The Management University of Africa
Sponsored by the Kenya Institute of Management

UNDERGRADUATE UNIVERSITY EXAMINATIONS

SCHOOL OF MANAGEMENT AND LEADERSHIP

DEGREE OF BACHELOR OF COMMERCE

FIN 312: **CORPORATE FINANCE**

DATE: **8TH AUGUST 2024**

DURATION: 2 HOURS

MAXIMUM MARKS: 70

INSTRUCTIONS:

1. Write your registration number on the answer booklet.
2. **DO NOT** write on this question paper.
3. This paper contains **SIX (6)** questions.
4. Question **ONE** is compulsory.
5. Answer any other **THREE** questions.
6. Question **ONE** carries **25 MARKS** and the rest carry **15 MARKS** each.
7. **Write all your answers in the Examination answer booklet provided.**

QUESTION ONE

Read the Case Study below carefully and answer the questions that follow:

STOCK EXCHANGE MARKET

Stock exchange (also known as stock markets) is special "market places" where already held stocks and bonds are bought and sold. They are, in effect, a financial institution, which provides the facilities and regulations needed to carry out such transactions quickly, conveniently and lawfully. Stock exchanges developed along with, and are an essential part of the free enterprises system. (No stock exchanges exist in the communist world outside Hong Kong and Macao - which have special status, and Taiwan which is also claimed by China).

The need for this kind of market came about as a result of two major characteristics of joint stock company (Public Limited Company), shares. First of all, these shares are irredeemable, meaning that once it has sold them, the company can never be compelled by the shareholder to take back its shares and give back a cash refund, unless and until the company is winding up and liquidates. The second characteristic is that these shares are, however, very transferable and can be bought and resold by other individuals and organizations, freely, the only requirement being the filling and signing of a document known as a share transfer form by the previous shareholder. The document will then facilitate the updating of the issuing companies shareholders register.

These two characteristics of joint company shares brought about the necessity for an organized and centralized place where organizations and private individuals with money to spare (investors), and satisfy their individual needs. Stock exchanges were the result emerging to provide a continuous auction market for securities, with the laws of supply and demand determining the prices.

The basic function of a stock exchange is the raising of funds for investment in long-term assets. While this basic function is extremely important and is the engine through which stock exchanges are driven, there are also other quite important functions.

There is only one stock exchange market in Kenya i.e. The Nairobi Stock Exchange. A person wishing to acquire shares will do so either at an (Initial Public Offer (IPO) or in the secondary market. However, an investor cannot buy or sell stocks directly in the stock exchange market. They can only do so through stock brokers. The Nairobi Stock Exchange was established in 1954 as the in Nairobi. It was a voluntary association of stockbrokers in the European community registered under the Societies Act in British Kenya. Previous to its founding, dealing in shares and stocks started in the 1920s when it was the British colonial Kenya Colony (1920–1963), a part of the British Empire. A stock exchange was first floated in 1922 at the Exchange Bar in the Stanley Hotel in Nairobi. However, the market was not formal as there did not exist any rules and regulations to govern stock broking activities. Trading took place on a 'gentleman's agreement.' Standard commissions were charged with clients being obligated to honor their contractual commitments of making good delivery and settling relevant costs.

Over the years the Nairobi Stock Exchange has instituted measures with an aim of encouraging higher trade volumes and position Kenya as one of Africa's leading .financial centers. One of the measures included day trading which sometimes saw the sales figures increase form an average of Kshs.25 million in one year to Kshs.30 million in another year.

Putting your money in stocks basically means buying shares in companies that have been listed in the Nairobi Stock Exchange which then entitles you to be part of that organization's earnings. Share profits come through gains in bonuses, share prices, rights, and dividends, and other methods of income generation that are used by the company.

Companies or enterprises sell shares to borrow or raise money from institutions, governments, and ordinary citizens. The intention is to expand their activities so that they can make even more profits. When you buy their shares, you have the power or right to influence or make decisions about how the company runs, as both the owner and lender of money to the company. By lending money, you expect profits as a reward for enabling the company to expand its business activities.

