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**University Examinations 2015/2016**

THIRD YEAR FIRST SEMESTER EXAMINATION FOR THE DEGREE

OF

BACHELOR OF COMMERCE

**BFC 3332: ADVANCED FINANCIAL MANAGEMENT**

**DATE: APRIL 2016 TIME: 2 HOURS**

**INSTRUCTIONS:** *Answer question* ***one*** *and any other* ***two***questions.

**QUESTION ONE (30 MARKS)**

1. Describe the basic objectives of a business organization (4 marks)
2. Explain the following financial management terms
3. Capital structure
4. Business risk
5. Operating leverage
6. Dividend policy
7. Capital rationing (10 marks)
8. Mafuko Industries Ltd. has an aging machine wich is outdated, the finance manager is aware of the more efficient machine that is already in use in the market, he requests the cost accountant to furnish him with relevant data on operational cost for the existing machine. He is provided with the following information, if the existing machine can continue in operation for the next 10 years the operating and maintenance costs will be shs. 300, 000, alternatively it could be sold and fetch shs. 150,000 now and be replaced with a new model machine which costs shs. 500, 000, but has reduced operating and maintenance costs at shs. 250, 000 per year. This machine could be sold at the end of its 10 year for shs. 50, 000. The third possibility is to spend shs. 200, 000 for an immediate overhaul of the old machine which will improve its efficiency for the rest of its life so that operating and maintenance costs become 265, 000 thereafter. The old machine will have a salvage value of zero in ten years time whether or not its overhauled. Mafuko industries ltd. requires a return on investment of 10% on projects in this risk class.

**Required:**

Evaluate the various alternatives and advice on the best course of action. (12 marks)

1. Under MM proposition II without taxes, a company with a cost of capital of 18%, a cost of debt of 12% and a debt equity ration of 1.5 what would be its cost of equity? (4 marks)

**QUESTION TWO (20 MARKS)**

1. A project which will cost shs. 1, 000, 000 has a life of 5 years with no salvage value, depreciation is on a straight line and the required rate of reurn is 15%, tax rate is 30%. Sales are projected at shs. 8, 000 per year, the price per unit is shs. 2, 000, variable cost shs. 9,000 and fixed costs are shs. 500, 000 per annum no changes in working capital is required.

Suppose the unit sales, price, variable costs and fixed costs projection are accurate to within 5%.

1. What is the uppr and lower bounds for these projections? (4 marks)
2. Calculate the base case NPV (4 marks)
3. What are the best case and worst case scenario NPV? (6 marks)
4. Describe four investment appraisal techniques that can be used to evaluate projects under situations of risks and uncertainties in expected cash-flows (6 marks)

**QUESTION THREE (20 MARKS)**

1. The success of any business organization is dependient on the decisions that finance manager make, using specific examples of decision that finance managers make, describe the managerial functions of finance (9 marks)
2. Meru food processors is currently involved in a restructuring program that involves increasing its existing debt from shs. 5 million to shs. 25 million. The interst rate on debt is 12% and its not expected to change. The company has currently one million shares outstanding and the proice per share is shs. 40. If the restructuringis expected to increase the Return on Equity (ROE).

What is the minimum level of EBIT that Meru food processors should be expecting? Ignore taxes (5 marks)

1. Describe four main sources of long term financing for a business firm (6 marks)

**QUESTION FOUR (20 MARKS)**

1. Describe four factors that influence the capital structure of a business (8 marks)
2. Meru farmers Ltd currently operates with terms of net 30 days. The company has sales of Sh. 12m and its average collection period is 45 days. To stimulate demand, the company is considering the possibility of offering terms of net 60 days. If it offers these terms, sales will increase by 20%. After the change, the average collection period is expected to increase to 75 days with no difference in payment habits between old and new customers. The company has variable costs of sh. 70 for every shs. 100 of sales. The required rate of return on receivables is 20%.

Required:

Should the company extend its credit period (assume a year has 365 days) (12 marks)

**QUESTION FIVE (20 MARKS)**

1. Discuss the economic advantages of leasing as a method of business financing (5 marks)
2. Kithino coffee millers Ltd. have decided to install a new milling machine. The machine costs shs. 2,000, 000 and it would have a useful life of five years with a salvage value of shs. 400, 000 at the end of the fifth year. Additional cash flows from the machine would be shs. 800, 000 a year for five years. A decision has now to be taken on the method of financing the project. Two methods of finance are being considered.
3. The company could purchase the machine for cash, using bank loan facilities on which the current rate of interest is 13% before tax.
4. The company could lease the machine under an agreement which would entail payment of shs. 480, 000 at the end of each year for the next five year.

The company’s weighted average cost of capital, normally used for project evaluating, is 12% after tax. The rate of company income tax is 30%. If the machine is purchased, the company will be able to claim an annual tax depreciation allowance of 25% on cost.

**Required:**

1. Advise the management on whether to acquire the machine (4 marks)
2. The most economical method of financing (11 marks)