

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA (U) EXAMINATIONS

LEVEL TWO

FINANCIAL ANALYSIS – PAPER 9

TUESDAY, 16 DECEMBER 2003

INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours**
2. Attempt all questions in Section **A**, any three questions from Section **B** and **one** question from Section **C**.
3. Section **A** has **ten** compulsory questions; each carrying 2 marks.
4. Section **B** has **four** questions and only **three** questions are to be attempted.
Each question carries 20 marks.
5. Section **C** has **two** questions and only **one** question is to be attempted.
Each question carries 20 marks.
6. Please read further instructions on the answer book

SECTION A**Question 1**

- (i) Which of the following can be classified together?
- (i) Internal rate of return.
 - (ii) Pay back period.
 - (iii) Accounting rate of return.
 - (iv) Net present value.
 - (v) Profitability index.
- (a) (i), (iv) and (v).
(b) (ii), (iii) and (v).
(c) (i) and (iv).
(d) (ii), (iii) and (iv).
- (ii) Ratios which indicate the firm's ability to meet its long-term obligation are:
- (a) Profitability ratios.
(b) Activity ratios.
(c) Gearing ratios.
(d) Liquidity ratios.
- (iii) According to Modigliani and Miller theory with corporation tax, the value of a geared company will always be greater than the value of its ungeared counterpart by:
- (a) The amount of debt-associated tax saving of the geared company.
(b) The amount of cost associated with debt of a geared company.
(c) The amount associated with the cost of equity of ungeared company.
(d) The amount of tax saving on the cost of raising the required gearing.
- (iv) Which of the following is true?
- (a) The Central Bank exists solely to lend money to the commercial banks for on-ward lending to citizens.
(b) The Central bank usually lends money to individuals and is the banker to the government.
(c) The Central bank charges the bank rate to individuals and the re-discount rate to commercial banks.
(d) The Central Bank is the regulatory authority for financial institutions.

- (v) Capital rationing is:
- (a) When funds are not available to undertake all the projects put forward by divisional managers.
 - (b) When financial markets are told by borrowers not to lend beyond imposed limits.
 - (c) When managers have to divide money equally between different departments so that none is left behind.
 - (d) When funds are not available to finance all wealth-enhancing projects.

- (vi) ICPAU is considering an expansion of its library facilities. The feasibility studies shows the category of library users and the project income.

	Probability	Projected income (Shs millions)
CPA students	20%	40
ATC students	30%	60
Researchers	50%	20

How much income should the Institute expect?

- (a) Shs 120 million.
 - (b) Shs 36 million.
 - (c) Shs 20 million.
 - (d) Shs 100 million.
- (vii) Which of the following is correct?
- (a) Financial leverage is irrelevant to the firm's cost of capital since the leverage is externally influenced.
 - (b) Shareholders do not bear financial risk since their loss is limited to the capital they contributed.
 - (c) The firm's cost of capital cannot be influenced by the level of earnings' retention since retained earnings do not attract a direct interest charge.
 - (d) Borrowing increases the company's gearing level and the firm's cost of capital.
- (viii) ICA Ltd has Shs 8 million of 10% debentures and Shs 10 million in equity. The firm's equity beta (β) is 1.2 while the market rate of return is 16% and the risk free rate of return is 8%. What discount rate should the company use in the evaluation of a relatively small project, which is to be financed by equity and debt in the ratio of 10:8 respectively?
- (a) 17.6%.
 - (b) 14.6%.
 - (c) 20.0%.
 - (d) 16.2%.

- (ix) Which of the following will improve a project's IRR?
- (a) Reduction of the estimated selling price.
 - (b) Reduction of the estimated sales volume.
 - (c) Reduction of the estimated variable costs.
 - (d) Increase in the estimated initial investment.
- (x) Which of the following is a mismatch?
- (a) Operating lease; Invoice discounting; Factoring
 - (b) Gearing ratio, debt ratio; interest cover ratio.
 - (c) Preference shares; ordinary shares; dividends.
 - (d) Factoring, Leasing, trade credit.

SECTION B

Question 2

- (a) The following data relate to three probable projects at the Ministry of Defence:
- (i) Project CON may yield a return of Shs 2.5 million with a probability of 0.3, or a return of Shs 4 million with a probability of 0.7.
 - (ii) Project RWA may earn a negative return of Shs 5 million with a probability of 0.3 or a positive return of Shs 9 million with a probability of 0.7.
 - (iii) Project UGA yields a return of Shs 3 million which is certain.

Required:

Comment on the mean return and the risk of each project.

(10 marks)

- (b) Rugo Ltd is trying to decide whether to invest Shs 450 million in a new product line. The project will last 8 years, and there will be no scrap value from the project. Other relevant forecasts are:
- Sales volume of 21,500 units per year;
 - Selling price Shs 23,000 per unit;
 - Variable direct cost Shs 17,500 per unit.

There are no other costs. Ignore inflation and taxation.

Required:

The General manager has asked you to calculate the internal rate of return (IRR) of the project based on the forecast, and advise him.

