JARAMOGI OGINGA ODINGA UNIVERSITY

OF SCIENCE & TECHNOLOGY

UNIVERSITY EXAMINATIONS 2012/2013

2ND YEAR 1ST SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF BUSINESS ADMINISTRATION WITH IT

(BUSIA L.CENTRE)

COURSE CODE: ABA 202

COURSE TITLE: INTRODUCTION TO FINANCE

DATE: 12/8/2013 **TIME: 2.00-4.00 PM**

DURATION: 2 HOURS

INSTRUCTIONS

1. **This paper consists of 5 Questions.**
2. **Answer Question 1 (Compulsory) and any other 2 questions.**
3. **Write your answers on the answer booklet provided.**

QUESTION ONE

1) Justify and criticize the usual assumption made in financial management literature that the objective of a company is to maximize the wealth of its shareholders. (30 marks)

QUESTION TWO

Karim Ltd has annual earnings before interest and taxes of Sh.150 million. These earnings are expected to remain constant. The market price of the company's ordinary shares is Sh.8.60 per share cum dividend and of debentures sh.1055.0 per debenture ex. Interest. An interim dividend of Sh.0.60 per share has been declared. Corporate tax is at the rate of 30% and all available earnings are distributed as dividends.

Karim's long term capital structure is shown below:

	Sh.000
Ordinary share (Sh.2.5 par value)	125,000
Reserves	243,000
16% debenture 31.12.X4 (Sh.100 par)	236,970
	604,970

Required:

Calculate the cost of capital of Karim Ltd according to the traditional theory of capital structure. Assume it is now 31.12.X1 and the capital structure is optimal.

(10 marks)

(b) Canalot Ltd is an all equity company with an equilibrium market value of Sh.32.5 million and a cost of capital of 18% per year. The company proposes to repurchase Sh.5 million of equity and to replace it with 13% irredeemable loan stock. Canalot Ltd's earnings before interest and taxes are expected to be constant for the foreseeable future. Corporate tax is at the rate of 30%. All profits are paid out as dividends. (10 marks)

Required:

Using the assumptions of Modigliani and Miller explain and demonstrate how this change in capital structure will affect:

I) the market value

II) The cost of capital

III) The cost of equity of Canalot Ltd. (20 marks)

QUESTION THREE

A company's expected annual net operating income (EBIT) is kshs.50, 000.The Company has kshs.200, 000, 10 % debentures. The equity capitalization rate (ke) of the company is 12.5%.Calculate the value of the firm using the Net income approach, Assume there are no taxes.

(20 marks)

QUESTION FOUR

Bondo co ltd has two projects A and B.Their service lives are different, A has a service life of one year while B's useful life is five years. The initial cash outlay for both the projects is kshs.20,000.each.The cash proceeds of project A at the end of the years is kshs.24,000.The cash generated by project B at the end of the fifth year is likely to be kshs.40200.Assumimg that the required rate of return is 10%.

Compute

a) The NPV for both the projects and

b) The IRR for both the projects. (20 marks)

QUESTION FIVE

What are the main sources of finance to the business?

Give the five examples enumerating their advantages and advantages of each of the source and as a manager which one would you choose and why.

(20 marks)