

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA (U) EXAMINATIONS

LEVEL THREE

FINANCE – PAPER 14

TUESDAY, 16 DECEMBER 2003

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 and 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.

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SECTION A**Question 1**

Rand Trust Ltd is a large South African Conglomerate. For sometime the Chairman has wanted the company to expand into the education supplies sector in a fast growing African country and a number of companies have been examined as potential take-over targets. However, so far, no suitable company has been identified.

PLM & Co, the auditors of Rand Trust Ltd, after a very successful launch of an associate in Uganda last year, have now identified a number of possible companies in their new market. They have also brought to the Chairman's attention a medium Ugandan unquoted school supplies' company, The National UPE Supplies Ltd. During their meeting with the Chairman, the auditors asserted that Ugandan companies engaged in the education sector do not suffer from 'failures'. "There is a very good market in Uganda given the current Universal Primary Education (UPE)", they went on. They provided the following financial information about the National UPE Supplies Ltd.:

The National UPE Supplies Ltd
Balance Sheet as at 31 December 2002

	Shs '000'
Non-current Assets	<u>1,305,000</u>
Current Assets:	
Raw material inventories	250,000
Finished products inventories	782,000
Trade and other receivables	1,490,000
Cash and Bank	<u>316,000</u>
	<u>2,838,000</u>
Total Assets	<u>4,143,000</u>
Equity and Liabilities	
Ordinary Share Capital	100,000
Accumulated profits	<u>810,000</u>
	<u>910,000</u>
Current Liabilities:	
Trade and other payables	1,507,000
Borrowings	<u>1,726,000</u>
	<u>3,233,000</u>
Total Equity and Liabilities	<u>4,143,000</u>

Previous Income Statements Data

	2002	2001	2000	1999	1998
	Shs '000'	Shs '000'	Shs '000'	Shs '000'	Shs '000'
Net income	106,000	96,000	100,000	138,000	62,000
Extra ordinary items	<u>10,000</u>	<u>(20,000)</u>	<u>-</u>	<u>(5,000)</u>	<u>-</u>
	116,000	76,000	100,000	133,000	62,000
Dividend	<u>50,000</u>	<u>50,000</u>	<u>50,000</u>	<u>45,000</u>	<u>41,000</u>
Retained profits	<u>66,000</u>	<u>26,000</u>	<u>50,000</u>	<u>88,000</u>	<u>21,000</u>

Rand Trust Ltd's Financial Analysts have undertaken some further enquiries about The National UPE Supplies Ltd and have estimated that the company's production equipment would have a replacement value of around Shs 1.5 billion and a sale value of Shs 1 billion. Similarly raw material and finished products inventories would have a replacement cost value of around Shs 1.2 billion and a sale value of Shs. 1.1 billion. The industry standard level of bad debts in Uganda is currently 1.9% of sales value.

Rand Trust Ltd's Analysts have estimated that the average asset beta of quoted Ugandan school supplies companies is 0.90 and the average price earnings ratio 10. The current return on the Treasury Bills is 7.5% and the excess market return on the Uganda Securities Exchange is 5%. Rand Trust Ltd estimates that its own weighted average cost of capital is 17% and a price earnings ratio of 15%. (Ignore the effects of tax).

Required:

- (a) Estimate the Shilling value of the National UPE Supplies Ltd's equity capital on the basis of;
- (i) Balance Sheet Value **(3 marks)**
 - (ii) Asset Replacement Cost. **(3 marks)**
 - (iii) Dividend Valuation Model. **(5 marks)**
 - (iv) Earnings Method. **(5 marks)**
- (b) (i) Discuss the usefulness and limitations of the above valuation approaches used to value the company. **(8 marks)**
- (ii) Outline the policies that the National UPE Supplies Ltd (a listed company) might adopt to defend itself against the takeover bid. **(4 marks)**
- (c) Explain the following terms:
- (i) Economic failure **(3 marks)**
 - (ii) Financial failure. **(3 marks)**
- (d) Outline the causes of failures. **(6 marks)**
- (Total 40 marks)**

SECTION B**Question 2**

Assume that you have been appointed Finance Director of Tororo Accessories Ltd., a company which won the tender to supply the Uganda Police Force (Traffic Unit) with speed monitoring devices for vehicles. The company is considering investing in the production of speed monitoring devices, with an expected market life of five years.

The previous Finance Director had undertaken an analysis of the proposed project; the main features of his analysis are shown below. He had recommended that the project should not be undertaken because the estimated annual accounting rate of return is only 12.2%.

