

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA (U) EXAMINATIONS

### LEVEL THREE

#### FINANCE – PAPER 14

**TUESDAY, 17 DECEMBER 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

On 2 September 2002, Bank of Baroda (U) Ltd issued a prospectus in which an initial offer was made to the public. The following text has been adapted from the said prospectus:

“An application to list has been submitted to the Uganda Securities Exchange (USE). Permission has been granted to list on the first tier of the ordinary share capital of Bank of Baroda (U) Ltd., abbreviated as “BOBU”, comprising in aggregate up to 40,000,000 issued ordinary shares of Shs 100 each being the whole issued share capital of Shs. 4,000,000,000. Admission to the offer list is expected to become effective on Thursday 14 November, 2002 ...”

The Financial Statements included in the prospectus are as below:

#### INCOME STATEMENT SUMMARY – 30 SEPTEMBER

	2002	2001	2000	1999	1998	1997
	Shs 000	Shs 000	Shs 000	Shs 000	Shs 000	Shs 000
Interest Income	12,860	10,500	9,280	7,520	8,700	8,300
Interest Expense	(3,500)	(3,100)	(2,900)	(2,960)	(4,400)	(4,800)
Net interest income	9,360	7,400	6,380	4,560	4,300	3,500
Other Income	3,000	1,200	5,200	3900	4,100	2,800
Non-interest expenses	(3,600)	(1,800)	(5,100)	(2,600)	(2,800)	(2,400)
Bad and doubtful debts expenses	(2,400)	(1,750)	(2,600)	(3,200)	(2,700)	(2,400)
Profit before Tax	6,360	5,050	3,820	2660	2,900	1,500
Income tax (expense)/credit	(2,100)	1,750	(1,200)	(1050)	(1,800)	-
Profit after tax	<u>4,260</u>	<u>3,300</u>	<u>2,620</u>	<u>1,610</u>	<u>1,100</u>	<u>1,500</u>
Basic earnings per share	1,065	825	665	403	275	375
Diluted earnings per share	106.5	82.5	66.5	40.3	27.5	37.5
Basic dividends per share	-	400	330	280	-	100
Diluted dividends per share	-	40	35	28	-	10

The diluted earnings and dividends per share are based on the 40,000,000 ordinary shares resulting from the share split. The financial statements for the period ending 30 September 2002 have not been audited.

#### Balance Sheet Summary as at 30 September

	2002	2001	2000	1999	1998	1997
	Shs 000s	Shs 000s	Shs 000s	Shs 000s	Shs 000s	Shs 000s
Total assets	<u>107,076</u>	<u>92,984</u>	<u>95,827</u>	<u>83,980</u>	<u>81,804</u>	<u>71,094</u>
Total liabilities	93,365	85,533	86,115	76,717	76,388	66,397
Shareholders equity	13,711	12,451	9,712	7,263	5,416	4,697
Total equity & liabilities	<u>107,076</u>	<u>97,984</u>	<u>95,827</u>	<u>83,980</u>	<u>81,804</u>	<u>71,094</u>

The following additional information is also available:

- (i) Prevailing interest rate is 16% per annum.
- (ii) The discount rate on the 364 days treasury bills is estimated to be 10% per annum.

The following estimates are also made for the year ending 30 September 2003:

	<b>Shs</b>
Interest income	8,750,000
Interest expenses	<u>(2,870,000)</u>
Net interest income	5,880,000
Other income	4,150,000
Bad and doubtful debts	-
Non interest expenses	<u>(4,500,000)</u>
Profit before tax	5,530,000
Income tax expense	<u>(1,659,000)</u>
Profit after tax	<u>3,871,000</u>
Basic earnings per share	97
Dividends per share	50

You are a new Investment Accountant for ICPAU. Your boss the Finance Manager will be appearing before the ICPAU Council and he urgently needs your advice.

**Required:**

- (a) Explain why BOBU is obtaining a listing on the USE. What requirements do you think were complied with to obtain a first tier listing on the USE?

**(10 marks)**

- (b) The Finance Manager has prepared a minute to you detailing the following terms of reference:

- Identify the risk factors to be considered in determining the required rate of return to be used as the cost of finance to be used in determining the feasibility of investments for the ICPAU Council.
- Perform a technical analysis to determine the feasibility of investment in the ordinary shares of BOBU Ltd if the offer price is set at Shs 600.
- Advise whether ICPAU should invest in these shares.

Prepare a memo to the Finance Manager summarising your work in responding to the above terms of reference.

**(15 marks)**

- (c) Comment on the reliability of the method used in your analysis.

**(3 marks)**

- (d) How do you expect the financial policies of BOBU Ltd to change following floatation?

**(5 marks)**

- (e) Explain the possible effect of the listing on corporate governance practices of BOBU.

Hint: Ensure that you explain the concept of corporate governance.

**(7 marks)**

**(Total 40 marks)**

## SECTION B

### Question 2

- (a) When Uganda Commercial Bank Limited (UCBL) came up for divestiture after the infamous Westmont-Greenland fiasco, many other banks including Stanbic Bank, and DFCU bank were front-runners. Indeed Stanbic won the bid and has since taken-over UCBL. Some commentators reasoned that Stanbic must have expected multiple synergies out of this transaction.

#### Required:

- (i) Explain the general types of mergers and indicate the type of merger described above.

**(4 marks)**

- (ii) Explain the synergies that arise after businesses merge. Include how they could arise in the case above.

**(4 marks)**

- (b) While considering the decision to bid for UCBL, Stanbic Bank Finance Director did very extensive analysis. The following information was of particular significance to the decision as was given by Bank of Uganda.

