a firm are Kshs. 640,000/-. It has a gross profit margin of 15% and a current ratio of 2.5. The firms current liabilities are Kshs. 96,000/-, inventories Kshs. 48,000 and cash Kshs. 16,000.

Required:

i.) Determine the average inventory to be carried by the firm with an inventory turn-over of 5 times based on a 360 day year (5 marks)

ii.) Determine the average collection period if the opening balance of debtors is to be Kshs. 80,000/- based on a 360 day year (5 marks)

QUESTION FIVE

a.) What is the CAPM approach for calculating the cost of equity? What is the difference between this approach and the constant growth approach? Which one is better? Why? (5 marks)

b.) The Ndungu Company has the following capital structure as of 30/06/2004:

Ordinary Shares (200,000 shares)	Kshs. 4,000,000
10% Preference Shares	Kshs. 1,000,000
14% Debentures	Kshs. 3,000,000
	Kshs. 8,000,000

The share of the company sells at Kshs. 20/-. It is expected that the company will pay next year a dividend of Kshs. 2/- per share, which will grow at 7% forever. Assume a 50% tax rate.

Required:

i.) Compute the WACC based on the existing capital structure (5 marks)

ii.) Compute the new WACC if the company raises an additional Kshs. 2,000,000/- debt by issuing 15% debenture. This will lead to increasing dividend to Kshs. 3/- and leave the growth unchanged, but the share price will fall to Kshs. 15/- per share (5 marks)

iii.) Compute the cost of capital if in (ii.) above, the growth rate increases to 10%. (5 marks)