

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA (U) EXAMINATIONS

LEVEL THREE

FINANCE – PAPER 14

THURSDAY, 20 JUNE 2002

INSTRUCTIONS TO CANDIDATES

1. Time allowed is **3 hours**
2. Section **A** has **one** compulsory question carrying 40 marks.
3. Section **B** has **three** questions only **two** questions are to be attempted. 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**

According to the Chief Finance Officer (CFO) of Tabu Holdings Limited, a manufacturing company, investment appraisal for the company is a very involving process and on several occasions, he has had disagreements with the Managing Director. He believes that the best way to create a meaningful discourse on this prickly subject is to have a workshop facilitated by an independent financial consultant whereby all parties discuss and openly agree on the best methods of evaluating a project. You are approached by the CFO to act as a resource person at the workshop. In your discussions with the CFO it is agreed that you will explain the overall concept of investment appraisal, advise which technique of investment appraisal is the best for the company and also use a practical example to illustrate investment appraisal. In your preparation, you decide to make a write up to deal with the different issues identified.

Required:

- a) Write a memo explaining the concept of investment appraisal and the assumptions used in making the appraisals. You should include in your memo the following:

i) A description of the different techniques of investment appraisal and why a specific technique could be superior to others.

(12 marks)

ii) An explanation of the concept of time value of money.

(3 marks)

- b) In your research, you collect the following data about an investment decision. A company has an opportunity to buy a machine for Shs. 10,000,000. Returns from the project are expected to be Shs. 5,000,000 per annum for the next four years after which the machine will be disposed off for Shs 1,000,000. The working capital requirement for the project is Shs 1,000,000 at the time of investment and the rate of discount is 11%. Taxes are payable at a rate of 30% after allowing for Industrial Building Allowances of 25% on the initial outlay on a straight-line basis. Tax payments are lagged by one year.

Use the data collected to construct a working example of how the investment should be appraised.

(20 marks)

- c) As you finish your preparations for the presentation, it occurs to you that no mention of the difficulties and pitfalls of investment appraisal has been included. You then decide to write an additional section on the shortcomings of investment appraisal. Because of time constraint you have to present this in the form of brief notes

Required:

Write brief notes explaining the pitfalls and shortcomings of investment appraisal.

(5 marks)**(Total 40 marks)**

SECTION B**Question 2**

The CEO of Maendeleo Limited has been attending a seminar where someone informed him that the Uganda Securities Exchange (USE) was now fully operational. It was pointed out to him that by listing on the exchange, his company would become a very important economic player and would also stand to benefit from this exposure to other investors.

He comes to you and explains to you what he was told about the USE and accordingly requests you to advise him.

Required:

With examples, write a memo to the CEO in four sections covering the following:

- (a) Benefits to Maendeleo Limited.
- (b) Benefits to savers who wish to invest in a company listed on USE.
- (c) Benefits to the economy of companies listing on the USE.
- (d) Problems arising from listing on USE.

(20 marks)**Question 3**

The following financial data relates to Rafo Ltd.

Year	Earnings per share (Shs)	Net dividend per share (Shs)	Share price (Shs)
1991	420	170	2,520
1992	460	180	1,840
1993	510	200	2,550
1994	550	220	2,750
1995	620	250	3,720

A firm of market analysts which specializes in the industry in which Rafo Ltd operates has recently re-evaluated the company's future prospects. The analysts estimate that Rafo Ltd's earnings and dividends will grow at 25% for the next two years. Thereafter, earnings are likely to increase at a lower annual rate of 10%. If this reduction in earnings growth occurs, the analysts consider that the dividend payout ratio will be increased to 50%.

Rafo Ltd is all equity financed and has one million ordinary shares in issue.

The tax rate of 30% is not expected to change in the foreseeable future.

Required:

- (a) Calculate the estimated share price and P/E ratio which the analysts now expect for Rafo Ltd, using the dividend valuation model, and comment briefly on the method of valuation you have used. Assume a constant post tax cost of capital of 18%.
(7 marks)
- (b) Comment on whether the dividend policy being considered by the analysts would be appropriate for the company in the following two sets of circumstances:
- i) the company's shareholders are mainly financial institutions.
(5 marks)
 - ii) the company's shareholders are mainly small private investors.
(5 marks)
- (c) Describe briefly three other dividend policies which Rafo Ltd could consider.
(3 marks)
- (Total 20 marks)**

Question 4

The financial statements of Abachaka Ltd., for the years 2000 and 2001 are shown below:

ABACHAKA LIMITED

Income Statements for the years ended 31 December 2001 and 2000.

	2001	2000
	Shs million	Shs million
Turnover	1,212	1,090
Cost of Sales	<u>(1,063)</u>	<u>(811)</u>
Gross profit	149	279
Other Income/(Losses)	(6)	7
Distribution Costs	(46)	(42)
Employment Costs	(40)	(38)
Administrative Costs	<u>(65)</u>	<u>(57)</u>
Operating Profit/Loss	(8)	149
Tax	<u>(35)</u>	<u>(45)</u>
Loss/Profit after tax	<u>(43)</u>	<u>104</u>
EPS	(1.69)	4.09

ABACHAKA LIMITED

Balance Sheets as at 31 December 2000 and 2001

	2001	2000
	Shs million	Shs million
Assets		
Non-current Assets		
Tangible Assets	2,681	2,452
Intangible Assets	<u>25</u>	<u>203</u>
	<u>2,706</u>	<u>2,655</u>
Current Assets		
Inventories	310	274
Trade receivables	115	136
Prepayments	30	23
Cash and Bank Balances	<u>54</u>	<u>16</u>
	<u>509</u>	<u>449</u>
TOTAL ASSETS	<u>3,215</u>	<u>3,104</u>
Capital and Liabilities:		
Capital and Reserves		
Share Capital	254	254
Revaluation Reserve	1,540	1,450
Revenue Reserve	<u>674</u>	<u>714</u>
	<u>2,468</u>	<u>2,418</u>
Non Current Liabilities		
Term Loans	383	226
Debentures	<u>64</u>	<u>213</u>
	<u>447</u>	<u>439</u>
Current Liabilities		
Trade payables	250	213
Accruals	36	31
Term Loans due in current period	<u>14</u>	<u>3</u>
	<u>300</u>	<u>247</u>
	<u>3,215</u>	<u>3,104</u>

Required:

Assess the financial position of the company and write a memo to your client who wishes to invest in this company giving advice about her proposed intentions.

(20 marks)

SECTION C

Question 5

“The executive directors/CEOs of companies that are listed on the stock exchange markets usually ensure that their company survive so that they might keep their jobs”.

Discuss the validity of this statement.

(20 marks)

Question 6

The concept of corporate governance has become a modern byword for the practices and conduct of managers whose stewardship role in this age means that they are at the commanding heights of business.

Required:

Your Board of Directors, in a bid to implement the concept of corporate governance have requested you to write a memo explaining the concept, and how it can be introduced in your organisation.

(20 marks)