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**University Examinations 2016/2017**

THIRD YEAR FIRST SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR

OF COMMERCE

**BFC3332: ADVANCED FINANCIAL MANAGEMENT**

**DATE: DECEMBER 2016 TIME: 2HOURS**

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

**QUESTION ONE (30 MARKS)**

1. Nchiru Ltd is considering the purchase of equipment that will cost ksh. 3 million. The annual cash inflows estimated to arise from this investment is Ksh. 800,000. The new machine has a life of 6 years with a residual value of ksh. 200,000. The company uses straight line depreciation method. The required rate of return is 12% and tax rate is 30%

Advice the management if:

1. The kshs. 800,000 is after tax inflows
2. The kshs. 800,000 is before tax and depreciation (12 marks)
3. Discuss the key objectives of a firm (8 marks)
4. Explain the meaning of the following terms as applied in financial management
5. Time value of money
6. Cost of capital
7. Agency costs
8. Venture capital (10 marks)

**QUESTION TWO (20 MARKS)**

XYZ Co. ltd is evaluating the investments projects below

Project initial cost expected annual life of project

Kshs. “000” cash flows

1 50,000 20,000 4

2 100,000 30,000 5

3 120,000 25,000 7

4 180,000 40,000 6

5 200,000 40,000 7

The company uses 10% cost of capital

**Required:**

1. Rank the above projects using net present value and profitability index methods

(10 marks)

1. Supposing the company’s capital budget is kshs. 350 million which of the five projects would be fully undertaken using the methods above (5 marks)
2. Explain the ways of evaluating investment projects under risk and uncertain in expected cashflows (5 marks)

**QUESTION THREE (20 MARKS)**

1. The capital structure of a firm is irrelevant in determining the value of the firm. Discuss this hypothesis by modigiani and millers(1958) (8 marks)
2. Discuss two dividend policy practices for companies quoted at the Nairobi securities exchange (4 marks)
3. The expected return of securities A and B under different states of the economy are tabulated below. The investment is security A is kshs. 220,000 and Kshs. 280,000 in security B.

State of economy probability Return on ‘A’ Return on” B”

Poor 0.5 0.02 0.01

Average 0.3 0.10 0.11

Good 0.2 0.15 0.21

Compute the expected return standard deviation and the expected value of the portfolio after one year of the portfolio these two securities (8 marks)

**QUESTION FOUR (20 MARKS)**

1. Explain the ways of adjusting for inflation in investments appraisal (5 marks)
2. Makutano ltd is evaluating two projects Pand Q for investment

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Cost of capital  Present value of cashflows  NPV | P | | Q | |
| 10%  480,000  60,000 | 12%  600,000  50,000 | 12%  500,000  80,000 | 14%  400,000  (10,000) |

1. Calculate the profitability index (PI) for each project using a discount rate of 10% for P and 12% for Q (4 marks)
2. Calculate the internal rate of return (IRR) for each project (5 marks)
3. Differentiate between the following pairs of financial management terms
4. Business risk and financial risk (2 marks)
5. Operating leverage and financial leverage (2 marks)
6. Capital structure and financial structure (2 marks)

**QUESTION FIVE (20 MARKS)**

1. Discuss three main sources of long term finance for a profit making company (8 marks)
2. Mini Ltd and Ware ltd have the same level of financing. However the two companies have different capital structures. The company’s earnings before interest and taxes (EBIT) is kshs. 7 million for both tax rates for both companies is 30%. The capital structure of the two companies is given below.

Mini Ltd (kshs) Were Ltd (shs.)

Ordinary share capital (shs.20 each) 3,000,000 2,000,000

10% pref. shares (shs. 1 each) 1,000,000 -

10% debentures (100 each) - 2,000,000

Total capital 4,000,000 4,000,000

Required:

Compute the earnings per share (EPS) for each company and explain the difference in EPS between mini Ltd and Were Ltd (12 marks)