(10 marks)

(Total 20 marks)

Question 3

The following information is available from the books of Real Ltd:

Income Statement for the year ended 30 September

	2003	2002
	Shs 000	Shs 000
Sales	1,150,000	1,250,000
Less: Cost of sales	<u>(770,000)</u>	<u>(850,000)</u>
Gross profit	380,000	400,000
Administration expenses	<u>(177,000)</u>	<u>(191,000)</u>
Selling and distribution	<u>(86,000)</u>	<u>(91,000)</u>
Earnings before interest and tax	117,000	118,000
Interest charges payable	<u>(26,000)</u>	<u>(34,000)</u>
Net profit before taxation	91,000	84,000
Corporation tax	<u>(16,000)</u>	<u>(23,000)</u>
Net profit after taxation	75,000	61,000
Proposed dividend	<u>(23,000)</u>	<u>(26,300)</u>
Retained profit for the year	<u><u>52,000</u></u>	<u><u>34,700</u></u>

Balance Sheet as at 30 September

	2003	2002
	Shs 000	Shs 000
Non-current Assets:		
Freehold land and buildings	172,000	134,000
Fixtures and fittings	47,000	52,000
Motor vehicles at cost	<u>69,000</u>	<u>45,000</u>
	<u>288,000</u>	<u>231,000</u>
Current Assets:		
Inventory	135,000	104,000
Trade receivables	<u>112,000</u>	<u>102,000</u>
	<u>247,000</u>	<u>206,000</u>
Current Liabilities:		
Bank overdraft	163,000	74,400
Trade payables	97,000	81,000
Proposed dividend	22,000	26,300
Taxation	<u>16,000</u>	<u>23,000</u>
	<u>298,000</u>	<u>204,700</u>
Net current assets/(liabilities)	<u>(51,000)</u>	<u>1,300</u>
	<u><u>237,000</u></u>	<u><u>232,300</u></u>
Long-term liabilities and capital		
10% Debentures	75,000	105,000
Ordinary Shs 50 Shares	50,000	50,000
Retained earnings	<u>112,000</u>	<u>77,300</u>
	<u><u>237,000</u></u>	<u><u>232,300</u></u>

Required:

- (a) Calculate the following ratios:
- (i) Return on capital employed (ROCE).
 - (ii) Asset turnover.
 - (iii) Interest cover.
 - (iv) Financial gearing ratio.
- (8 marks)**
- (b) Comment on the management of working capital of the company by calculating any 2 relevant ratios.
- (8 marks)**
- (c) What are the limitations of ratio analysis?
- (4 marks)**
- (Total 20 marks)**

Question 4

The members of Uganda Fruits Ltd are planning to start manufacturing a new product. At their last Annual General Meeting, they agreed to hire more consultants to advise them on the financial implications of their plans. The following information is available from the project advisors:

They expect to have a cash balance of Shs 15 million by the end of this year, and require a minimum of Shs 8 million at all times.

Demand for the new product is expected to be 10,000 units in the first month (January), growing at a rate of 5% per month. The selling price is expected to remain constant at the launching price of Shs 6,000 per unit.

It is expected that all sales will be on cash basis.

Variable production costs per 1,000 units will be as follows:

Labour Shs 2,000,000
 Materials Shs 1,500,000
 Overheads Shs 1,000,000.

Labour and variable overheads are to be paid for in the month they are incurred. Materials will be paid for one month in arrears. There are fixed production overheads, excluding depreciation expected to amount to Shs 3 million per month and payable in the month the expenditure is incurred.

The production process is expected to yield a by-product at the rate of 5 per 100 units of good output. The selling price of this by-product is expected to be Shs 5,000 per unit. All units will be sold in the month of their production.

The company employed advisors on the project, whose outstanding bill of Shs 15 million is to be paid in March 2004.

A machine essential in the production process and worth Shs 50,000,000 will be purchased on January 2004, on a 30-day credit. The machine will be depreciated at the rate of 25% on straight-line basis.

Required:

- (a) Prepare a cash budget for the first four months of the coming year. **(14 marks)**
- (b) What limitations are likely to accrue to the company if it wished to raise finance for further expansion through commercial banks? **(6 marks)**
- (Total 20 marks)**

Question 5

- (a) Define the following:
- (i) Capital structure.
 - (ii) Weighted Average Cost of Capital. **(4 marks)**
- (b) Give two reasons why the Capital Asset Pricing Model would be a superior method of evaluating the cost of capital than the weighted average cost of capital. **(4 marks)**
- (c) CPA Ltd. has the following capital structure:

	Shs million
20% Long-term irredeemable loan stock	40
10% Preference shares par Shs 100	10
Ordinary shares	30
Retained earnings	<u>20</u>
	<u>100</u>

CPA Ltd anticipates that dividends on ordinary shares will be Shs 5,000. per share and the market price per share is Shs 22,000 ex-div. It is expected that the dividends will grow at a rate of 6% annually forever. The market value of debt is Shs 100 per stock unit and that of preference shares is Shs 105 per share. The corporation tax rate is 30%.

Required:

Determine the weighted average cost of capital to the nearest decimal point. **(12 marks)**

(Total 20 marks)

SECTION C

Question 6

- (a) Explain the role that the Bank of Uganda plays in the economic development of Uganda.

(12 marks)

- (b) The Bank of Uganda in association with the Uganda Bankers' Association recently introduced the Electronic Funds Transfer (EFT) system and issued a press release in the newspapers on how the system will operate.

Required:

What are the advantages of the Electronic Funds Transfer system?

(8 marks)

(20 marks)

Question 7

- (a) The Privatisation Unit of the Ministry of Finance, Planning and Economic Development on 1 November 2003 celebrated many years of the privatisation of public enterprises in Uganda.

Required:

Discuss the merits and demerits of privatisation of public enterprises in Uganda.

(12 marks)

- (b) Why should a company like Bank of Baroda Uganda Ltd get listed on the Uganda Securities Exchange?

(8 marks)

(Total 20 marks)