

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA (U) EXAMINATIONS

### LEVEL TWO

#### FINANCIAL ANALYSIS – PAPER 9

**THURSDAY, 20 JUNE 2002**

#### INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours**
2. Attempt all questions in Section **A**, any three questions from Section **B** and **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. Each question carries 20 marks.
6. Please read further instructions on the answer book

**SECTION A****Question 1**

- (i) The following statements relate to capital markets:
1. Transaction costs of buying and selling are high but they do not discourage trading significantly.
  2. The prices of securities bought and sold reflect all the relevant information available to the buyers and sellers.
  3. No individual dominates the market and there is competition.
  4. Buyers are not as skilled as the sellers in analysing all the available market information.
  5. Share prices will vary in a fairly irrational way.

Which combination is true about an efficient capital market?

- (a) 1, 2, and 3.
  - (b) 1, 2 and 4.
  - (c) 2, 3, and 5
  - (d) None of the above combinations.
- (ii) Which of the following statements is true within the context of portfolio theory?
- (a) An investor should only invest in risk-free investments; otherwise he will make significant losses.
  - (b) An investor, while making the choice of investments should take into account the security of the investment, the expected return, the liquidity of the investment, but not necessarily the company's targeted growth objectives.
  - (c) Experience shows that diversification of investments completely eliminates inherent and systematic risks of a portfolio or projects.
  - (d) Diversification of investments will yield better results if the various projects/ business lines under consideration are negatively correlated than if they are positively correlated.
- (iii) A finance manager will at best be pre-occupied with decisions regarding:
- (a) Capital budgeting; working capital management; recruitment of finance department staff; and production of accurate and timely financial reports.
  - (b) Capital budgeting; working capital management; financing and dividend policies.
  - (c) Capital budgeting; cash budgeting, financial information to insider and outsider stakeholders; and internal control systems.
  - (d) Raising long-term funds for the organisation; ensuring efficient utilisation of these funds; and producing financial statements for shareholders and government authorities.

- (iv) Bantu Ltd recently declared a dividend of Shs 20 per share. The share price is Shs 380 cum div and earnings for the most recent year were Shs 30 per share. Compute the price-earnings ratio:

- (a) 21.
- (b) 12.
- (c) 13.
- (d) 13.3.

- (v) Which of the following is a mismatch?

- (a) Market order.
- (b) Limit order.
- (c) Short sale.
- (d) Over the counter.

- (vi) Equities Limited (EL) has the following capital structure:

	Value	Cost of finance
Equity	Shs 10 million	15%
Debt	Shs 8 million	9% (pre-tax)

Assume a corporation tax rate of 31%.

What is EL's weighted average cost of capital?

- (a) 11.09%.
  - (b) 12%
  - (c) 12.33%
  - (d) The above is inadequate information.
- (vii) Which of the following statements is correct?
- (a) Financial leverage causes shareholders to increase their cost of capital, and this is a disadvantage of borrowing.
  - (b) Too high borrowings will increase bankruptcy risks, but this is the trend of current business.
  - (c) Interest costs may not be a tax-deductible expense, but if it were a sure deal, borrowing would be a cheap source of finance.
  - (d) Any level of borrowing should basically be discouraged if a business has to offer high returns to shareholders.
- (viii) ICPAU Ltd has issued some 9% debentures which are redeemable at par in 3 years time. You are an investor who requires an interest yield of 10%. What is the current market value of Shs 100,000 debentures?
- (a) Shs 100,000.
  - (b) Shs 22,390.
  - (c) Shs 97,470.
  - (d) Shs 79,470.

- (ix) Businesses will extend credit to customers for various reasons. However, such a strategy is least likely to be targeted at:
- (a) Expansion of the sales volume and the customer base.
  - (b) Encouraging sales and clearing-off excess or old inventory.
  - (c) Making friends and associates benefit from the business.
  - (d) Encouraging consumption of a new product, as a promotion strategy.
- (x) Which of the following statements is true?
- (a) "Capital markets" are a general term that includes money markets, primary and secondary markets for securities.
  - (b) Commercial banks play a leading role in Capital markets, because of the nature of their lending.
  - (c) Many companies are not listed on the Uganda Securities Exchange (USE) mainly because the USE is still in its early stages of development.
  - (d) A rights issue will lower the company's gearing level, while a bonus issue will not affect it.

## SECTION B

### Question 2

St Paul's Health Centre has provided you with the following information and requested you to prepare for them a cash budget for the year ending 30 June 2003:

Cash expected on 1 July 2002	Shs 30 million
Consultation fees: 1 <sup>st</sup> Quarter	Shs 60 million
Drug sales: 1 <sup>st</sup> Quarter	Shs 40 million

It is expected that consultancy fee collections will grow at a rate of 10% per quarter while drug sales will grow at 20% per quarter.

Expenditure:

Quarter	1 <sup>st</sup> Shs '000	2 <sup>nd</sup> Shs '000	3 <sup>rd</sup> Shs '000	4 <sup>th</sup> Shs '000
Salaries	60,000	65,000	70,000	70,000
Drug purchases	30,000	32,000	44,000	35,000

Rent will be paid at a rate of Shs 2 million per month, and the centre plans to purchase equipment in September 2002 worth Shs 45 million, and will be depreciated at 20% per annum.

The centre requires a minimum cash balance of Shs 5 million at the end of each quarter.

#### Required:

- (a) Prepare a cash budget (on a quarterly basis) for the Centre for the year ending 30 June 2003.

