

COVENANT UNIVERSITY

TUTORIAL KIT

PROGRAMME: BANKING AND
FINANCE

ALPHA SEMESTER

200 LEVEL



Raising A New Generation Of Leaders

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BFN 211: Business finance I

COVENANT UNIVERSITY

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TITLE OF EXAMINATION: Alpha Semester Examination
COLLEGE: CBSS DEPARTMENT: Banking and Finance
SESSION: 2014 /2015 SEMESTER: Alpha
COURSE CODE: BFN 211 COURSE TITLE: Business Finance 1
Answer any four questions. Time allowed: 2 ½ hours

1. (a) Define working capital management (5mks)
(b). Discuss any five supporting institutional arrangements that would ensure that MFBs succeed in their operations (7 ½ mks)
(c)The need to achieve financial sustainability has led to the current financial system approach to microfinance provision. Discuss, clearly showing five features of this approach. (5mks)
2. (a)Microfinance is not simply banking it is a developmental tool .Discuss (7mks)
(b)Define Optimum Working Capital and mention at least five (5) factors that affect the working capital needs of an organization (7½ mks)
(c)In not more than two sentences differentiate between Permanent and Fluctuating Working Capital.(3mks)

3.Mr. Ota plan to invest N40,000 for a period of one year.He is considering two proposals both of which have discrete probability distribution of cash flows as listed below.

Probability(P)	Proposal A(CF)	Proposal B(CF)
0.10	3,000	2,000
0.20	3,500	3,000
0.40	4,000	4,000
0.20	4,500	5,000
0.10	5,000	6,000

Required: Compute

- (a) The expected value of the cash inflows of the two proposals.
(b) The Standard deviation of the probability distribution for the two proposals
(c) The coefficient of variation for the two proposals
(d) Offer your advice based on your computation (17 ½)

4.A, Give at least four reasons why NPV is considered superior to IRR in project appraisal (6mks)

b. BMP Ltd is considering the following projects requiring an outlay of N50,000 and has the following cash flows. The cost of capital is 15%.

Year	A	B	C
1	20,000	25,000	30,000
2	35,000	20,000	32,000
3	38,000	40,000	34,000

- Required: Calculate the NPV using the conservation estimate method and determine the project viability.(6mks)

c. Distinguish between risk and uncertainty (2mks)

d. Briefly explain any three disadvantages of payback period (3 ½ mks)

5. Ishan Investments is considering selection between two projects. Projects A and B which has the following information.

	Project A	Project B
Cost of Project	N100,000	N150,000
Estimated life of the project	4	4
Residual value	N5,000	N15,000
Estimated future profit before depn& tax		
Year 1	N35,000	N40,000
2	N50,000	N52,000
3	N56,000	N60,000
4	N60,000	N80,000

Assuming straight line depreciation, a tax rate of 35% and company's target rate of return of 20% which of the projects should the company select? (17 ½ mks)

6A, List any five advantage of DCF method over traditional method in project appraisal(7 ½mks)

B, Philip ltd is considering a project costing N50,000. The project is expected to generate annual cash benefits of N20,000 per annum for 5yrs before depreciation. Calculate the IRR of the project, should the project be accepted if the company's cost of capital is 20%. (10mks)

Bfn 211 2014/2015 marking guide

1. A, Working Capital Management can thus be defined as the Management of all aspects of current assets and current liabilities. **5mks**

B. The supporting institutional arrangements that would ensure that mfbs succeed in their operation including:

1. Independently managed micro finance development fund; to provide wholesale fund, refinancing facilities and other services to support the financial activities of MFBs and micro finance institutions.
2. certification programme for staff and management of MFBs to provide adequate knowledge on micro finance practise, enhance operational activities and ensure that rights persons manages the MFBs
3. Rating agencies to provide institutional assessment of MFBs and other institutions.
4. Credit bureaux to provide credit information of micro finance client in support of credit and other decision making processes of the MFBs.
5. Apex association of the MFBs, to ensure compliance with standard and best practices. **1 ½ mks each =7 ½ mks**

C, This recognition of the need to achieve financial sustainability has led to the current financial system approach to microfinance. This approach is characterized by the following beliefs or features;

- (1) Subsidized credit undermines development
- (2) Poor people can pay interest rates high enough to cover transaction costs and the consequences of the perfect information market in which lenders operate.

- (3) The goal of sustainability (cost recovery and eventually profit) is the key not only to institutional performance in lending, but also to making the lending institution more focused and efficient.
- (4) Because loan sizes to the poor people are small, MFIs must achieve sufficient scale if they are to become sustainable.
- (5) Measurable enterprise growth, as well as impacts on poverty cannot be demonstrated easily or accurately, outreach and repayment rates can be proxies for impact.

