CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

EXAMINATION FOR THE AWARD OF DEGREE OF MASTER OF MASTER OF BUSINESS ADMINISTRATION

MBAD 832: ADVANCED FINANCIAL MANAGEMENT

STREAMS: MBAD Y2S1 TIME: 3 HOURS
DAY/DATE: THURSDAY 07/10/2021 2.30 P.M – 5.30 P.M.

INSTRUCTIONS:

- **Answer ALL questions.**

QUESTION ONE

(a) Discuss the functions that requires skilful planning, control and execution of financial activities. (6 marks)

(b) Agent problem exists when agents pursue their own interests rather than the interest of their principles. Discuss the causes of conflicts that occurs when managers pursues their own interest rather than the interest of shareholders. (6 marks)

(c) Company A is evaluating a new technology for its production. The technology has 2 years and costs Sh. 100,000. Its impact on the company is subject to uncertainties. In the first year the management estimates that the technology has an equal chance of generating good and normal returns of 50,000 and 80,000. If it provides good returns in the first year then the second year cash flows will be 40,000, 50,000 and 60,000 with associated probabilities of 0.3, 0.5 and 0.2 respectively. If it provides normal returns in the first year then second year cash flows will be 70,000, 80,000 and 90,000 with associated probabilities of 0.3, 0.4 and 0.3 respectively. Require a decision tree depicting the above information and the expected net present value if the cost of capital is 10% (9 marks)

(d) XYZ currently has 10,000 outstanding shares currently selling at Sh. 150 each. The dividend for the financial year 15 per share. The company expects a net income of Sh. 160,000 and a proposal of making a new investment of Sh. 300,000.

(i) Show that under MM hypothesis that dividend payment has no effect on the value of the firm if the equity capitalization rate is 12%. (6 marks)

(ii) State three criticisms of Modigliani and miller hypothesis. (3 marks)

(e) ABC Ltd intends to acquire a new asset to replace the existing one. The new asset will cost Sh. 8 million and it will require an installation cost of Sh. 2 million. The new asset has an economic life of 5 years and a salvage value of Sh. 2,000,000. The old asset has a net book value of 4,000,000 and the market value of the machine is Sh. 3,200,000 with a salvage value of Sh. 800,000. The company uses straight line method of depreciation. As a result of this replacement, sales will increase from 3,000,000 to 5,500,000. In addition it will increase cost from 1,500,000 to 1,800,000. The company tax rate is 50% and the cost of capital is 12%. Required: Advise the company whether it should replace the asset or not. (10 marks)

QUESTION TWO

(a) Discuss the role played by capital markets in Kenya. (6 marks)

(b) Compare A limited is taking over Company B limited. The relevant data for the two companies is as follows. The shareholders of company B would receive 0.8 shares of Company A for each share held by them.

	Company A	Company B
Net sales	400,000	120,000
Profit after tax	150,000	50,000
Number of shares	15,000	5,000
Earning per share	6	4
Market price per share	40	20
Price earnings ratio	10	5

(i) Required: Calculate the combined (9 marks)
EPS
PER
MPS
Number of shares
Total market capitalization

(ii) Explain the strategies that can be employed by company B in order to avoid takeover by company A. (5 marks)

QUESTION THREE

(a) A company has net operating income of Sh. 120,000, it has 5% Sh. 1,000,000 debenture, the equity capitalization rate is 10%.

(i) Calculate the value of the firm and the overall capitalization rate using the net income approach. (4 marks)

(ii) Highlight the assumptions of net income approach. (3 marks)

(b) A company is considering relaxing its credit standards, the firm currently credit terms is net 20 but the average collection period is 45 days. Current annual sales amount to Sh. 8 million, the firm wants to extend the period to net 90, with that sales will increase by 25% and bad debts will increase from 2% to 3% of annual credit sales. Collection cost will increase from 90,000 to 190,000. The return on investment in debtors is 13%. Selling price per unit is Sh. 100 and the variable cost per unit is Sh. 70. Assume a year has 360 days. Required should the firm change the credit policy. (7 marks)

(c) Haltons limited has 1,200,000 shares outstanding at a current market price of Sh. 150 per share. The company needs 20,000,000 to finance its proposed project. The board of directors has decided to issue rights for raising required funds. The subscription price has been fixed as Sh. 50 per share. (6 marks)

(i) How many rights are required to purchase one new share?
(ii) What is the price one share after rights issue?
(iii) Compute the theoretical value of the share?

QUESTION FOUR

A company wants to acquire an asset that costs Sh. 600,000 for 6 years. The company is to depreciate the asset using straight line method. There are two financing alternatives either leasing or borrowing to buy the asset. The loan has an interest rate of 13% paid in equal year end instalments or A lease that will be set to amortize the cost of the equipment over the lease period, the return on capital of the lessor is 12%. The corporate tax rate is 30% and no salvage value.

(i) Advise the company on whether to lease or buy the asset. (15 marks)

(ii) Discuss the economies of leasing. (5 marks)