“UCBL currently uses 40% debt but if it were acquired, Stanbic Bank would increase UCBL’s debt ratio to 50%. Both banks are in the 30% tax bracket. The interest payments are expected to increase the debt ratio to 50% plus additional debt required after the merger to finance growth while maintaining the 50% target capital structure. UCBL’s cash flows are expected to grow at constant rate of 10% after 2002. UCBL’s market determined pre-merger beta is 1.28 and reflects its pre-merger 30% debt ratio.

In making estimates of post-merger cost of equity, the risk free rate of return used was 10% and a risk premium of 5% was deemed sufficient.

UCBL has 12 million shares that are trading at Shs. 7,000 per share. The post merger cash flows statements are indicated below:

**Stanbic Bank Ltd**

Projected Post merger Cashflow Statements for UCBL as at 31 December.

	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Net income (before depreciation)	20	27	32	38
Depreciation	<u>8</u>	<u>9</u>	<u>9</u>	<u>10</u>
EBIT	12	18	23	28
Interest	<u>4</u>	<u>5</u>	<u>6</u>	<u>6</u>
EBT	8	13	17	22
30% Tax	<u>2.4</u>	<u>3.9</u>	<u>5.1</u>	<u>6.6</u>
Net Income	5.6	9.1	11.9	15.4
Add: Depreciation	<u>8</u>	<u>9</u>	<u>9</u>	<u>10</u>
Cash flow	13.6	18.1	20.9	25.4
Cash dividends	4	7	9	20
Terminal value	-	-	-	?
Net Cash flows	<u>9.6</u>	<u>11.1</u>	<u>11.9</u>	?

**Required:**

- (i) Determine the terminal value and net cash flow for the year 2002.  
(4 marks)
  - (ii) What is the maximum value at which UCBL should have been acquired?  
(4 marks)
  - (iii) Discuss the measures that firms can use to resist take-overs.  
(4 marks)
- (Total 20 marks)**

**Question 3.**

Kampala International Management Institute (KIMI) is a newly established Institute specialising in the production of training materials and delivering the training to their clients.

The founders have other investments and would like to borrow Shs 20 million to finance the Institute's working capital requirements for the coming year. One financial Institution in town has indicated they will give them this money to be repaid after 3 years with interest. They are, however, not sure this money will be enough for their planned activities.

The budget available to you indicates the following:

Turnover for the year:	Shs 50,000,000.
Cost as percentage of sales:	%
Direct materials	30
Direct labour	20
Variable overheads	20
Fixed overheads	10

On average, debtors will take two months to pay and 30% of sales will be on cash basis. Materials will be purchased just-in-time but the materials may take up to a month in the production process, while finished training materials will take two months on average to be cleared due to marketing difficulties. Credit has also been negotiated as follows:

Direct materials	2 months
Direct labour	1 month
All overheads	2 months

They will also require a minimum of Shs 4 million in cash to finance any eventualities.

**Required:**

- (a) Determine the working capital requirements for KIMI. Indicate if they will have a deficit or surplus?  
**(10 marks)**
- (b) Prepare a Memo to the Finance Director advising him on how to invest the surplus or finance the deficit as determined from (a) above and why the working capital requirements may be different from their other consultancy company with the same level of turnover.

**(10 marks)**

**(Total 20 marks)**

**Question 4.**

MUDE & Co. Certified Public Accountants is one of the fast expanding Accounting firms in Kampala City offering multiple services which ranges from Audit, Taxation, Management Consultancy and Accounting services among others.

You were recently hired as a trainee accountant in the firm's accounting division.

The Managing Partner has given you the following ratios of a client, Vital Supplies and Logistics (VSL) Ltd, to assess their performance:

**Vital Suppliers and Logistics Ltd.**

**Selected performance indicators for the year ended 30 October 2002.**

Ratio	VSL (Ltd)	Industry
Return on capital employed.	30%	20%
Return on equity	21%	14%
Operating profit margin	12.5%	10%
Current ratio	1.15:1	1.8:1
Acid test ratio	0.65:1	1.2:1
Gearing ratio	89%	18%
Interest cover	3.3	5.2
Dividend cover	110	2.6
P/E ratio	6.8	13.1

**Required:**

- (a) From the performance indicators given above, prepare a report of the financial performance of VSL Ltd.
- (b) Outline the limitations of your analysis and state what more information if any would have been provided to complete the analysis.

**(14 marks)**

**(6 marks)**

**(Total 20 marks)**

## SECTION C

### Question 5

“In August 2002, TransAfrica Bank was closed. Around the same time “**Lunchon the Lake**” Hotel was being auctioned. A house belonging to **MEC International**; a small construction firm; was advertised in the New Vision for auction by their bankers. Yet two other prominent figures were under investigation, one was a former Grenada Bank Chief Executive alleged to have bought multi-million dollar villas in Uganda out of unethically acquired funds, and the other was a high-flying, prolific and well known banker working with the famous Washington based World Bank.”

Two CPA (U) students travelling from their revision classes were heard remarking. “This situation is confusing, and all these must be resulting from financial distress or people are just unethical!

**Required:**

- (a) Explain the term “financial distress” and its causes. (10 marks)
  - (b) What is unethical behaviour and how can it be minimised? (10 marks)
- (Total 20 marks)**

**Question 6**

- (a) Explain how investment appraisal differs from business planning. Outline the steps involved in each. (10 marks)
  - (b) Explain the sources of finance available for an unlisted company, operating mainly in the transport sector. (10 marks)
- (Total 20 marks)**