



**JARAMOGI OGINGA ODINGA UNIVERSITY OF SCIENCE AND TECHNOLOGY**  
**SCHOOL OF BUSINESS & ECONOMICS**  
**UNIVERSITY EXAMINATION FOR THE DEGREE OF BACHELOR OF BUSINESS**  
**ADMINISTRATION WITH IT**  
**2<sup>ND</sup> YEAR 1<sup>ST</sup> SEMESTER 2018/2019 ACADEMIC YEAR**  
**KISII CAMPUS-PART TIME**

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**COURSE CODE: MBA 823**

**COURSE TITLE: CORPORATE FINANCE**

**EXAM VENUE:**

**STREAM: (BBA )**

**DATE:**

**EXAM SESSION:**

**TIME: 3 HOURS**

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**Instructions:**

- 1. Answer Question ANY 4 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. Preferred stock is somewhat similar to debt. It combines the features of common stock and those of debt. Discuss the features of preferred stock that make them distinct from debt and common stock. [10mks]
- b. Explain why a company may prefer to issue convertibles as a source of finance. [5mks]

### **QUESTION TWO**

REDMAL is a public limited company with a paid up share capital of ksh 1.2m ksh 1 shares and no long term debt. The dividend has been paid at the rate of 45cts per share in each of the last two years and the market price per share has not varied significantly from its current market price of ksh. 3.60.

The company now wishes to finance the expansion of its existing premises and has announced a rights issue of 1 new ordinary share at a price of ksh. 3.00 for every 4 shares currently held. The company forecast the future dividend will be at the rate of 43.5cts per share on the enlarged share capital and that its existing ratio of dividend cover can be maintained. You are required to comment on the theoretical and practical validity of the following two reactions to the announcement from various shareholders.

- i. I hold 5% of the equity. Whether I take up or surrender my rights, I should be getting a bargain at the offer price of ksh. 3.00. [10mks]
- ii. As I understand the position, I should not have been out of pocket in the long run if the company had priced the rights issue at ksh. 5.00 Instead of ksh.3.00. I think they should have done that to raise a bit more money. [5mks]

### **QUESTION THREE**

- a. The company may have a large amount of cash which it may wish to return to its shareholders, especially if its future cash flow predictions are strong. But in practice a company must consider several factors when determining its dividend policy. Discuss the various aspects of dividend policy. [10mks]
- b. Discuss the arguments in support of the dividend relevancy theory. [5mks]

### **QUESTION FOUR**

Flava plc is considering installing Ksh. 20 M factory. expected values of the underlying variables are as follows.

Initial outlay	Ksh. 20M
Sales Volume	2M units
Unit selling price	ksh. 30 per unit
Unit variable cost	ksh. 13.5 per unit
Average fixed cost	ksh. 4M

Depreciation is as a percentage of written down value at 25%. Factory life is 8years.

Corporate tax is at 30% and a discount rate of 12%.

The pessimistic and optimistic estimates are:

Sales Volume	Pessimistic 1.5M units	Optimistic 2.5 M units
Selling Price	ksh. 13.5	ksh. 33
Unit variable cost	ksh. 14.85	ksh. 12.15
Average variable cost	ksh. 9.6M	ksh. 6.4M

By changing the sales volume and selling price and holding other variables constant, recompute the NPV and determine which of the variables is a critical variable. [15mks]

### **QUESTION FIVE**

A firm wishes to determine whether a new data processing system will cost ksh. 2M. It has seven year economic life and will be depreciated over 5 years using the rates 15%, 22%, 21%, 21%, and 21% respectively. The system is eligible for a 10% ITC. Its estimated salvage value is ksh. 0.2M at the end of its economic life. If purchased, the system can be financed with a 7 year 20% interest loan of ksh. 1.8M (ksh. 2M – 10%, ITC). The loan requires 7 equal end of year payments comprising principal and interest. If the system is leased, the lessor will receive the benefit of the ITC. The capital lease will require 7 beginning of year lease payments of ksh. 420,000. The bank's marginal Tax rate is 40% on ordinary income.

- Compute Present Value analysis of leasing option. [10mks]
- Discuss the merits of leasing assets. [5mks]

### **QUESTION SIX**

- Factoring allows a company to raise finance based on the value of its outstanding invoices. It also gives the business the opportunity to outsource its sales ledger operations and to use more sophisticated credit rating systems. Explain the way it works. [10mks]
- Discuss the legal implication of debt capital. [5mks]