

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

FINANCE – PAPER 14

CPA (U) EXAMINATIONS

JUNE 2001

INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours**.
2. Section **A** has **one** compulsory question which carries 40 marks.
3. Section **B** has **three** questions and you can attempt any **two** questions. Each question carries 20 marks.
4. Section C has **two** questions and only **one** question is to be attempted. Each question carries 20 marks.
5. Please read further instructions on the answer book

SECTION A

Question 1

Prime Solutions Ltd. is considering making an initial public offer (IPO) for sale of shares through the Uganda Stock Exchange (USE). The summarised accounts of the company for the last four years are as follows:-

YEAR	Shs. Millions			
	2000	1999	1998	1997
Non Current Assets:				
- Tangible	2,520	2,320	2,100	1,790
- Associated companies	130	120	290	130
Current Assets	<u>870</u>	<u>700</u>	<u>320</u>	<u>260</u>
	<u>3,520</u>	<u>3,140</u>	<u>2,710</u>	<u>2,180</u>
Share Capital and Reserves:				
- Share Capital	340	340	340	340
- Reserves	1,840	1,620	1,470	1,270
Non Current Liabilities	300	370	350	350
Current Liabilities	<u>1,040</u>	<u>810</u>	<u>550</u>	<u>220</u>
	<u>3,520</u>	<u>3,140</u>	<u>2,710</u>	<u>2,180</u>
Operating Results				
Turn over	9,560	8,070	7,390	5,980
Gross Profit	1,560	1,440	1,510	1,320
Profit Before Tax	670	530	590	580
Tax	368	298	320	300
Dividends	82	82	70	60
Retained Earnings	220	150	200	220

The share capital of the company consists of fully paid ordinary shares of Shs.3,400 each and the current dividend represents a net amount of Shs.600 per share.

Year(s)		A	B
2000	Earnings per share (EPS)	3,000	4,500
1997-00	Average earnings per share	2,450	3,900
2000	Average market price per share	21,000	74,000
2000	Dividend per share	1,600	3,100
1997-00	Average dividend per share	1,500	3,000
2000	Average book value per share	20,000	41,000

Two other companies which are considered to be competitors in the market and are already quoted have the following data from the East African Newspapers.

YEARS		COMPANY A	COMPANY B
2000	Earnings per share (EPS)	3,000	4,500
1997-2000	Average earnings per share	2,450	3,900
2000	Average market price per share	21,000	74,000
2000	Dividend per share	1,600	3,100
1997-2000	Average dividend per share	1,500	3,000
2000	Average book value per share	20,000	41,000

You are the accountant of the company and you are required to advise the directors.

(a) Write a memo explaining the possible price range that might be obtained, showing clearly the application of the following alternative methods, their advantages and disadvantages.

- (i) Value of net assets.
- (ii) Earnings per share.
- (iii) Dividends per share.

(25 marks)

(b) Explain the information that will be required to prepare the accountant's report which shall be included in the prospectus.

(10 marks)

(c) What are the disadvantages of a company's shares being traded on the Uganda Stock Exchange.

(5 marks)

(Total 40 marks)

SECTION B

Question 2:

Kilolo and Sons Ltd. are interested in investing in a wood parquet making plant. They have been in the carpentry business for seven years and feel that there is a need to expand into other lines given the difficulties of maintaining a reasonable customer base. Kilolo Senior has been told by his friends that the only way he can increase his investment and therefore income is to take out a loan to finance the purchase of machinery. He comes to you seeking advice and you believe that he must make a proposal to the bank in the form of a business plan. Mr. Kilolo commissions you as his consultant to draw up the plan.

Required:

- (a) Prepare a memo to Kilolo and Sons Ltd. explaining the requirements of drawing up the business plan and suggest an outline for the business plan in your memo. You should also be able to point out to the client the advantages of your outline.
- (10 marks)**
- (b) As part of the business plan, you are also to draw out a cash flow forecast for the six months period for which he will take out the loan.

