



MACHAKOS UNIVERSITY

University Examinations for 2016/2017 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF
ACCOUNTING, BANKING AND FINANCE

SECOND YEAR SECOND SEMESTER EXAMINATION FOR DEGREE IN

BACHELOR OF ECONOMICS AND FINANCE

BAC 204: BUSINESS FINANCE II

DATE: 31/5/2017

TIME: 8:30 – 10:30 AM

INSTRUCTIONS:

Answer Question One and Any Other Two Questions

QUESTION ONE (COMPULSORY) (30 MARKS)

- (a) Explain the advantages and disadvantages of the payback period method. (6 marks)
- (b) Explain the process of capital budgeting. (6 marks)
- (c) Prof. James E. Walter argues that; the dividend policy almost always affects the value of the firm. Based on this statement state and explain the six assumptions of Walter's Dividend Policy Model. (6 marks)
- (d) The market price per equity share of ABC Ltd. is Ksh. 50 and issue expense per share is Ksh.5. The dividend per share and growth rate in equity is Ksh,3 and 5% respectively. Calculate the cost of equity share capital for ABC Ltd. (6 marks)
- (e) State and explain the merits of adequate working capital for a business firm. (6 marks)

QUESTION TWO (20 MARKS)

- (a) A company issued Ksh. 2,000,000, 10% redeemable debentures at a discount of 5%. The floatation cost amounted to Ksh. 50,000. The debentures are redeemable after 8 years. Calculate before and after tax cost of debt capital, assuming tax rate is 55%. (12 marks)
- (b) What are the four major theories explaining the relationship among capital structure, cost of capital and value of the firm. (8 marks)

QUESTION THREE (20 MARKS)

- (a) The owner of Trans line Classic Ltd is considering to buy 33 seats coach which will sale for Ksh.6,000,000/= and is expecting to bring cash inflows of Ksh. 10,000/= per a day after expenses. The cost of funds is 15%. The coach is expected to last for three years before a new model will be needed to attract passengers. Should the coach be purchased? (12 marks)
- (b) Explain the essential features which an appropriate capital structure should possess. (8 marks)

QUESTION FOUR (20 MARKS)

- (a) A Company issued 10,000; 10% preferred share capital of Ksh. 10/= each, and the cost is Ksh.2/= per share. Calculate the cost of preferred share capital if they are issued at: par, 10% premium and 5% discount. (12 marks)
- (b) Explain four advantages of profitability index. (8 marks)

QUESTION FIVE (20 MARKS)

- (a) Raja Ltd, earns a rate of 12% on its total investment of Ksh.600,000/= in assets. It has 600,000 outstanding common stock at Ksh. 10/= share. Discount rate of the firm is 10% and it has a policy of retaining 40% of the earnings. Calculate the price of Raja's shares using Gordon's Model. (12 marks)
- (b) State and explain two criticism of Gordon's dividend model. (8 marks)