



MURANG'A UNIVERSITY COLLEGE

(A constituent College of Jomo Kenyatta University of Agriculture & Technology)

MAINCAMPUS

ORDINARY UNIVERSITY EXAMINATIONS

2015/2016 ACADEMIC YEAR

THIRD YEAR FIRST SEMESTER EXAMINATIONS

FOR THE DEGREE

OF

BACHELOR OF COMMERCE

COURSE CODE: HBF 2302;

COURSE TITLE: ADVANCED FINANCIAL MANAGEMENT

DATE: 17, AUGUST 2015

TIME:9.00 A.M-11.00 A.M

INSTRUCTIONS TO CANDIDATES

Question ONE (1) is compulsory

Answer THREE (3) questions

Marks are indicated alongside the questions

MRUC observes ZERO tolerance to examination irregularities

QUESTION ONE

- a) Discuss the Four roles played by the Financial Manager. (4marks)
- b) Differentiate between;
- (i) Weighted average cost of capital and marginal cost of capital. (2marks)
- (ii) Hard rationing and soft rationing. (2marks)
- (iii) Mutually exclusive projects and Independent projects (2marks)
- c) Discuss the implications of any four theories of Dividends. (4marks)
- d) Arahuka Limited is considering the launch of the new product `P` for which an investment of 6 million in plant and machineries will be required. The production of `P` is expected to last for five years after which the plant and machineries would be sold for sh 2.4 million

Additional Information:

1. `P` would be sold at sh750 per unit with a variable cost of sh460 per annum.
2. Fixed production cost [excluding depreciation] would amount to sh850,000 per annum.
3. The company applies the straight line method of depreciation.
4. The cost of capital is 15% per annum.
5. The number of units of `P` expected to be produced and sold per annum for the next five years is shown below:-

Year	units expected to be produced and sold
1	10,000
2	9,000
3	9,000
4	7,000
5	5,000

6. The corporation tax rate is 30%.

Required

Advice the management of Arahuka ltd on the appropriate course of action using ;

- [i] The net present value [NPV] approach [8marks]
- [ii] The initial rate of return [IRR] approach [8marks]

[Total: 30 marks]

QUESTION TWO

- a) Determine any **six** factors to be considered when making a capital structure decision (6marks)
- b) Explain the following theories of Capital structure and Dividends.
(i) Pecking order theory. (3marks)
(ii) Bird-in-hand theory. (3marks)
- c) ABC ltd has the following capital structure as at 31st march 2014.

Sh. "Million"	
6 Million fully paid Ordinary shares	60
Retained earnings	40
2 Million 8% preference share capital	30
400,000 10% Long-Term debentures	<u>70</u>
	<u>200</u>

The company intends to raise additional finance as follows;

Sh50Million from issuing 8% debentures.

Sh40 Million from selling new ordinary shares at a floating cost of Sh. 2per share.

The current market value of each ordinary share is Sh.40.The shareholders expect a dividend of Sh.5 per share next year.The dividend grows at the rate of 12% per annum into perpetuity. The debentures of the company have a face value of sh.100 each with a market value of sh.150. The company's tax rate is 30%.

Required:

- (i)The weighted average cost of capital [WACC] of the firm as at 31st March 2014. (5marks)
- (ii) The marginal cost of capital (3marks)

[Total 20marks]

QUESTION THREE

- a) Differentiate between Financial leverage and operating leverage (4marks)
- b) d) XYZ Ltd undertook project 'M' with the following cash flow over its useful life of 3 years. The cost of capital for the project is 12%. The abandonment values of the project have been given below:-

Year	cash flow	Abandonment values
	Sh000'	sh000'
0	(14,400)	14,400
1	6,000	9,000
2	5,625	5,700
3	5,250	0

Required

Advice the management of XYZ ltd, on when to abandon the project 'M'. (8mks)

- c) The data below relate to the financial performance of ABC Limited for the year ended 30 September 2014;
- Sh "000"
- | | |
|----------------------------------|-------|
| Earnings before interest and tax | 4,480 |
| Profit before tax(PBT) | 1,280 |
| Fixed cost | 2,800 |

Required:

- (i) Degree of operating leverage(2marks)
- (ii) Degree of Financial leverage (1mark)
- (iii) Degree of combined leverage (2marks)
- (iv) Percentage change in earnings per share if sales increase by 5% (3marks)

[Total 20marks]

QUESTION FOUR

- a) Highlight four ways in which a company could reduce its working capital cycle
(4 Marks)
- b) Explain three factors that lead to financial innovation in the economy of your country
(6 marks)
- c) The management of XYZ ltd is in the process of determining the optimal cash levels it should hold in the next financial year 2015/2016. The finance department has established that the annual cash requirement for the company is sh.2,500Million. The fixed cost of selling securities to raise cash per transaction is sh.500. The opportunity cost of holding cash is 12%.

Required

Using the Baumolmodel of cash management determine the following:

- i. Optimal cash balance that the company should hold (5marks)
- ii. The total cost of managing the optimal cash balance (5marks)

(Total; 20marks)