Required:

a) Examine three functions of the Nairobi Stock Exchange alluded to in the case study above **(6 marks)**

b) …" However, an investor cannot buy or sell stocks directly in the stock exchange market. They can only do so through stock brokers." Propose four benefits enjoyed by investors who buy and sell stocks using brokers. **(4 marks)**

c) Evaluate three factors that investors consider before investing in shares at the Nairobi Stock Exchange **(6 marks)**

d) Apart from selling shares, highlight three other methods companies use to raise funds to fund their operations **(3 marks)**

e) One of the measures instituted by the Nairobi Stock Exchange to encourage higher trade volumes included day trading which sometimes saw the sales figures increase form an average of Kshs.25 million in one year to Kshs..30 million in another year. Calculate the sales index in this case. **(6 marks)**

QUESTION TWO

a) Examine three limitations of the profit maximization goal **(6 marks)**

b) The share of a company is currently selling for Kshs. 100. The company wants to finance its capital expenditure of Kshs. 10,000 either by retaining earnings or selling new shares. If the Company sells new shares, the issue price will be Kshs. 95, the div per share next year, DIV1 is Sh.4.75 and it is expected to grow at 6%.

Required:

i. Calculate the cost of internal equity (retained earnings) **(4 marks)**

ii. Calculate the cost of external equity (retained earnings) **(5 marks)**

QUESTION THREE

a) Evaluate the difference between Bird-in-Hand Theory and MM Dividend Irrelevance Theory in their attempt to explain when to pay dividends **(6 marks)**

b) The following financial statements extracts have been provided for company X

Balance Sheet 20X1

Liabilities	Ksh.	Assets	Ksh.
Equity share capital	100,000	Land and Buildings	50,000
General reserves	12,500	Plant & machinery	57,500
Creditors	10,000	Stock	10,000
Bills payable	5,000	Debtors	7,500
Provident fund	12,500	Cash & bank	15,000
	140,000		**140,000**

Profit & Loss A/C 20X1

Particulars	Ksh.	Particulars	Ksh.
To Opening Stock	5,000	By Sales	62,500
To Purchases	37,500	By Closing Stock	10,000
To Office Expenses	7,500	By Profit on Sale of Furniture	2,500
To Selling Expenses	5,000		
To Finance Expenses	2,500		
To Net Profit	17,500		
	75,000		**75,000**

Required:

Required:

Calculate the following ratios:

i. Current Ratio **(3 marks)**

ii. Gross Profit Margin **(3 marks)**

iii. Stock Turnover Ratio **(3 marks)**

QUESTION FOUR

a) Project/investment appraisal methods to be used to assess the viability of a project/investment must fulfill a number of requirements. Assess two requirements the appraisal methods must fulfill. **(4 marks)**

b) Highlight five reasons why people fail in financial planning **(5 marks)**

c) The following information has been provided on the NPV and IRR of four projects.

Project	NPV	IRR
A	300	40
B	200	35
C	300	40
D	600	30

Two options have been provided for consideration as below:

- Option 1- Undertake projects A,B and C
- Option 2- Undertake projects C and D

Required:

Evaluate the two options that have been presented above **(6 marks)**

QUESTION FIVE

a) Describe five accounting indicators for overtrading **(5 marks)**

b) Illustrate how a horizontal merger takes place. **(3 marks)**

c) The following estimates have been provided by Company X

States of nature	Cashflows- Project A (Ksh)	Probability
Optimistic	900,000	0.2
Moderate pessimistic	600,000	0.6
Pessimistic	300,000	0.2

Compute the expected cashflow for project A **(4 marks)**

d) Explain three key steps in investment appraisal **(3 marks)**

QUESTION SIX

a) Explain the three financial factors that influence the value of a business **(6 marks)**

b) ABC Systems, which provides investors with computerized information about stock prices, is considering the establishment of a lockbox system with its bank. The firm receives daily remittances of Ksh 1.5 million, and could earn 9% on any funds freed up through faster collections. If the lockbox system can save 2 days in the collection process, and the firm's bankers will charge Ksh 200,000 per year to operate the lockbox system.

Required:

Establish whether it is worth it for ABC systems to establish the lock box system. **(9 marks)**