

# **THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD**

*A Committee of the Council of ICPAU*

## **CPA (U) EXAMINATIONS**

### **LEVEL THREE**

#### **FINANCE – PAPER 14**

**TUESDAY, 17 JUNE 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.**

Network International Limited (NIL) is one of the leading enterprises in Kampala providing e-Business portal services. The Chairman of network international is a very ambitious man who has of recent run into trouble with unfulfilled loan covenants and banks are closing in on his assets.

The Auditors of NIL have argued that the problems of the company are resulting from lack of financial planning and that unless medium term financial plans are drawn up and implemented, the company and its associated companies will meet more financial difficulties than ever before.

The Finance Director of NIL has been asked to prepare a medium term financial plan and present it to the next board meeting scheduled for 20 June 2003. You have been appointed on the team to work with the Finance Director.

In the course of your work, you discover expansion plans with the following forecasted investment in non-current assets:

Year ending	Shs million
31 December 2003	200
31 December 2004	300
31 December 2005	310

You also discover that the financial appraisal of the capital investment plans was conducted and the project appears viable. Whereas further forecasts show that sales are expected to increase by 10% in the next year as a result of the general upturn in demand, the expansion plans are expected to result into increased sales as follows:

Year ending	
31 December 2003	20%
31 December 2004	25%
31 December 2005	30%
31 December 2006	30%

The financial statements below are also provided:

**Balance sheet as at 31 December 2002**

	Shs.'000	Shs.'000
Net non-current asset		400,000
Inventory	150,000	
Trade receivables	20,000	
Bank	<u>10,000</u>	
	180,000	
Current liabilities	<u>(30,000)</u>	<u>150,000</u>
		<u>550,000</u>
Ordinary share capital		300,000
20% loan stock		100,000
Reserves		<u>150,000</u>
		<u>550,000</u>

**Income Statement for the year ended 31 December 2002**

	Shs.'000
Sales	1,600,000
Cost of goods sold	<u>900,000</u>
	700,000
Other expenses	<u>250,000</u>
Earnings before interest and taxes	450,000
Interest	<u>20,000</u>
Profit before tax	430,000
Tax (30%)	<u>129,000</u>
Equity earnings	301,000
Dividends	<u>101,000</u>
Retained earnings	200,000
Retained earnings b/f	<u>(50,000)</u>
Retained earnings c/f	<u>150,000</u>

The following additional information has also been provided.

- (i) The loan stock is redeemable after five years.
- (ii) There are no short-term borrowing or overdraft included in the current liabilities.
- (iii) NIL will look for finance in the following order:
  - Retained earnings;
  - Overdraft;
  - Long term debt and rights issue of ordinary shares.

- (iv) The minimum acceptable current ratio is 1.4 to 1 and the maximum acceptable gearing is 60% book value of total debt to book value of shareholders funds.
- (v) The cost of goods sold is 70% of sales while other expenses will be computed as 10% on sales and 10% of non-current assets at the start of the year.
- (vi) Interest on the existing loans is 20%, overdraft can be obtained at 15% and any new long-term loan will be obtained at least 25% per annum. Interest is payable at the end of each year.
- (vii) Corporation tax will remain constant at 30%.
- (viii) Dividends will grow at 15% per annum.
- (ix) At the end of December 2003, the inventories will be estimated to be 3 times for the first two years above the value of the end of December 2002, while trade payables will be more by 10%. In 2005, inventory will be 30% of the cost of sales for the year. Current liabilities (excluding overdrafts) will be 10% of sales at the end of the same period.

**Required:**

As a member of the team:

- (a) Explain the constituents of a financial plan. (5 marks)
- (b) What are the key roles served by financial planning? (4 marks)
- (c) Compute the working capital required by NIL at the end of December 2003. (4 marks)
- (d) Prepare the forecasted income statements for the years ending 31 December 2003, 2004 and 2005 and the balance sheets of NIL as at those dates. (15 marks)
- (e) The financial director expected that the Board would be interested in the funding requirements as well as the forecasted performance resulting from the expansion program. Accordingly, he has delegated to you as the most competent member of the team the key tasks, with the following instructions:
  - (i) Prepare a schedule of funding requirements for all the periods covered by the plan. (6 marks)
  - (ii) Produce the forecasted performance measures for profitability, liquidity and gearing. (6 marks)

**(Total 40 marks)**

## SECTION B

## Question 2

Worldwide Cyber Café Ltd (WCCL) is an unlisted company providing computer software support, Internet services and also producing computer chips. It was established in 1986 and has realized tremendous growth over the years. However, raising finance for the new projects remains a daunting job and usually contentious.

