

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA (U) EXAMINATIONS

LEVEL TWO

FINANCIAL ANALYSIS – PAPER 9

TUESDAY, 17 DECEMBER 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) Which of the following is correct about total asset turnover ratios?
- (a) They are a measure of liquidity.
 - (b) They measure efficiency.
 - (c) They are profitability ratios.
 - (d) They measure solvency.
- (ii) Calculate the Expected NPV of the following project which has an outlay of Shs 16,000,000 and a 10% cost of capital.

		Cashflows (Shs)	
		Year 1	Year 2
Optimistic	0.2	11,000,000	14,000,000
Most likely	0.5	8,000,000	11,000,000
Pessimistic	0.3	6,000,000	9,000,000

- (a) Shs 10,368,000.
 - (b) Shs 5,310,000.
 - (c) Shs 3,000,000.
 - (d) Shs 358,000.
- (iii) Vitalo Enterprises Ltd has the following capital structure:

	Shs
Ordinary shares (1,000 shares of Shs. 1,000)	10,000,000
10% debentures	<u>2,500,000</u>
	<u>12,500,000</u>

During the year ended 30 November 2002, the company made a pre-tax profit of Shs. 11,250,000. The company is in the 40% corporation tax rate bracket.

Required:

What is Vitalo's earnings per share?

- (a) Shs 6,600.
- (b) Shs 11,000.
- (c) Shs 11,250.
- (d) None

- (iv) Which of the following is a mismatch?
- (a) Equity shares of public companies.
 - (b) Convertible debentures.
 - (c) Money market.
 - (d) Bank deposit.
- (v) In efficient market hypothesis, a semi-strong form is said to have occurred if:
- (a) Current market share prices reflect all pertinent information, whether public or private.
 - (b) Current market share prices reflect all publicly available information.
 - (c) Market prices reflect fully all the past price movements.
 - (d) None of the above is correct.
- (vi) Which of the following statements is correct about systematic risk?
- (a) It is business risk plus financial risk.
 - (b) It is diversifiable.
 - (c) It is undiversifiable.
 - (d) It is caused by negligence of management.
- (vii) Which of the following is / are a mismatch?
- (i) Net present value.
 - (ii) Accounting rate of return.
 - (iii) Internal rate of return.
 - (iv) Profitability index.
 - (v) Pay back period.
- (a) (i) and (iii).
 - (b) (v) and (v).
 - (c) (iv) and (v).
 - (d) (v).
- (viii) Which of the following factors is an unlikely cause of soft capital rationing?
- (a) Management's reluctance to issue additional share capital for fear of outsiders gaining control of the business.
 - (b) Management's desire to limit investments to levels that can be solely financed from retained earnings.
 - (c) Non-availability of soft loans in the money and capital markets.
 - (d) The desire not to issue additional share capital if it will lead to dilution of earnings per share.

- (ix) Which of the following statements is false in the context of portfolio theory?
- (a) The Beta factor is the measure of the volatility of the price of a security and thus of its systematic risk, and ought to be considered in determination of the cost of capital.
 - (b) While determining a firm's cost of capital, it is not useful to consider the cost of equity since it is always variable and equity holders do not attach a charge on their funds.
 - (c) In determining the weighted average cost of capital, the firm should consider the proportion of each capital component, the marginal cost of each source.
 - (d) There is always a cost attached to retained earnings which should be equal to the return that shareholders would expect if they had received dividends and bought more stock in the firm.
- (x) Which of the following statements is true about "working capital cycle"?
- (a) If turnover period for inventories and debtors lengthens, and payment period to creditors shortens, working capital cycle will lengthen.
 - (b) If the turnover period for inventories and debtors lengthens and payment period to creditors shortens, the investment in working capital will reduce.
 - (c) Working capital cycle can be estimated as: Average stock days plus time taken to pay creditors, plus time taken to produce goods, plus time taken by customers to pay for goods.
 - (d) Estimation of Working Capital cycle takes account of the debtors and creditors payment periods and excludes stock days since during that time stock is not "working".

SECTION B**Question 2**

One of the key decision areas of a financial analyst is the management of working capital. The working capital decisions primarily concern establishing policies to manage the short-term assets.

Required:

- (a) State and explain two important decisions that are usually made in the management of working capital and justify the importance of proper working capital management.
(6 marks)
 - (b) State the principle components of a cash management policy and explain why people hold cash.
(6 marks)
 - (c) Explain any four factors that are likely to influence the working capital needs of an organisation.
(8 marks)
- (Total 20 marks)**

Question 3

- (a) In developing the required rate of return on an investment, there are some components to consider. Briefly explain any two of these components.
(4 marks)
- (b) Distinguish between primary and secondary markets and explain the importance of these markets to investors.
(4 marks)
- (c) Bank of Baroda offered its shares for listing on the Uganda Securities Exchange (USE). Explain what could have motivated the Bank of Baroda to get listed on the USE.
(4 marks)
- (d) Below is the performance of two securities on the Uganda Securities Exchange for the last five weeks:

Week	Stock A	Stock B
1	14	8
2	6	5
3	-11	-8
4	-1	2
5	12	3

If you are an investor, in which of the two stocks would you invest and why? (Performance refers to weekly returns).