You are provided with the following information:

	Shs. millions
Expected monthly sales	95
Opening cash balance	21
Loan amount	250
Other income	12
Operating costs (monthly)	
Rent	7
Wages	5
Utilities	3
Purchases (materials)	16
Directors' Allowances	2

Other information:-

1. The machine, and its installation is expected to cost Shs.256m/=. The machine is available locally and will be installed in the first month.
2. Interest on the loan is charged at a rate of 2.5% per month.
3. Depreciation on the new machinery is applicable at a rate of 3.33% per month.
4. Ignore taxation.
5. The loan is repayable in two installments every 3 months.

Required:

Prepare a cash flow forecast for six months and advise Kilolo and Sons Ltd. accordingly.

(10 marks)
(Total 20 marks)

Question 3

Associated Quarries uses a machine for which the operating costs, maintenance expenses and residual value are:

	(Shs.000s)		
Time	Operating costs	Maintenance	Residual value
0	0	0	1,500
1	2,500	500	1,000
2	3,000	1,000	600
3	3,500	1,500	100
4	4,000	1,700	0

The machine is to be replaced by a new model whose financial data are as follows:-

Time	0	1	2	3	4
Outlay	7,000				
Operating costs		1,800	2,200	2,600	2,800
Maintenance costs		200	500	900	1,200
Residual value		4,000	3,000	2,000	1,000

Required:

(a) If the discount rate is 8%, at what time should the existing machine be replaced.

(15 marks)

(b) Explain why NPV is considered a superior method of evaluating projects.

(5 marks)

(Total 20 marks)

Question 4

Car Parts Ltd. and Aero Parts Ltd. are companies with the same level of business risk. Both companies have gross operating profits of Shs.280,000,000/= per annum which are expected to be constant in the foreseeable future. The two companies have different capital structures as car parts relies entirely on equity sources and Aero uses both loan and equity. Their capital structures are as follows:-

	Shs m
Car Parts Ltd.	
Equity (Market value)	1200
Aero Parts Ltd	
Equity (Market Value)	680
8% Debentures	<u>680</u>
	<u>1,360</u>

At present, Mr. Kayonza owns 3% of car parts share capital. In order to increase his income, he is considering switching to an investment in Aero Parts Ltd. Mr. Kayonza is considering purchase of 3% of the equity of Aero Parts Ltd. and some of its debentures with the balance of the money obtained from sale of his equity in Car Parts Ltd. This proposal is expected to maintain the same risk for his portfolio. Assume that corporation tax is payable at 30% per annum at year end.

Required:

- (a) Find the effect of the proposal on Kayonza's financial position. **(5 marks)**
- (b) Calculate the equilibrium of Aero Parts Ltd.'s equity assuming that:-
- (i) The arbitrage process will be carried out by many investors.
 - (ii) The value of Car Parts Ltd.'s debentures remain unchanged.
- (10 marks)**
- (c) Discuss the implications of your calculations for the determination of the optimal financial structure of a firm.

(5 marks)
(Total 20 marks)

SECTION C

Question 5:

The management of Kampala Arts Ltd. and Okapi Galleries Ltd. have been holding discussions about a possible merger of their businesses. The directors of the two companies are not very clear about the motives and benefits for the merger.

Required:

Write a memo to the Board of Directors explaining the motives and benefits of the merger. Use examples in your memo.

(20 marks)

Question 6:

Johnson Chemonges has been dealing in Lime production for six years. He believes that if he could increase the company's capital, he would be able to purchase better mining tools and a paper bag-stitching machine. At present, he has invested about Shs.16 million in the business and is looking for appropriate micro finance.

Required:

Write a memo for Johnson Chemonges and explain to him the following:-

- (a) The type of credit he should target.
- (b) The available sources of capital for a business like his.
- (c) The procedures he should use to raise the capital.
- (d) The implications of loan capital to his business.

(20 marks)