The Worldwide Cyber Café financial statements for the last year are summarized below:

**Balance Sheet as at 31 December 2001**

	Shs '000'
<b>Non-current Assets</b>	
Land and buildings	20,000
Machinery	40,000
Furniture and fittings	<u>10,000</u>
	<u>70,000</u>
<b>Current Assets</b>	
Inventory	20,000
Trade Receivables	20,000
Prepayments	3,000
Cash	<u>5,000</u>
	<u>48,000</u>
	<u>118,000</u>
<b>Financed by:</b>	Shs '000'
Issued share capital	
Voting	6,000
Non-voting	4,000
28% Debenture	6,000
Retained profit	<u>60,000</u>
	<u>76,000</u>
<b>Current Liabilities</b>	
Trade payables	30,000
Bank overdraft	<u>12,000</u>
	<u>42,000</u>
	<u>118,000</u>

**Income Statement for the year ended 31 December 2001**

	Shs '000'
Turnover	165,000
Cost of sales	<u>130,000</u>
Operating profit	35,000
Interest charge	<u>6,000</u>
Profit before taxes	29,000
Corporation tax	<u>8,000</u>
Profit attributable to ordinary shares	21,000
Dividends	<u>5,000</u>
Retained earnings	<u>16,000</u>

The following information is also available regarding financial indicators for the computer industry:

Return on capital employed	24%
Return on equity	16%
Operating profit margin	12%
Current ratio	2:1
Acid test	12:1
Interest cover	20%
Dividend cover	6.2%
P/E ratio	3

**Required:**

- (a) Analyse and discuss the performance and financial strength of World Cyber Café. Comment on the reliability of your analysis.  
(7 marks)
- (b) How should World Cyber Café restructure its balance sheet prior to floatation and how should the financial policy be changed following floatation?  
(8 marks)
- (c) Briefly explain why a company of this type would seek stock exchange listing.  
(5 marks)

**(Total 20 marks)**

**Question 3**

General Clays (U) Ltd produces a range of clay products sold within the East African region. They recently co-financed a research and development of a production facility, and are now considering whether they should go ahead and install the facility at their industrial area production centre. The following information is available to help evaluate the commercial viability of the new production facility:

- (i) The research costs amounted to Shs 120 million, while the initial development costs amounted to Shs 93 million. The company has already paid their fraction of all these costs, which was one third of the total.
- (ii) The facility would produce 10,000 units of Brika per year, a highly marketable kind of brick, for the next 5 years. The selling price of each unit will be Shs 4,100.
- (iii) The facility would immediately require additional fittings that would cost Shs 21 million. The fittings have an estimated scrap value of Shs 4 million.
- (iv) Total fixed costs of Shs 17 million will be apportioned to the new product per annum, of which Shs 5.5 million is estimated to arise as a direct result of introducing the new product.
- (v) Additional working capital of Shs 11 million will be required immediately to support the use of the new facility. This will be released at the end of the production period.
- (vi) Two types of raw materials would be required – type USM and type UGM. Material USM is imported, and each unit costs US \$ 1.50. There are 1,000 units of this material (USM) in stock, which would be disposed off at cost since they are no longer useful in the existing product range. Material UGM is locally sourced, widely used throughout the product range, and each unit costs Shs 4,500. The production of 10 units of Brika requires 3 USM units and 2 units of UGM.
- (vii) Labour costs are estimated at Shs 1,480 per hour, and each unit of Brika will require half an hour (1/2 hour) of this kind of labour. At the end of the production period, the company will incur redundancy costs of Shs 2,600,000 on account of the employees no longer required.
- (viii) The cost of capital is estimated to be at 14%.
- (ix) The exchange rate will be Shs 2,000 = US\$ 1 in year 1, and the Shilling is expected to depreciate against the dollar at the rate of 5% per annum.

Ignore taxation, and your workings should be in thousands of Shillings (Shs '000).

**Required:**

- (a) Calculate the incremental cash flows arising from the decision to install the new facility.

