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**University Examinations 2015/2016**

THIRD YEAR, FIRST SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF COMMERCE

**BFC 3331: ADVANCED FINANCIAL MANAGEMENT**

**DATE: NOVEMBER 2015 TIME: 2 HOURS**

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

**QUESTION ONE (30 MARKS)**

A Company whose cost of capital is 11% is considering two Machines X and H. Machine X costs Kshs. 802,000 while Machine H costs Kshs. 705,000

The following data is available:

|  |  |  |
| --- | --- | --- |
| Cash inflows | Machine X (Kshs) | Machine H (Kshs) |
| 1st year | 140,000 | 310,000 |
| 2nd year | 205,000 | 265,000 |
| 3rd year |  0 | 135,000 |
| 4th year | 295,000 | 160,000 |
| 5th year | 545,000 |  0 |

**Required:**

1. Recommended in which machine the company should invest in by using the following methods
2. Pay back method (2 Marks)
3. Net present value (5Marks)
4. Profitability index (3 Marks)
5. What are the main advantages of using the market value weight when determining the cost of capita of a company? List and explain any other two alternatives to the market value weights (6 Marks)
6. A study conducted on the dividend policies of companies quoted in the Nairobi Securities Exchange established that companies exhibit diversity in their dividend payments. State and explain the main Determinants of Dividend Policy of quoted companies in Kenya (10 Marks)
7. A project costs Kshs 9,000,000 and yields annual cash inflow of Kshs. 3,450,000 for 3 years. Calculate its payback period. What are the drawbacks of this capital budgeting techniques?

(4 Marks)

**QUESTION TWO (20 MARKS)**

1. Must Firms Pay Dividends? Briefly explain why they should (8 Marks)
2. Two firms Kupe Ltd and Nut Ltd have the same level of financing but different capital structures. The company’s earnings before interest and taxes (EBIT) is Ksh. 3,000,000 for both. The corporation tax rate is 30% for both companies.

|  |  |  |
| --- | --- | --- |
|  | Kupe Ltd | Nut Ltd |
|  | Sh. | Sh. |
| Ordinary Share capital shs. 20 each | 4,500,000 | 3,5000.000 |
| 10% preferences share “ 1 each | 2,500,000 |  |
| 10% debentures “ 100 each |  | 3,500,000 |
| Total Capital | 7,000,000 | 7,000,000 |

Calculate the earnings per share (EPS) for each company and explain the difference in EPS between the two companies. (12 Marks)

**QUESTION THREE (20 MARKS)**

Whatabout Ltd. is contemplating to expand its business and accordingly it desires to increase its assets by 50% by the end of the year 2017.

The existing capital structure of the company is given as:

6% debentures Kshs. 4,000,000

8% preference share capital Kshs. 1,000,000

Equity shares Kshs. 5,000,000

New debentures can be sold at par at 10% interest rate. Preference shares will have a 12% dividend rate and can be sold at par. Equity shares can be sold to net Kshs. 188 per share. The shareholder required rate of return is 7% which is expected to grow at the rate of 3%. Returned earnings for the year are estimated to be Kshs. 600,000. Assume corporate tax rate is at 30%.

**Required:**

1. Determine amount of new capital expenditure? (3 Marks)
2. Determine the optimal structure of new financing? (5 Marks)
3. Determine the cost of individual capital components (8 Marks)
4. Determine the weighted average cost of capital of the company (4 Marks)

**QUESTION FOUR (20 MARKS)**

Distinguish the following terms as applied in financial management;

1. Operating leverage and financial leverage (3 Marks)
2. Capital structure and financial structure (3 Marks)
3. Business risk and financial risk (3 Marks)
4. Internal rate of return (IRR) and Accounting rate of ret urn (ARR) (3 Marks)
5. Arbitrage Prizing theory from Capital Asset Pricing Model (8 Marks)

**QUESTION FIVE (20 MARKS)**

1. **EXPLAIN** the main Costs and Benefits of debt finance in determining the capital structure of a

firm (10 Marks)

1. Explain the argument that “According to The Miller Modigliani Hypothesis Dividends don’t matter” (6 Marks)
2. What assumptions must exist for the Miller Modigliani Hypothesis argument to hold? ( 4 Marks)