

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

CORPORATE FINANCIAL MANAGEMENT - PAPER 18

TUESDAY, 17 JUNE 2003

INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours.**
2. Section **A** has one compulsory question carrying 60 marks
3. Section **B** has **three** questions and only **two** questions should be attempted.
Each question carries 20 marks.
4. Please read further instructions in the answer book.

SECTION A

Question 1

- (a) Akolyte Systems are developing a new telephone switching system that is capable of handling calls from Celtel, MTN and UTL networks at the same time. The initial outlay for this project is Shs 383 million, of which Shs 156 million will be provided from internally generated funds, Shs 140 million from a rights issue and the remainder through a loan at a rate 14% per annum. The proportion of debt represents the optimum debt capacity of the company.

The expected costs of engineering this project finance are estimated at 3.5% for the rights issue and 1% for the term loan. Corporate taxes are payable at the rate of 30% on net operating cash flows. The treasury bills yield is 9%, while the market return is 14%. An appropriate asset beta for the investment is believed to be 1.5. The project net operating cash flows (after tax) are as follows:

Year	Shs million
1	119
2	218
3	99

Required:

- (i) Estimate the adjusted present value of the project and advise Akolyte's management whether they should proceed with the investment. (10 marks)
- (ii) Why is adjusted present value (APV) deemed to be a more realistic technique of project evaluation? (5 marks)

- (b) The value of HB Investments' shares was Shs 60 billion on 1 January, 2003. The company planned to raise Shs 30 billion during the year for new projects. The capital structure of the firm at that date was as follows:

Equity	Shs 30 billion
Debt	Shs 30 billion

The coupon rate on new bonds available from the PTA bank is 8%. Equity shares currently selling at Shs 30,000 per share can be sold for Shs 27,000 a share. The next dividend is expected to be Shs 12,000 with a growth rate of 8% per annum. Retained earnings for the year are expected to be Shs 300 million. The company has an investment licence and does not pay tax.

Required:

- (i) In order to maintain its capital structure, how much of the new investment must be financed by issue of equity?
(5marks)
 - (ii) Using the MM theory of capital structure, calculate the cost of both debt and equity.
(10 marks)
 - (iii) Because the company has been growing very fast, the managers are fairly new to the world of investment financing through stock markets.
Explain why dividends are a cost to the company, and why it is important for dividends to keep on growing. Does Dividend policy matter?
(10 marks)
 - (iv) In your own assessment, what risks does the company face if the proportion of debt increases? Does capital structure matter?
(5 marks)
- (b) There are several competing views of capital structure and its importance to a firm. These views starting from the traditional view to the Modigliani-Miller propositions, argue for different ways of looking at debt which has caused a lot of confusion in the mind of your CEO.

Required:

Write a memo, explaining the arguments underlying the different points of view presented in these models, and advise the CEO as to how these different views can be reconciled for the benefit of your firm.

(15 marks)
(Total 60 marks)

SECTION B

Question 2

- (a) Musa Engineering School are interested in improving the quality of their investment planning and have approached you to provide them with information regarding the following investment terms:

- (i) Annuities and perpetuities.
- (ii) Yield to maturity.
- (iii) Accounting rate of return and net present value.
- (iv) Time value of money and discount factors.

Write a memo explaining to management of the School, the meaning of the above terms and how the School can use them in their planning process.

(8 marks)

(b) After appreciating the importance of investment planning, management of Musa Engineering School wishes to know whether they should purchase or fabricate their own tools. You are again requested to help the School to make a rational decision using the following information:

- If the School fabricates its own equipment, the capital cost is Shs 100,000,000 which is incurred immediately in the purchase of various inputs. The equipment would last four years and have a scrap value of Shs 15,000,000. Maintenance costs would be Shs 130,000,000 in Year 1, Shs 140,000,000 in Year 2, Shs 170,000,000 in Year 3, and Shs 180,000,000 in Year 4.
- If they decide to purchase the equipment outright, the outlays will be Shs 170,000,000 in Years 1 and 2, and Shs 220,000,000 per year in Years 3 and 4. For purposes of analysis, it is assumed that all outlays are incurred at year-end. The current cost of capital under the Apex Funds Scheme, which the School wishes to apply to is 15%.

Required:

Should Musa Engineering School fabricate or purchase its own tools? Justify your answer.

(12 marks)

(20 marks)

Question 3

Alderman John Mutyabule, a Councillor of Iganga Town Council in charge of Finance, is interested in devising methods of improving the Council's financial management methods and has been reading texts on financial management. His extensive foray into the world of finance has however not helped improve his understanding of some financial terms and he comes to you for assistance.

Required:

Using examples, explain the following terms to the alderman:

- (a) Mezzanine finance.
- (b) Securitization.
- (c) Venture Capital.
- (d) Municipal Bonds.

(20 marks)

Question 4

The following share investments, which used to belong to the defunct Uganda Commercial Bank, were purchased in 1988 by the Managing Director as part of the effort to diversify the bank's international dollar investment portfolio:

	No. of Shares	Current Price	Beta	Specific Risk	Annual Abnormal Return
African Provident	16000	900cts	1.2	28.5%	+14%
IAA Hotels	8000	500cts	1.1	33.75%	8%
British American International	8000	600cts	0.9	21%	+4%

The Bank of Uganda, which is responsible for the dissolution of the residual affairs of UCB, is interested in determining whether it is useful to keep the shares, in trust for the Uganda Government. You are hired as a consultant to help arrive at a rational decision.

Required:

Explain the following issues as part of your consultancy:

- The meaning of the term beta, which is attached to each stock. (3 marks)
 - The difference between specific and systematic risk. (3 marks)
 - If the market risk is 18%, what is the total risk associated with the shares held in African Provident? (3 marks)
 - If the return on the NYSE (on which the shares were purchased and are traded) over the last year was 27% and the risk free rate of 14%, what was the actual return on IAA Hotels? (4 marks)
 - If a decision to keep the shares were made, and the risk free rate over the next year is 12% with a market risk premium of 8%, what would be the return that Bank of Uganda, should expect to receive from holding the securities? (4 marks)
 - In your opinion, do you think that the portfolio is adequately diversified? (3 marks)
- (Total 20 marks)**