Proposed Speed Monitoring Accessories

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
	Shs. (m)	Shs. (m)	Shs. (m)	Shs. (m)	Shs.(m)	Shs. (m)
Investment in Non-current Assets	4,500					
Cumulative Investment in working capital	300	400	500	600	700	700
Sales		<u>3,500</u>	<u>4,900</u>	<u>5,320</u>	<u>5,740</u>	<u>5,320</u>
Materials		535	750	900	1,050	900
Labour		1,070	1,500	1,800	2,100	1,800
Overheads		50	100	100	100	100
Interest		576	576	576	576	576
Depreciation		<u>900</u>	<u>900</u>	<u>900</u>	<u>900</u>	<u>900</u>
		<u>3,131</u>	<u>3,826</u>	<u>4,276</u>	<u>4,726</u>	<u>4,276</u>
Taxable profit		369	1,074	1,044	1,014	1,044
Taxation		<u>110.7</u>	<u>322.2</u>	<u>313.2</u>	<u>304.2</u>	<u>313.2</u>
Profit after tax		<u>258.3</u>	<u>751.8</u>	<u>730.8</u>	<u>709.8</u>	<u>730.8</u>

- Total initial investment is Shs. 4,800,000,000.
- Average annual after tax profit is Shs. 591,000,000.

You also learn that all the above cash flow and profit estimates have been prepared in terms of present day costs and prices, since the previous Finance Director assumed that the sales price could be increased to compensate for any increase in costs.

You have the following additional information:

- Selling prices, working capital requirements and overhead expenses are expected to increase by 5% per year.
- Material costs and labour costs are expected to increase by 10% per year.

- (iii) Capital allowances are allowable for taxation purposes against profits at 35% per year on a reducing balance basis. (No initial allowance granted).
- (iv) Taxation on profits is a rate of 30%, payable one year in arrears.
- (v) The non-current assets have no expected salvage value at the end of five years.
- (vi) The company's real after-tax weighted average cost of capital is estimated to be 8% per year, and nominal after-tax weighted average cost of capital is 15% per year.

Furthermore assume that all receipts and payments arise at the end of the year to which they relate, except those in Year 0, which occur immediately.

Required:

- (a) Estimate the net present value of the proposed project. State clearly any assumptions that you make.
(12 marks)
 - (b) How does your recommendation compare with that of the previous Finance Director?
(3 marks)
 - (c) Describe how sensitivity analysis might be used to assist in assessing this project.
(3 marks)
 - (d) What are the weaknesses of sensitivity analysis in capital investment appraisal?
(2 marks)
- (Total 20 marks)**

Question 3

- (a) Having successfully completed a corporate banking course at the Havard Business School, Mr. Gae landed a post at one of the major banks in Uganda as a Loans Officer.

In the first week of his assignment, he was presented with a case to handle. It consisted of financial information of two companies; Delta Ltd and Maxim Ltd., belonging to the same industry.

	Delta Ltd.	Maxim Ltd
Current ratio	3.2:1	2.0:1
Acid test ratio	1.7:1	1.1:1
Debt-equity ratio	30%	40%
Number of times interest earned	6	5

Assume you are Mr. Gae and both companies have requested for a loan of equal amount to be repaid over the next two years. Based on the information above, if you were to grant:

- (i) a loan to only one company, which of the two would you choose and why?

(4 marks)

- (ii) loans to both the companies, would you be willing to do so? Explain.

(4 marks)

- (b) A newly appointed Managing Director of Games Retail (U) Ltd wishes to provide an extra return to the company's shareholders and has suggested taking the following action:

1. Issuing a 1 for 5 scrip dividend instead of the normal cash dividend.
2. Effecting a 1 for 1 share (stock) split in addition to the normal dividend.

Summarised Balance Sheet of Games Retail (U) Ltd as at 31 October 2002

	Shs. '000'
Non-current Assets	65,000
Current Assets	130,000
Current Liabilities	<u>(55,000)</u>
	<u>140,000</u>
Financed by:	
Ordinary Shares (0.5 Shs per share)	25,000
Share Premium Account	50,000
Accumulated profits	<u>40,000</u>
Shareholder's Funds	115,000
11% debenture	<u>25,000</u>
	<u>140,000</u>

The company's shares are trading at Shs. 3 cum-dividend and the company has Shs. 50,000,000 of profit from this year's activities to ordinary shareholders of which Shs. 30,000,000 will be paid as a dividend if Option 2 is chosen. None of the Shs 40,000,000 accumulated profits would be distributed. This year's financial statements have not yet been finalised.

Required:

- (i) For each proposal show the likely effect on the company's Balance Sheet at the end of this year.

(4 marks)

- (ii) Comment on how well these suggestions fulfill the Managing Director's objective of providing an extra return to the company's shareholders.

(4 marks)

- (iii) Outline reasons why a company might wish to undertake a:

- scrip dividend.

(2 marks)

- share (stock) split.