One of the main assumptions in the above view is that many poor people actively want productive credit and that they can absorb and use it. But as the field of microfinance has evolved, research has increasingly found that in many situations poor people want secure savings facilities and consumption loans just as much as productive credit and in some cases instead of productive credit. MFIs are beginning to respond to these demands by providing voluntary savings service and other type of loans. **5 mks**

2.A, MICROFINANCE

This is the provision of financial services to small businesses and the low income earners of the society. Micro finance has evolved as an economic development approach intended to benefit low-income women and men. The provision of financial services to the low income clients, include the self-employed. Thus, the definition of micro finance often includes both financial and social intermediation. Hence microfinance is not simply banking it is a development tool, as its activities usually involve :

- 1) Small loans, especially for working capital
- 2) Informal appraisal of borrowers and investment

- 3) Collateral substituted such as group guarantees or compulsory saving
- 4) Access to repeated larger loans, based on repayment performance
- 5) Stream lined loan disbursement and monitoring
- 6) Secure saving product. **7mks**

B, Optimum Working Capital involves the optimum utilization of Working Capital to minimize wastages resulting from excessive working capital and idle fund or under-utilization of Working Capital to stall growth and production. It is the Optimum level of current assets held that maximizes the wealth of shareholders. **2mks**

The five factors that affect the working capital needs of an organization can be taken from the following:

- i. Nature and size of business
- ii. Inflation (price level changes)
- iii. Sales and demand conditions.
- iv. Credit policy
- v. Business fluctuations
- vi. Technology and manufacturing policy (eg manufacturing circle)
- vii. Availability of credit from supplier.
- viii. Operating efficiency.
- ix. Growth and expansion activities **5mks**

C, Permanent Working Capital can be defined as the minimum level of current assets, which is continuously required by the firm to carry on its operations. Permanent working capital is also known as fixed working capital. Example minimum stock, bank and debtor balances of a company. While **Fluctuating Working Capital** can be defined, as the extra working capital needed to support the changing production and sales activities. Fluctuating working capital is also known as temporary or variable working capital. **1 ½ mks each x 2= 3mks**

4B, b.

Year	A	B	C
1	<u>20,000</u>	25,000	30,000

2	35,000	<u>20,000</u>	32,000
3	38,000	40,000	<u>34,000</u>

For the three years, Select the cash flow with the lowest value as highlighted in the table above.

Year	Cash flow	Discount Factor 15%	PV
1	20,000	0.869	17380
2	20,000	0.756	15120
3	34,000	0.658	22372
			<u>54872</u>

The project is viable because the present value is greater than the outlay

$$N54872 - 50,000 = N4872$$

(6marks)

c. Risk occurs where it is not known what the future outcome will be but where the various possible outcomes may be expected with some degree of confidence from knowledge of past or existing events. In other words probability estimates are available.

On the other hand, Uncertainty occurs where the future outcome cannot be predicted with any degree of confidence from knowledge of past or existing events, so that no probability estimates are available. Uncertainty It refers to a situation whereby the investor or financial analyst cannot estimate future returns accurately. In conditions of uncertainty, the probability of occurrence of earning is not known. **(2marks)**

D, Disadvantages of Payback Period

- Unless the discount factor payback period is used, it ignores the time value of money
- It ignores the cash flows after the payback period
- There are no standard rules for setting the maximum acceptable payback period.
- When dealing with non conventional cash flows, there is a problem in determining what cash outlay is. **3 ½ mks**

5.

	Project A	Project B
Total profit b/4 depn A(35+50+56+60)	N201,000	232,000
B(40+52+60+80)		
Less total depn A(100 – 5)	95,000	135,000
B (150 – 15)		
Total profit b/4 tax	106,000	97,000
Tax at 35%	<u>37,100</u>	<u>33,950</u>
Total Profit	<u>68,900</u>	<u>63,050</u>
Average profit A(68,900/4)	17,225	15,762.50
B(63,050/4)		

Average Investment	$(100,000 + 5,000)/2$	$(150,000+15,000)/2$
	N52,500	N82,500
ARR	<u>17,225</u>	<u>15,762.50</u>
	52,500	82,500
	32.81%	19.11%

Accept project A. 17 ½ mks

6. A, Advantage of DCF method over traditional method

- Recognises time value of money
- Does not rely on arbitrary managerial rule.
- It uses cashflows instead of accounting profit
- DCF methods make use of all cashflow to be generated by the project under consideration unlike payback period.
- The DCF method can be adjusted to account for risk profile of any risky project. **7 ½ mks**

B.Philip Ltd is considering a project costing N50,000. The project is expected to generate annual cash benefits of N20,000 per annum for 5yrs before depreciation. Calculate the IRR of the project, should the project be accepted if the company's cost of capital is 20%.

Solution

ARR = Average profit

Average Investment

$(100,000 - 50,000)/5$

$(50,000 + 0) / 2$

= 40%

$2/3 \times 40 = 26.67$ approximately 27%

Using 27%

Yr	Cashflow	DCF@27%	PV
0	(50,000)	1	(50,000)
1 – 5	20,000	2.5827	<u>51,654</u>
			<u>1,654</u>

Try using 30%

Yr	Cashflow	DCF@30%	PV
0	(N50,000)	1	(N50,000)
1 – 5	20,000	2.4356	<u>48,712</u>
			<u>-1,288</u>

Interpolation

$$LR + (NPV_p / NPV_p - NPV_n) \times HR - LR$$

$$27 + (1,654 / 1654 + 1,288) \times 30 - 27$$

$$27 + 1654/2942 \times 3$$

$$= 28.69$$

Calculated IRR is greater than the firm's cost of capital, the project should be accepted **10 ½ mks**