

LAIKIPIA



UNIVERSITY

UNIVERSITY EXAMINATIONS

2ND SEMESTER 2022/2023 ACADEMIC YEAR

SECOND YEAR EXAMINATION FOR THE DEGREE
OF BACHELOR OF COMMERCE

BCOM 224: BUSINESS FINANCE

STREAM:

TIME: 2 HRS

DAY: THURSDAY [11.30-13.30 P.M.]

DATE: 13/04/2023

THIS QUESTION PAPER CONSISTS OF FOUR (4) PAGES

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Answer question ONE and any other TWO questions Time: 2HRS

QUESTION ONE (COMPULSORY 30 Marks)

- a) Create an amortization schedule for a loan of Shs.500 000 that will be paid back over the course of the following three years in equal installments as required by the management of the company where you work. It has a 15% interest rate. **(6 marks)**
- b) Find the IRR of the project given below and state whether the project should be accepted if the company requires a minimum return of 15 per cent. **(6 marks)**

Year	Investment	Amount
0	Investment	(4 000)
1	Cash inflow	1 200
2	Cash inflow	1 410
3	Cash inflow	1 875
4	Cash inflow	1 150

- c) Highlight the advantages an overdraft has over a loan in business financing. **(6 marks)**
- d) Describe the advantages of a sole proprietorship business. **(6 marks)**
- e) Explain the arguments against using the WACC as the cost of capital for investment appraisal **(6 marks)**

QUESTION TWO

The Gamma Products Corporation has the following capital structure, which it considers optimal:

Bonds, 7% (now selling at par)	300,000
Preferred stock, Shs.5.00	240,000
Common stock	360,000
Retained earnings	<u>300,000</u>
	<u>1,200,000</u>

Dividends on common stock are currently Shs.3 per share and are expected to grow at a constant rate of 6 percent. Market price per share of common stock is Shs.40, and the preferred stock is selling at Shs.50. Flotation cost on new issues of common stock is 10percent. The interest on bonds is paid annually. The company's tax rate is 40 percent.

Required:

Calculate:

- a) The cost of bonds; **(4 Marks)**
- b) The cost of preferred stock; **(4 Marks)**
- c) The cost of retained earnings (or internal equity); **(4 Marks)**
- d) The cost of new common stock (or external equity); and **(4 Marks)**
- e) The weighted average cost of capital. **(4 Marks)**

QUESTION THREE

A company paid a dividend of Shs.250, 000 this year. The current return to shareholders of companies in the same industry is 12%, although it is expected that an additional risk premium of 2% will be applicable to the company, being a smaller and unquoted company. Compute the expected valuation of the company, if:

- The current level of dividend is expected to continue into the foreseeable future, **(6 marks)**
- The dividend is expected to grow at a rate of 4% pa into the foreseeable future.
- Describe the key assumptions of dividend models. **(6 marks)**

The return from an investment has the following probability distribution.

Return	Probability
X (%)	P
8	0.2
10	0.2
12	0,5
14	0,1

- Calculate the expected return and risk for the investment. **(8 marks)**

QUESTION FOUR

- State four purposes of ratio analysis **(4 marks)**
- The following information was extracted from the financial statements of Sunrise Ltd. and Sunset Ltd. in respect of the year ended 30 September 2020:

Income statement extracts for the year ended 30 September 2020:		
	Sunrise Ltd.	Sunset Ltd.
	Shs. '000'	Shs. '000'
Sales	497,000	371,000
Cost of sales	258,000	153,000
Operating profit	138,000	79,000
Interest expense	19,000	-
Statement of Financial Position extracts as at 30 September 2020:		
	Sunrise Ltd.	Sunset Ltd.
	Shs. '000'	Shs. '000'
Non-current assets	142,000	92,000

Current assets:		
Inventory	100,000	87,000
Debtors	46,000	42,000
Cash at bank	40,000	44,000
Current liabilities	98,000	108,000
Long-term loan	33,000	-
Shareholders' funds	197,000	157,000

Required:

For each company, compute the following ratios:

- i. Acid test ratio **(2 marks)**
 - ii. Inventory turnover **(2 marks)**
 - iii. Average collection period **(2 marks)**
 - iv. Return on capital employed **(2 marks)**
 - v. Debt equity ratio **(2 marks)**
- c) On the basis of the ratios computed in (b) above, comment on the overall performance of Sunrise Ltd. and Sunset Ltd. and advise which of the two companies would provide better investment. **(6 marks)**

