

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

FINANCIAL ANALYSIS - PAPER 9

JUNE 2000

INSTRUCTIONS TO CANDIDATES

1. Time allowed: 3 hours
2. Attempt **all** questions in Section **A**, any **three** questions in Section **B** and any **one** question from Section **C**.
3. Section **A** has **ten** compulsory questions each carrying 2 marks.
4. Section **B** has four questions, and only **three** questions are to be attempted. Each question carries 20 marks.
5. Section **C** has two questions and only **one** question is to be attempted. It carries 20 marks.
6. Please read further instructions on the answer book.

SECTION A

Question 1

- (i) The Net Present Value of a project is:
- a) the present value of all cash inflows from the project
 - b) the discount rate at which the present value of all cash inflows from the project is zero
 - c) the present value of all cash inflows less the present value of all cash outflows
 - d) the discount rate at which the present value of all cash inflows less the present value of all cash outflows is zero.
- (ii) A Bear is:
- a) an investor who has bought a security in the hope of selling it at a higher price
 - b) an investor who has sold a security in the hope of buying it back at a lower price
 - c) a security for which a register of ownership is kept by the company
 - d) a security for which no register of ownership is kept by the company.
- (iii) A company is considering investing in a project. This will require acquiring a factory for Shs 5 billion. The project would then yield after tax cash inflows of Shs 1.5 billion annually for five years. At the end of five years, the factory would be scrapped and sold off for Shs 200 million. If the company's cost of capital is 12%, then the Net Present Value of investing in the project would be (to the nearest million shillings):
- a) Shs 407 million
 - b) Shs 607 million
 - c) Shs 0.52 billion
 - d) Shs 0.29 billion

- (iv) Namakomo Ltd. has the following profit and loss account (extracts) for the year ended 31 March 2000.

	Shs million
Profit before interest and tax	600
Interest	(100)
Profit before tax	500
Tax	(150)
Profit after tax	350
Dividends	(200)
Retained profits	150

If the capital employed for Namakomo Ltd. on 31 March 2000 was Shs 1.5 billion, then the return on capital employed is:

- a) 10%
 - b) 33.3%
 - c) 23.3%
 - d) 40%
- (v) Over capitalisation describes a situation where:
- a) the company's current ratio is decreasing
 - b) the company has too much long term capital
 - c) the company has too much working capital
 - d) the company's gearing levels are increasing.
- (vi). The prime objective of a company is:
- a) maximise profitability for shareholders
 - b) maximise the shareholders/stakeholders wealth
 - c) maximise market share at the expense of the competition
 - d) maximise sales for the company

- ((vii) A good debtors control (credit management) policy would:
- a) minimise debtors
 - b) maximise debtors and sales
 - c) minimise the cost of carrying debtors, minimise bad debts and maximise profitability
 - d) maximise the cost of carrying debtors, minimise bad debts and maximise profitability.
- (viii) A company is considering investing in Investment X. An investment in X shares has the following estimated cash flows (returns) with attached probabilities

Investment in X shares	
Probability	Returns
	Shs million
0.2	20
0.5	30
0.3	10

The expected return of investing in X shares is:

- a) Shs 22 million
 - b) Shs 42 million
 - c) Shs 20 million
 - d) Shs 40 million
- (ix) By holding a portfolio of shares, one is able to diversify away an element of risk. In the Capital Asset Pricing Model (CAPM) unsystematic risk is:
- a) the element of risk caused by the market and outside the company's control This risk cannot be diversified away
 - b) the element of risk caused by the market and outside the company's control. This risk can be diversified away
 - c) the element of risk specific to a company caused by the nature of its operations/trade and assets. This risk cannot be diversified away
 - d) the element of risk specific to a company caused by the nature of its operations/trade and assets. This risk can be diversified away.

(x) The P/E ratio is given by:

- a) $\frac{\text{market price per share}}{\text{earnings per share}}$
- b) $\frac{\text{earnings per share}}{\text{market price per share}}$
- c) $\frac{\text{total earnings (profit) after tax}}{\text{total market value of the company}}$
- d) $\frac{\text{total earnings before tax}}{\text{total market value of the company}}$

SECTION B

Question 2

Bukaya Ltd. has sales of Shs 36 billion per annum of which 60% are made on credit. Bukaya extends credit for 60 days (debtor days) and bad debts are 1.5% of credit sales. Bukaya Ltd has an overdraft of Shs 50 billion with Njeru Ltd. on which it pays overdraft interest of 10% per annum.

