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University Examinations 2023/2024

SECOND YEAR SECOND SEMESTER EXAMINATION FOR THE DEGREE OF
BACHELOR OF BUSINESS ADMINISTRATION

BFC 3277: BUSINESS FINANCE

DATE: APRIL 2024

TIME: 2HOURS

INSTRUCTIONS: Answer question *one* and any other *two* questions

QUESTION ONE (30 MARKS)

- a. Describe various measures that would minimize agency problems between the owners of a company and the management. (8 marks)
- b. Explain how is dividend decision an important decision for a finance manager (6 marks)
- c. An investment manager of a quoted company has raised Sh.8,000,000 through issue of new shares. He is now evaluating two mutually exclusive projects with unequal economic lives. Project X has 7 years and Project Y has 4 years of economic life. Both projects are expected to have zero salvage value. These funds can only finance one project. Their expected cash flows are as follows:

Project	A	B
Year	Cash flows (sh.)	Cash flows (sh.)
1	2,000,000	4,000,000
2	2,200,000	3,000,000
3	2,080,000	4,800,000
4	2,240,000	800,000
5	2,760,000	-
6	3,200,000	-
7	3,600,000	-

The company expects to pay a dividend per share of Sh.6.50 in one year's time. The current market price per share is Sh.50. The future earnings are expected to grow by 7% per annum due to the undertaking of either of the projects. The firm has no debt capital in its capital structure.

Required:

- i The firm's cost of equity. (4 marks)
- ii The net present value of each project. (10 marks)
- iii Which project should be chosen and why? (2 marks)

QUESTION TWO (20 MARKS)

- a. A project is made up of two sub-projects. The first sub-project will require an initial outlay of Sh. 100,000 and will require an initial outlay of sh.300,000,000 and will generate sh.85,200,000 per annum for the 8 years of its useful life. This sub-project does not have a residual value at the end of the 8 years. Both sub-projects are to commence immediately. The company has a cost of capital of 16%.

Required:

Using the net present value (NPV) method, determine which project should be chosen

(12 marks)

b. Maisha Ltd has an estimated standard deviation of its daily net cash flow is Sh.22,750. The company pays Sh. 120 in transaction cost every time it transfers funds into and out of the money market. The annual rate of interest in the money market is 9.465%. The company uses the Miller-Orr Model to set its target cash balance. The minimum cash balance has been set by management at Sh.87, 500.

Required:

- (i) The company's target cash balance. (3 marks)
- (ii) The lower and upper cash limit. (3 marks)
- (iii) Maisha Ltd.'s decision rules. (2 marks)

QUESTION THREE (20 MARKS)

Biashara Ltd. has the following capital structure:

	Sh.'000'
Long-term debt	3,600
Ordinary share capital	6,500
Retained earnings	4,000

The finance manager of Biashara Ltd. has a proposal for a project requiring Sh.45 million. He has proposed the following method of raising the funds:

- Utilise all the existing retained earnings
- Issue ordinary shares at the current market price.
- Issue 100,000 10% preference shares at the current market price of Sh. 100 per share which is the same as the par value.
- Issue 10% debentures at the current market price of Sh. 1,000 per debenture.

Additional information:

1. Currently, Biashara Ltd. pays a dividend of Sh.5 per share which is expected to grow at the rate of 6% due to increased returns from the intended project. Biashara Ltd.'s price/earnings (P/E) ratio and earnings per share (EPS) are 5 and Sh.8 respectively.
2. The ordinary shares would be issued at a floatation cost of 10% based in the market price.
3. The debenture par value is Sh. 1,000 per debenture.
4. The corporate tax rate is 30%.

Required:

- i. Biashara Ltd.'s weighted average cost of capital (WACC). (14 marks)
- ii. As a finance manager, briefly explain the factors you would consider when setting a working capital policy of your company. (6 marks)

QUESTION FOUR (20 MARKS)

- a) In a company, an agency problem may exist between management and shareholders on one hand and the debt holders (creditors and lenders) on the other because management and shareholders, who own and control the company have the incentive to enter into transactions that may transfer wealth from debt holders to shareholders. Hence the need for agreements by debt holders in lending contracts.

Required:

State and explain any four actions or transactions by management and shareholders that could be harmful to the interests of debt holders (sources of conflict). (6 marks)

- b) Explain considerations a finance manager should have in mind when formulating a dividend policy for his firm. (4 marks)
- c) "The finance manager spends most of his time making managerial finance decisions as opposed to routine functions". Discuss the main managerial functions of the finance manager (10 marks)

QUESTION FIVE (20 MARKS)

An investor wishes to borrow Shs 3,000,000 from a financial institution. The going interest rate is 15% and the annual loan repayments are to be made at the end of each of the next 5 years.

Required:

- i. Calculate the annual instalment (6 marks)
- ii. Prepare a loan amortization schedule. (14 marks)