**Note:** Ignore the interest on any loans and assume the assumptions will work out as expected.

**(10 marks)**

- (b) Would you advise a fast growing business firm with a Shs 50 million-turnover to prepare a cash budget? Give reasons for your answer.

**(5 marks)**

- (c) State and briefly explain any five factors that determine the working capital requirements of a company.

**(5 marks)**

**(Total 20 marks)**

**Question 3**

- (a) Two companies, ATC Ltd and CPA Ltd, are quoted on the Uganda Securities Exchange. A raffle was drawn after the first round of the 2002 World Cup soccer finals and you emerged the winner of the raffle. You have just received a cheque of Shs 50,000,000 on condition that you invest part of this money in Stocks.

You have approached a stock broker who has provided you with the following returns for the stocks of the two companies:

<b>Month</b>	<b>ATC Ltd</b>	<b>CPA Ltd</b>
January	0.14	0.08
February	0.06	0.05
March	-0.11	-0.08
April	0.01	0.02
May	0.12	0.01

**Required:**

Using the mean, standard deviation and coefficient of variation, which of the two companies' shares will you invest in and why?

**(10 marks)**

- (b) After investing in the company you have chosen in 3(a) above, you have read in the business section of **The Monitor** newspaper that the company has just borrowed some funds from Stanbic Bank to acquire new machinery. Consequently the debt / equity ratio has risen from 40% to 70%.

How would this change affect the required rate of return on your stock holding?

**(5 marks)**

- (c) How would you expect the liquidity of the investment you have chosen in 3(a) above to differ from that of virgin land in Kiboga?

**(5 marks)****(Total 20 marks)**

**Question 4**

The following balance sheets were extracted from the financial records of BRM Ltd:

**Balance Sheets as at 31 December**

	<b>2001</b>	<b>2000</b>
	<b>Ushs'000</b>	<b>Ushs'000</b>
<b>Assets</b>		
Non-current Assets:		
Land & Buildings	<u>55,600</u>	<u>30,500</u>
Current Assets:		
Inventory	6,500	5,500
Prepayments	4,500	8,500
Trade receivables	6,000	11,000
Cash & Bank	<u>11,000</u>	<u>8,000</u>
	<u>28,000</u>	<u>33,000</u>
Current Liabilities:		
Bank overdraft	13,500	-
Trade payables	<u>19,000</u>	<u>10,500</u>
	<u>32,500</u>	<u>10,500</u>
Net Current Assets	<u>(4,500)</u>	<u>22,500</u>
	<u>51,100</u>	<u>53,000</u>
<b>Financed by:</b>		
Share capital	4,100	3,000
Retained earnings	21,000	28,500
Loans	<u>26,000</u>	<u>21,500</u>
	<u>51,100</u>	<u>53,000</u>

**Required:**

- (a) Calculate;
- Two liquidity ratios.
  - The gearing ratio
  - Return on capital employed

You have other information that Shs 6.4 million was paid out in taxes, an interest of 14% was paid on loans, and a minimal dividend of Shs 0.65m was declared for the year. For the year 2000, Shs 3.2 million was paid in taxes, while interest of Shs 0.85 million was paid and a Shs 0.65 million net profit was realised.

- (b) Comment on the liquidity position of the company.
- (c) Advise the company on what they could do in their current situation.

**(14 marks)**

- (d) Give four limitations of the financial analysis tool used in (a) above, suggesting ways in which they can be minimized if the tool has to be used anyway.

**(6 marks)**

**(Total 20 marks)**

### Question 5

A company is considering a group of mutually exclusive projects each with an initial outlay of Shs 180 million, and cash flow from operations as follows:

	Project A	Project B	Project C
Year	Shs '000	Shs '000	Shs '000
0	60,000	60,000	150,000
1	50,000	50,000	10,000
2	30,000	30,000	10,000
3	40,000	40,000	5,000
4	55,000	10,000	5,000
5	20,000	20,000	140,000

#### Required:

- (a) Compute the payback period for each of the projects.  
**(6 marks)**
- (b) Compute the NPV for each of the projects, taking the cost of capital to be equal to 10%.  
**(6 marks)**
- (c) Recommend to the company which of the projects A, B and C should be undertaken, stating reasons for your recommendation.  
**(4 marks)**
- (d) Given Internal Rate of Return, Net Present Value, Payback Period, Accounting Rate of Return and Profitability Index, which of these is superior and why?  
**(4 marks)**

**(Total 20 marks)**



## SECTION C

### Question 6

A large company like MTN-Uganda will not have difficulty raising long-term finance compared to a newly formed indigenous company called MEL Ltd with two directors and Shs 20 million in share capital.

#### Required

- (a) Evaluate this statement and advise MEL Ltd where it can source for financing.  
(10 marks)
  - (b) State and explain the merits and demerits of each source of finance.  
(10 marks)
- (Total 20 marks)**

### Question 7

Commercial banks are the engine of development for any economy, without which an economy will lag behind others with a developed commercial banking sector.

- (a) Discuss this statement in relation to the Ugandan economy.  
(12 marks)
- (b) The closure of International Credit Bank, Cooperative Bank and Greenland Bank made the public lose confidence in the commercial banking industry.

#### Required:

Assuming you are the Governor of Bank of Uganda, recommend policies to the government that will restore confidence in the commercial banking sector.

**(8 marks)**  
**(Total 20 marks)**