

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

FINANCIAL ANALYSIS - PAPER 9

DECEMBER 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) Which of the following best defines the risk associated with a project:
 - a) The variability that will occur in the future returns of the project
 - b) The variability that has to occur in the future returns of the project
 - c) The variability that is likely to occur in the future returns of the project
 - d) All the above are equally correct.
- (ii) 24,000The basic objective of the business undertaking is best stated as:
 - e) Profit maximization
 - f) Maximisation of shareholders wealth
 - g) Survival of management
 - h) Creation and retention of customers
 - i) Social responsibility
- (iii) Ratios that measure the management's overall effectiveness as shown by the returns generated on sales and investments are
 - a) Liquidity ratios
 - b) Activity ratios
 - c) Leverage ratios
 - d) Profitability ratios
- (iv) Gilt-edged securities are best described as:
 - a) Blue chips
 - b) Watered capital
 - c) Government bonds
 - d) Parri passu
- (v) Which of the following is most correct about the traditional approach to capital structure:
 - a) The market value of the firm is dependent on the net operating income and the risk attached to it and how it is distributed
 - b) The market value of the firm is independent of the net operating income and the risk attached to it and not how it is distributed
 - c) The market value of the firm depends on the net operating income and the risk attached to it but not how it is distributed
 - d) The market of the firm depends on the net operating income and not the risk attached to it and how it is distributed.
 - e) Non of the above
- (vi) Which of the following is most correct about stock split:

- a) It is the decrease in the number of shares in the company without changing the issued and paid capital
- b) The stock split does not affect the issuing company's future cash flows and its value
- c) The stock split does not affect the issuing company's cash flows and so does not affect its value
- d) It is the increase in the number of shares in the company that changes the value of the issued and fully paid capital

(vii) ICPAU Ltd. has the following capital structure:

10,000 ordinary shares of Shs. 10 each	100,000
5000 10% preference shares of Shs. 10 each	<u>50,000</u>
	<u>150,000</u>

The market price as quoted on Kampala stock exchange is Shs. 30 per share. Declared dividends were 10%. During the year ended 30th September 2000, the total earnings were Shs. 150,000 and the corporation tax rate is 30%.

Based on the information above, calculate the ICPAU's price earning ratio.

- a) 10 year
- b) 3 years
- c) 4 months
- d) None of the above

(ix) Born 19XI and died 19XII. The statement is similar to one that appeared in one of Uganda's Newspapers by a cartoonist. It related to events surrounding one of the banks that was incorporated some time back and Bank of Uganda closed down it's operations hence the birth and death:

As a financial analyst student which of the following statements is most true on the effect of closure of financial institutions on Uganda's economy

- a. The Uganda Shilling will depreciate
- b. The movement government will loose the forth coming elections because people have loss money
- c. Due to loss of confidence in the banking sector, there will be less savings and less investments and the economy will not grow
- d. There will be no effect since Uganda's economy is agro based and most of the farmers live below poverty line and have no money to bank

(x) The dividend cover is given by the following formula:

a)
$$\frac{\text{Total dividends declared}}{\text{number of ordinary shares in issue}}$$

b)
$$\frac{\text{Net profits after tax and preference share dividends}}{\text{Number of ordinary shares in issue}}$$

- c) $\frac{\text{Net profit after tax and preference share dividends}}{\text{dividends declared}}$
- d) $\frac{\text{Market price per share}}{\text{Dividends per share}}$
- (xi) Which of the following statements below is correct about capital rationing:
- It is a mixture of debt and equity capital raised to finance a project
 - In a perfect capital market, soft capital rationing would occur while hard capital rationing would be irrational
 - In a perfect capital market, hard capital rationing would occur while soft capital rationing would be rational
 - In a perfect capital market, hard capital rationing would not occur while soft capital rationing would be irrational

SECTION B

Question 2

- a) Explain what you understand by the term marginal cost of capital. **(2 marks)**
- b) Golf Limited is planning to build a business complex along Kitante Road. The project will cost 1.8 billion shillings. Golf Ltd's current capital structure which is deemed optimal is as follows:
- | | |
|-------------------------------------|--------------------|
| Debt | 480,000,000 |
| Ordinary shares of Shs. 10,000 each | 384,000,000 |
| Retained profit | <u>100,000,000</u> |
| | <u>964,000,000</u> |

The following additional information is provided.