**(9 marks)**

- (b) Compute the Net Present Value (NPV). (3 marks)
- (c) Derive the approximate Internal Rate of Return (IRR). (3 marks)
- (d) Advise whether the facility should be installed. (2 marks)
- (e) Which of the two investment appraisal methods above is preferred and why? (3 marks)
- (Total 20 marks)

#### Question 4

- (a) In order to arrive at meaningful forecasts, decision makers usually employ sensitivity analysis.

##### Required:

Explain the term sensitivity analysis. Give three advantages and three disadvantages of sensitivity analysis.

(8 marks)

- (b) The following Balance Sheet was extracted from the financial statements of Lutiko Ltd at 31 December 2001:

	Shs million
Assets	
Non-current assets	150
Inventories	100
Trade and other receivables	85
Cash and cash equivalents	10
Total assets	<u>345</u>
Share capital	100
Revenue reserves	<u>100</u>
	200
Bank loans	70
Trade and other payables	<u>75</u>
Total equity and liabilities	<u>345</u>

##### Additional information:

- (i) The company's sales are running at about Shs 500,000,000 a year, which is its capacity limit.
- (ii) The profit margin after tax on sales is 4%.
- (iii) During 2001, the company earned Shs 2,000,000 after taxes and paid out Shs 1,000,000 in dividends and it plans to continue paying out half of net profits as dividends.



**Required:**

Compute the additional financing required if sales increase to Shs 800,000,000 during 2002.

(12 marks)

(Total 20 marks)

**SECTION C****Question 5**

Enronic Ltd is listed on the stock exchange. Its headquarters are in Asia and it has global interests. Its subsidiary Hydron Ltd recently submitted a bid to invest in hydropower generation in Uganda.

Enronic is reputed for the enormous generosity of its executives. It has in the past made a lot of political and charity contributions. In fact, Hydron in pursuance of group policy made a number of contributions.

The most significant contributions were reported as under:

Date	Beneficiary	Contribution (Shs)
January 2001	Presidential campaign taskforce	312,500,000
April 2001	Kampala City mayoral campaigns	15,000,000
May 2001	Hard rock Foundation (a charity founded by a Director in the Privatization Unit)	50,000,000
June 2001	Graduation Party of Charlotte – Daughter of a Presidential Advisor	4,000,000

In June 2001, the following events took place:

1. The company was granted an exploration licence to build an independent power station.
2. The tax on the energy exploration costs was reviewed and an investments allowance of 50% on capital investments to the energy sector was introduced, courtesy of Enronic's sponsored lobby.
3. A tax holiday was created to run for the five years of investment for all investors in the energy sector.

The above notwithstanding, the following events took place:

- (i) In August 2001, the Enronic's Chairman told employees in a memo that he had "never felt better about the prospects of the company. Our strength has never been more certain." The employees were convinced to invest in the stock of the company since the prospects were great.

- (ii) Following renewed optimism of the employees, the market value of Enronic stocks shot up.
- (iii) In November 2001, Enronic admitted accounting errors inflating income by Shs 556 million since 1997.
- (iv) On 2 December 2001 Enronic filed for bankruptcy and insolvency proceedings commenced in earnest.

Following the events above, a hot debate has been going on regarding the legal and ethical issues emanating from the actions of the executives of Enronic Ltd.

**Required:**

- (a) Explain the ethical issues raised by the events above.
- (b) Discuss the different forms and causes of bankruptcy.

**(8 marks)**

**(12 marks)**

**(Total 20 marks)**

**Question 6**

While investigating her idea of a small business in a restaurant, Nakigudde, a resident of Najjanankumbi, a Kampala suburb, discovered that Pizza Restaurant was due for sale in Wandegaya, also a Kampala suburb. She decided to investigate further and asked the business transfer agent (broker) handling the sale to send her the particulars. After perusing through the documents, Nakigudde was excited. "It is just what I am looking for", she told her husband. I will not have to go through all the trauma of starting up from nothing. The business is obviously successful judging by the sales figures. "What about the price?" her husband asked. "Your mother left you Shs 30,000,000 only. Where will you get the rest from?" "I am going to talk to my friend who is an accountant about the price and all the details concerning the purchase of the restaurant. I am sure the Bank Manager will extend credit for the balance required. Also stock is already standing at 10,000,000", asserted Nakigudde.

**Required:**

- (a) List any six roles played by small businesses in an economy.
- (b) Outline the advantages and disadvantages of buying existing an business such as Pizza Restaurant.

**(6 marks)**

**(14 marks)**

**(Total 20 marks)**