(8 marks)
(Total 20 marks)

Question 4

Izima (U) Ltd is a manufacturing company located in Western Uganda. Since it was privatised the company has been expanding rapidly with the objective of penetrating the markets of Rwanda, Burundi and D.R. Congo.

The company has now encountered liquidity problems as illustrated by its balance sheets shown below:

	30.6.2002	30.6.2001
	Shs. '000'	Shs. '000'
Non-current assets	<u>308,000</u>	<u>264,000</u>
Current assets:		
Inventory	220,000	95,000
Trade receivables	210,000	108,000
Cash	<u>1,750</u>	<u>1,750</u>
	<u>430,000</u>	<u>204,750</u>
Current Liabilities		
Bank	158,000	41,250
Trade payables	<u>205,000</u>	<u>82,500</u>
	<u>363,000</u>	<u>123,750</u>
Net current assets	<u>67,000</u>	<u>81,000</u>
Net total current assets	<u>375,000</u>	<u>345,000</u>
Capital and reserves		
Issued share capital	18,000	18,000
Reserves	<u>357,000</u>	<u>327,000</u>
	<u>375,000</u>	<u>345,000</u>

Additional information:

- Sales for the year to 30 June 2001 were Shs. 1.7 billion; yielding a gross profit of Shs. 330 million and a net profit before tax of Shs. 82 million.
- The corporation tax rate is 30%.
- For the year ended 30 June 2001, dividends of Shs. 35 million were paid out.
- On 1 July 2001, the company bought a new conveyor belt, dumping trucks and a limestone crusher and recruited six more marketing staff.
- Sales for the year ended 30 June 2002 were Shs 3 billion, with a gross profit of Shs. 450 million and net profit before tax of Shs. 60 million.
- Dividends for the year ended 30 June 2002 amounted to Shs. 12 million.

Required:

- (a) Using the balance sheet information of Izima (U) Ltd identify the likely problems faced by the company and explain why such problems are common for manufacturing companies when sales are expanding very rapidly.

(10 marks)

- (b) Explain why Izima (U) Ltd has not increased its net profit, despite large increase in sales between 30.6.2001 and 30.6.2002.

(5 marks)

- (c) Suggest five ways in which Izima might seek to resolve its current problems.

(5 marks)

(Total 20 marks)

Question 5

Zebra Enterprises Ltd is considering an expansion involving two projects, both of which are expected to last 5 years. The following information is available about the two projects:

Project	Alpha Shs. '000'	Omega Shs. '000'
Initial outlay	52,000	55,000
Inflows		
Year 1	7,000	8,000
2	5,400	17,000
3	6,400	7,100
4	15,000	4,500
5	11,000	5,000
Expected scrap value at end of Year 5	4,000	5,500

It is estimated that the cost of debt will remain at an average of 15% per annum and that the weighted average cost of capital is 20% due to a much higher cost of equity which is estimated at about 23%.

Required:

- (a) Advise the company in which project it should invest in, on the basis of:
- Pay Back Period.
 - Net Present Value. (The projects are mutually exclusive. Your answer should be corrected to one decimal place).

(15 marks)

- (b) Which of the two appraisal methods in (a) above is preferable. Give reasons to support your choice.

(5 marks)

(Total 20 marks)

SECTION C**Question 6****Two more Banks in Uganda Faced with Closure.**

“Speculation as to which of the remaining 16 banks is headed for closure has prompted depositors to make huge withdrawals. Banks survive on sentiments. The moment there is a negative statement, depositors will rush to withdraw their money as quickly as possible, a bank official said. Teeffe Bank, Greenland Bank, Cooperative Bank, International Credit Bank and TransAfrica are deceased financial institutions.”

Extracted from: *The East African Newspaper, 9 – 15 September 2002*

Required:

- (a) State and explain four functions of effective liquidity management in the banking industry. **(8 marks)**
 - (b) State and explain four measures that Bank of Uganda should undertake to curb bank closures. **(6 marks)**
 - (c) Explain four causes of non-performing loans in Uganda’s financial sector. **(6 marks)**
- (Total 20 marks)**

Question 7

Write short notes on the following:

- (a) Capital asset pricing model. **(4 marks)**
 - (b) Venture capital and the sources of venture capital. **(4 marks)**
 - (c) Risks associated with acquiring funds external to the economy. **(4 marks)**
 - (d) Capital rationing. **(4 marks)**
 - (e) Properties of financial assets. **(4 marks)**
- (Total 20 marks)**