- The new debt will be secured by issuing debentures of Shs. 100 per value each at an interest rate of 20%. No floatation costs will be incurred.
- Ordinary shares currently sell at Shs. 300 per share with a dividend of Shs. 500 per share with an expected growth of 10%. Floatation costs amount to 4 % .
- The marginal tax rate is 30%

Required

- 2b(i) How much of the project cost should be raised from equity capital so as to leave the capital structure unchanged **(2 marks)**
- 2b(ii) How much of the capital should be raised from retained earnings **(2 marks)**

- 2b(iii) Determine how many new ordinary shares have be floated to raise the required portion of equity capital (4 marks)
- 2b(iv) Compute Golf Ltd's marginal cost of capital (10 marks)
- (Total: marks 20)**

Question 3

- a) What are the limitations of ration analysis as a tool to financial analysis (3 marks)
- b) Kagezi Ltd. is considering two mutually exclusive project requiring an initial outlay of Shs. 1,000,000 each and have useful life spans of five years.
Kagezi Ltd's required rate of return is 20% and the corporation tax rate is 30%. The project will be depreciated on straight-line basis. The earnings before depreciation and taxes cash flows expected to be generated by the project is as follows:

Year	2001	2002	2003	2004	2005
Project Gulu 400,000	400,000	400,000	400,000	400,000	
Project Jinja 500,000	600,000	300,000	200,000	500,000	

You are required to calculate the following for each project.

- 3b(i) Pay back period (2 marks)
- 3b(ii) Average rate of return (2 marks)
- 3b(iii) Net present value (NPV) (4 marks)
- 3b(iv) Profitability index (2 marks)
- 3b(v) List any four-non financial factors that must be considered during capital budgeting (4 marks)
- (Total: marks 20)**

Question 4

- a) What do you understand by the term preemptive right? (2 marks)
- b) The information below relates to shares of Uganda Clays Limited, a company quoted on Kampala Stock exchange
- (i) The market price per share is Shs. 500/=
 - (ii) The subscription price is Shs. 450/= per share
 - (iii) It takes four rights to buy an additional share

- Best on the above information calculate the following:
- 4b(i) The theoretical value of a right when stock is selling cum-right (2 marks)
- 4b(ii) Ex-rights value (2 marks)
- 4c The value of the right may differ sometimes from the theoretical value. State two factors that may cause this (just state) (2 marks)
- 4d Paparazi Ltd. has the following financial statements as at 31 October 2000.

Non current assets	Ushs.
Plant and equipment	2,000,000

Current assets

Stock	700,000	
Debtors	400,000	
Cash	<u>200,000</u>	<u>1,300,000</u>
		<u>3,300,000</u>

Equity and liabilities

Ordinary shares 10,000 of Shs. 100 each	1,000,000
Retained earnings	<u>500,000</u>
Shareholders funds	<u>1,500,000</u>

Non current liabilities

20% debenture	1,000,000
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Current liabilities

Trade creditors	<u>800,000</u>
Total equity and liabilities	<u>3,300,000</u>

For the period ended 31st October 2000, Paparazi Limited made a profit of Shs. 10,000,000 before charging interest.

Management has further proposed to declare a dividend of Shs. 1,000,000 to all the shareholders. Tax rate is 30%.

Based on above information, you are required to calculate the following:

- 4d(i) Two liquidity ratios (4 marks)
- 4d(ii) Interest cover (2 marks)
- 4d(iii) Dividend cover (2 marks)

- 4d(iv) Dividends per share (2 marks)
 4d(v) Comment on the liquidity position of Paparazi Limited (2 marks)
(Total: marks 20)

Question 5

- a) The managing director of Bibawo Limited recently attended one of the seminars organised by the institute. During the seminar, the presenter stated that there is need to diversify the risk and that the higher the return expected on an investment, the higher the risk. Bibawo Limited holds the following investment port folio:

Investment	Expected return	Portfolio
Uganda Clays Limited	30%	2/3
BAT Uganda Limited	60%	1/3

You are one of those persons who attended the seminar and the managing director has approached you with the following questions which he badly needs the answers.

- 5a(i) Explain to him what is a portfolio. (2 marks)
 5a(ii) What is diversification? (2 marks)
 5a(iii) Compute the expected return of portfolio for the two investments Bibawo holds. (4 marks)
 5a(iv) If the co-efficient of correlation (r) between Uganda Clays Ltd. and BAT Uganda Limited investments is positive one (+1). Explain what it means to the Managing Director. (2 marks)
 5b(i) Given that the risk free rate of return is 8%, the market expected rate of return is 12% and the standard deviation of the market return is 2% while the covariance of return for Uganda Clays Limited's share and the market is 2%. Calculate the required rate of return for Uganda Clays Limited security. (Use the capital asset pricing model) (4 marks)
 5c State four limitations with the technique you have used above. (4 marks)
 5d Define an efficient portfolio. (2 marks)

(Total: marks 20)

SECTION C

6. Write short notes on the following:
- (i) Mutually exclusive projects (2 marks)
 - (ii) Concentration banking and lock box system (4 marks)
 - (iii) Capital rationing (6 marks)
 - (iv) Kampala stock exchange (4 marks)
 - (v) Financial futures and options (2 marks)
 - (vi) Stock split and reverse split (2 marks)
- (Total: marks 20)**

Question 7

Write short notes

- a) Technical and legal insolvency (2 marks)
 - b) Determinants of working capital of a firm (6 marks)
 - c) Venture capital (2 marks)
 - d) Independent projects (2 marks)
 - e) Gilt market and jobbers (4 marks)
 - f) Capital asset pricing model (4 marks)
- (Total: marks 20)**