- a) Given the debtor days above of 60 days, compute the company's debtors (assume a 365 day year). **(4 marks)**
- b) Define what is meant by the cost of carrying debtors. **(3 marks)**
- c) Given the bank overdraft rate of 10%, calculate Bukaya's cost of carrying debtors. **(3 marks)**
- d) Compute the company's bad debts. **(2 marks)**
- e) Bukaya Ltd. is considering a new credit policy as follows:
 - Offer a discount of 3% to all credit customers paying within 30 days. It is estimated that 50% of all credit customers will take advantage of the discount (**credit discount**)
 - Offer cash customers a 4% discount (**cash discount**)
 - Extend credit (for credit customers not taking cash discount) to 90 days
 - Bad debts estimated to remain at 1.5% of credit sales, but only on the customers who do not take the discount
 - The company expects to increase sales in the new policy by Shs 4 billion per annum split as:
 - Shs 3 billion credit sales increase
 - Shs 1 billion cash sales increase
 - Contribution is also expected to increase by 25%.

Required:

Perform a cost benefit analysis of changing over from the old policy to the new policy and determine whether it is worthwhile to change to the new credit policy.

(8 marks)

(Total: 20 marks)

Question 3

Busitema Ltd. has the following capital structure on 31 March 2000:

Capital structure

- Ordinary shares of Shs 1,000 each (nominal) with a nominal value of Shs 10 billion
- 8% debentures redeemable in 5 years at par (Shs 100 each), nominal value of Shs 5 billion.

Market value of capital employed

- Ordinary shares have a current market value of Shs 1,000 each (cum div price)
- The redeemable debentures have a market value of Shs 95 ex-interest (ignore tax)

Dividends

- The company has just declared a dividend of Shs 100 each per share. This is expected to grow thereafter at 10% per annum.

Required: (give answers to the nearest decimal point and ignore tax).

- Define a company's cost of capital **(2 marks)**
- Compute Busitema's cost of equity **(5 marks)**
- Compute Busitema's cost of debt (debentures) **(5 marks)**
- Compute Busitema's weighted average cost of capital **(6 marks)**
- Busitema Ltd is considering starting up a honey factory project. The project cash flows have been forecast and analysed and are estimated to have an internal rate of return of 20%. State, giving reasons, whether Busitema Ltd should go ahead with the project. **(2 marks)**

Question 4

Banya Ltd, a manufacturing company, is investigating the possibility of reducing its operating cycle (working capital cycle).

Required:

- a) What is meant by the operating cycle (working capital cycle) above?
(3 marks)
- b) Why would a company be concerned about the length of its operating (working capital) cycle?
(2 marks)
- c) The following has been extracted from Banya Ltd's annual accounts:

	Shs '000
Stocks: raw materials	500,000
Stocks: work in progress	300,000
Finished goods	500,000
Purchases	800,000
Cost of goods sold	700,000
Sales	800,000
Debtors	200,000
Trade creditors	100,000

All sales are on credit.

Required:

Calculate the length of Banya Ltd working capital / operating cycle (assume a 360 day year)
(9 marks)

List two possible actions that Banya Ltd. might take to reduce the length of the operating cycle and the possible disadvantages of each. (6 marks)
(Total: 20 marks)

Question 5

Capital rationing describes the situation where a company is unable to undertake all the projects it has identified as having positive Net Present Value (NPV) due to lack of capital.

Required:

- a) Describe what is meant by hard capital rationing (4 marks)
 - b) Describe what is meant by soft capital rationing (4 marks)
 - c) Describe what is meant by multiple period capital rationing (4 marks)
 - d) Describe what is meant by single period capital rationing (4 marks)
 - e) Describe what is meant by a profitability index? (4 marks)
- (Total: 20 marks)**

SECTION C

Question 6

Write short notes on the following sources of finance available to companies:

- a) New issue of shares (4 marks)
 - b) Rights issues (4 marks)
 - c) Fixed rate debenture (4 marks)
 - d) Floating rate debentures (4 marks)
 - e) Deep discount debentures (4 marks)
- (Total 20 marks)**

Question 7

- a) Profit making companies and their business projects are exposed to business risk.

Required:

Describe what is meant by business risk. Then give two examples with reasons of the kind of business risk a company operating in the soft drink industry would experience in Uganda and East Africa as a whole.

(10 marks)

- b) Business can also be exposed to financial risk.

Required:

Describe what is meant by financial risk. State how financial risk has **affected** businesses operating in Uganda and East Africa as a whole.

(10 marks)

(Total 20 marks)