

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

CORPORATE FINANCIAL MANAGEMENT - PAPER 18

INSTRUCTIONS TO CANDIDATES

1. Time allowed is **3 hours**
2. Section **A** has one compulsory question which carries **60 marks**
3. Section **B** has **three** questions, of which you should attempt **two**.
4. Please read further instructions in the answer book

SECTION A (This section is compulsory and carries sixty marks)**Question 1**

Puma Limited is a company which operates in the telecommunications sector. The telecommunications sector is reputed to be the sector with the highest level of debt delinquency in the Country and the company has appointed a Credit manager to try and improve the situation. For this financial period she has carried out an analysis of debts based on the personal characteristics of the customers. The analysis provides statistics on good and bad debts. Customers are ranked using a points system from 0 - 100, where 0 denotes a class of customers with the highest default rate and 100 denotes customers with the highest payment rate.

The following table is an extract of the statistics from the analysis

<i>Class of Debtors</i>	<i>Cumulative number of orders Received</i>	<i>Cumulative number of Orders that turn out to be good debts</i>	<i>Orders that turn out to be bad debts</i>
0-10	1150	200	950
0-20	2100	450	1650
0-30	2850	750	2100
0-40	3950	1500	2450
0-50	6600	4000	2600
0-60	8150	5400	2750
0-70	9100	6250	2850
0-80	9500	6600	2900
0-90	9750	6800	2950
0-100	10000	7000	3000

The table shows the cumulative breakdown of customers by class and debt grouping within each class per 10000 orders received. This means that for every 10,000 orders received, 8150 will be for customers with a credit rating of 60 and below, of whom 5400 will be good debts and 2750 will turn out to be bad debts.

During the month of May which has just ended, the company declined credit to all customers with a credit rating of 50 and below. The result of this decision is reflected in the periodic financial report below.

Sales	340,000 airtime units @ 140 per unit	47,600,000
Variable Costs		
Purchases		
340,000 units @ 30 per unit	10,200,000	
Distribution		
340,000 units @ 20 per unit	6,800,000	
		17,000,000

Contribution to overheads and profit	30,600,000
Overheads:	
Administration and Selling expenses	18,200,000
Bad Debts 40,000 units @ 140 per unit	5,600,000
	23,800,000
Profit before tax	6,800,000

Required

- a) Assuming that administration and selling costs remain constant, use the May financial report to calculate for the Credit manager the effect of declining to accept orders in each class for the first five classes. Tabulate your answer in columnar form to show the contributions to overheads and profit lost, costs saved and total gain or loss.
(20 marks)
- b) Prepare a forecast income statement like the one above based on receiving 10,000 orders, assuming that all orders for customers with a credit rating of 20 and below are rejected.
(15 marks)
- c) What are the other factors that the firm should consider in each of the following debt management alternatives?
- Assessing the credit worthiness of a customer.
 - Whether to offer or not to offer discounts to debtors who pay their accounts promptly.
- (10 marks)
- d) Write a memo to the Credit manager explaining the concepts of factoring and forfeiting and their value to the company in the control its working capital situation.
(15 marks)

SECTION B**Question 2**

The Double 'R' Co. Ltd was created by J. Bitegeka to invest in shares on the Uganda Stock Exchange. He has been collecting information about the shares on the market and he now comes to you to assist him assess where he should put his money. He provides you with the following information.

State of Economy	Probability of state occurring	Share A return if state occurs	Share B return if state occurs
Recession	0.3	-10%	10%
Normal	0.4	20%	10%
Boom	0.3	50%	10%

You are required to help J. Bitegeka decide the following

- a) Determine the expected return, variance and risk associated with each of the shares
(6 marks)
- b) Determine the covariance and correlation between the returns for both shares
(4 marks)
- c) Determine the expected return and risk of an equally weighted portfolio of the two shares
(4 marks)
- d) Explain to Mr. Bitegeka in a short memo the difference between unique and systematic risk
(6 marks)

Question 3

In order to add value to their business, firms/companies merge. Such mergers are usually classified into three broad types:

- Horizontal integration.
- Vertical integration.
- Conglomerate.

Required:

Discuss the reasons for such mergers in the process of value creation.
(20 marks).

Question 4

Blanco Ltd. is a Company manufacturing and selling special pottery products. The company is considering whether to introduce a new production process which will result in reduced variable costs but increased fixed costs. The new process will enable the company to meet additional sales demand in the market which is currently constrained by the existing production process. The cost of the new process is Shs 500 million with a life of 5 years and the company's cost of capital is 12%.

Additional data is as follows:

Existing Reduction Process

Sales price of product ranges Shs 18,000 – 21,000 per unit sales quantity varies between 0.8 million and 1.1 million units.

Profit is $(PQ)^{0.8} - 30,000,000$ where P = price and Q = quantity.

New Production Process

Sales price Shs. 18,000.

Sales quantity varies between 0.8 million and 2.0 million units.

Profit would be $(PQ)^{0.8} - 20Q - 50,000,000$

Required:

(a) Evaluate the existing and new production processes.
(10 marks)

(b) Advise whether it is worthwhile for Blanco to change to the new process.
(5 marks)

- (c) What other considerations must be taken into account in your evaluation if the new production process is decided upon.

(5 marks)

(Total 20 marks)