(2 marks)
(Total 20 marks)

Question 4

Koro Kara Ltd is a medium sized motorcycle parts manufacturer in Uganda. A recent survey indicates that sales are highly seasonal, the peak occurring in September, when farmers sell off their produce and purchase motorcycles for up country use. All sales are on terms that allow a cash discount for payments made within 30 days; if the discount is not taken, the full amount must be paid in 60 days. However, Koro Kara Ltd, like most other companies finds that some of its customers delay payment up to 90 days. Experience has shown that 20% of the debtors pay within 30 days, 70% pay within 60 days and 10% within 90 days.

Koro Kara's production is geared to future sales. Purchased materials and parts, which amount to 70% of sales, are bought from Korea, the month before the company expects to sell the finished product. Its own purchase terms permit Koro Kara to delay payment on its purchases for one month. Below are Koro Kara's forecast figures for the 6 months of 2003.

	July Shs million	August Shs million	September Shs million	October Shs million	November Shs million	December Shs million
Sales	20,000	30,000	40,000	20,000	20,000	10,000
Salaries and wages	1,500	2,000	2,500	1,500	1,500	1,000
Rent	500	500	500	500	500	500
Other expenses	200	300	400	200	200	100

The company also has a tax payment of Shs 8 billion due in August. Its capital budgeting plans call for the purchase in July of a new machine tool costing Shs 10 billion, payment is to be made in the second month after purchase. Sales for May and June 2003 were Shs 10 billion per month. There are also high chances that the January 2004 sales will be similar to May or June 2003.

Assume Koro Kara needs to keep a Shs 5 billion cash balance at all times for precautionary purposes and has Shs 1 billion in excess of its desired minimum on 1 July 2003.

Required:

- (a) Prepare a suitable statement for internal management purposes showing the company's financial requirements for the period July to December 2003.

(16 marks)

- (b) Explain the terms degree of:

- (i) Operating leverage
- (ii) Financial leverage.

(2 marks)

(2 marks)

(Total 20 marks)

SECTION C**Question 5**

Recently Ms Mboka, a renowned stock dealer, was chatting with Mr. Musoke, a banker. He was complaining bitterly about the difficulties he has to go through obtaining adequate securities even for small advances to some of his deserving clients. He started enumerating to Ms Mboka the types of securities that his clients have to offer to banks e.g Title Deeds, Log Books, Guarantees, Bills of Exchange, Deposit Receipts, Treasury Bills, etc. “While the above are suitable, they are rare”, observed Mr. Musoke. He went on to say that the more he hustles with unsuitable securities the more he thinks that banks should increasingly embrace ‘character’ or ‘cash flow’ lending particularly for small advances. He said that he felt time had come for the establishment of a National Credit Reference Bureau in Uganda to support such activities.

Due to frustrations, Mr. Musoke now considers specialising in credit control policies. Here he thinks he would appropriately advise his clients to manage their receivables better so as to avoid constant borrowings.

It was at this point that Ms Mboka chipped in and suggested that Mr. Musoke should instead work as an Investment Advisor in the Uganda Securities Exchange. After a detailed explanation by Ms. Mboka on the operations of the Uganda Stock Exchange, Mr. Musoke is now delighted. However, he needs to know a number of issues before making up his mind.

Required:

- (a) Explain to Mr. Musoke the basic economic objectives investors require to fulfill on the stock market.
(4 marks)
- (b) Outline to him the role played by the Uganda Securities Exchange.
(7 marks)
- (c) Explain to Mr. Musoke the difference between a stock broker/dealer and an investment advisor.
(3 marks)
- (d) Due to frustrations Mr. Musoke had suggested to act as a consultant in credit control policies for his clients. Outline the factors he would put into consideration when formulating credit control policies for his clients.
(6 marks)

(Total 20 marks)

Question 6

During a Budget Breakfast organised by the Institute of Certified Public Accountants of Uganda, a leading scholar delivered a keynote address on the theme “Review of Uganda’s Investment Climate”. Below is an extract of his speech.

“A business unit operates in an environment where it supplies goods or services. Its activities are extracted from factors outside it and when combined with its own resources, it then operates as an entity in the environment. The environment must therefore be necessarily good for the business to succeed. These outside factors that are external to and beyond the control of an individual business unit are commonly referred to as the environment.

Environment is the totality of these factors, all the external factors that make up the macro context within which the business unit as a micro unit operates. The environmental factors are numerous in number and form. Some are dynamic while others are static. Some dynamic ones may be changing slowly and other rapidly. Some may be evolutionary while others are revolutionary.” In his conclusion, he said that it is the ability of managers of business to conceptualise better and understand these factors that lead to investment decisions.

Required:

You work as a Financial Analyst for Plato International Ltd. Explain to the Managing Director the factors referred to in the above extract to enable her make investment decisions.

(20 marks)