

**THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD**

*A Committee of the Council of ICPAU*

**CPA(U) EXAMINATIONS**

**LEVEL FOUR**

**CORPORATE FINANCIAL MANAGEMENT - PAPER 18**

**WEDNESDAY, 17 DECEMBER 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.

*© 2003 Public Accountants Examinations Board*

## SECTION A

### Question 1

Muto Industries Ltd has been in business for over five years in Uganda, having been established in the late 1990s. They have a paid up share capital of Shs 2 billion, but also have a significant gearing level. Whereas they are specialists in the provision of financial services, they have gradually diversified. Now they have interests in the media, real estate development and agriculture exports.

At the recent Board meeting, Muto Industries Ltd approved a management's proposal to expand its operations to, at least, one of the East African countries. One member of the Board, Mrs Maroa is, however, not convinced about the rather quick approval of the proposal. She keeps on asking all sorts of questions about the proposal ranging from the financing sources, risks involved, to its viability and the possibility of strategic partnerships.

To allay her fears, a rather cautious Finance Director refers her to their recent Financial Reports, the Chairman's Report, and some financial data produced by management. The following are extracts from some of these documents:

"The company would establish and run a subsidiary in Rwanda, for a period of 5 years, after which they expect to sell part of the subsidiary excluding working capital, for a consideration of non-taxable Rwanda francs (Frw) 150 million in cash; and keep a 10% share-holding in the purchasing company. It is expected that this equity holding will generate, after tax dividends of Frw 20 million from year six in perpetuity.

The cost of establishing the Rwandese Subsidiary would be Frw 580 million. This investment would be represented by Frw 320 million in non-current assets and the balance in working capital - which is recoverable in full on divestment.

The Branch planned to specialise in the media sector, would have annual turnover of Frw 355 million, and incur cash expenditures of Frw 170 million a year.

The corporation tax rate in Rwanda is expected to be at 33%, payable one year in arrears. With a double taxation agreement expected to be in force, the Ugandan corporation tax is expected to be at 30%.

Tax allowable depreciation is at a rate of 25% on a straight line basis on all non-current assets".

A week later, Mrs Maroa meets the Finance Director and comments: "I have actually analysed the reports and forecasts, but my concerns about exposure to foreign exchange risk are still valid."

**Required:**

- (a) Write a memo to the Board explaining the following:
- (i) The procedure the firm should follow before undertaking a large capital expenditure project and justify each step. (9 marks)
  - (ii) Three types of exchange risk and how each type could deplete shareholder value. (9 marks)
- (b) Assuming that the foreign exchange risk was real; explain to Mrs Maroa possible actions Muto Industries Ltd would take to mitigate the risk. (8 marks)
- (c) Muto Industries Ltd expects to hedge against the fluctuations in foreign exchange rates between the Ugandan Shilling and the Rwandese francs (Frw) by one of the actions you have suggested in (b) above. The company's cost of capital is 18%;
- Should this investment in Rwanda be undertaken?
- (Base your answer on calculations that would guarantee the increase in shareholder value). (12 marks)
- (d) Despite the release of news about the expansion programs, accompanied by the release of the latest quarterly results - which showed a relatively high increase in the company's earnings per share, the share price of Muto Ltd, (which is listed on the Uganda Securities Exchange) continued to suffer the usual movements in share prices, like before the release of this information.
- Comment on this phenomenon, in view of the efficient market hypothesis, (EMH), and also highlight the implications of the EMH to Finance Managers of companies listed on USE. (14 marks)
- (e) The bankers of Muto Industries Ltd have advised them that they could be approached anytime for a loan to finance the investment in Kigali, which they think could be a month from now.
- The bank has quoted the following exchange rates for Shs/Frw:
- |               |             |
|---------------|-------------|
| Spot rates    | 2.50 - 3.05 |
| 1 month rates | 2.45 - 2.93 |
- (i) How much money shall Muto Industries Ltd need to borrow in Uganda shillings to finance the investment in one month, ignoring bank commission and charges?
  - (ii) Assuming the annual percentage rate of borrowing was 15%, would the company be better off borrowing now or in the one-month's time?

- (iii) Give three reasons as to why the one-month exchange rates are different from the spot rates.

(8 marks)

(60 marks)

## SECTION B

### Question 2

The Ugandan press recently reported that the National Service Funds Ltd (NSF Ltd) had acquired 50% shareholding in Uganda Finance Ltd (UF Ltd). These shares were previously held by the *DF Group*. Nothing was reported about the value that was exchanged.

Some candidates of Paper 9 of the CPA(U) course, are aware that you are about to finalise your Level IV examinations and have approached you for advice on what could have been the likely consideration. One of the candidates has come with a newspaper cutting of the recently published financial statements of UF Ltd, which showed the following information:

#### Balance Sheet as at 31 December 2002:

	2002 Shs '000	2001 Shs '000
Cash at hand and at bank	3,350,600	2,300,500
Treasury Bills and other investments	4,650,700	3,490,000
Tax recoverable and other receivables	900,200	846,500
Loans and advances to customers	37,022,372	31,870,000
Non-current assets	<u>2,750,000</u>	<u>2,160,000</u>
	<u>48,673,872</u>	<u>40,667,000</u>
<b>Liabilities, Capital and reserves</b>		
Customer deposits	16,450,000	13,500,000
Tax payable and other payables	678,000	879,000
Long-term liabilities	24,500,000	20,540,000
Share capital	1,000,000	1,000,000
Revaluation Reserves	1,230,000	998,000
Retained earnings	<u>4,815,872</u>	<u>3,750,000</u>
	<u>48,673,872</u>	<u>40,667,000</u>

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

	2002	2001
	Shs '000	Shs '000
Interest and similar income	5,298,195	4,534,220
Earnings before tax	2,152,835	1,875,718
Taxation	(586,963)	(659,757)
Earnings after tax	1,565,872	1,215,961
Dividends	(500,000)	(400,000)
Retained earnings for the year	1,065,872	815,961

The following information is also availed to you:

- (i) The market value of UF Ltd's land and buildings is estimated at Shs 1.7 billion (but has been included on the balance sheet at Shs 1.35 billion), because of the recent renovations that cost the company Shs 300 million; Computer software and other intangible assets of Shs 430 million are also included in non-current assets; while the net advances to customers include Shs 250 million which is doubtful.
- (ii) The UF Ltd's Chairman recently disclosed that the company had developed a strategic business plan, which is expected to increase the Company's after tax earnings by Shs 135 million in the year ending 31 December 2003, and that they will be paying 40% of earnings after tax for that period in dividends. He also said that they expected that dividends thereafter will grow at an average rate of 8% per annum for the foreseeable future.
- (iii) Information is also available for quoted firms in the financial services industry. The following two companies are considered of similar size and structure:

	Line Bank Ltd	Riont Finance Ltd
Share price	Shs 4,500	Shs 3,500
Earnings per share	Shs 500	Shs 700
Equity beta	1.2	1.6

- (iv) The current Treasury bill yield is 10%, and the Bank of Uganda officials have vowed to keep it stable at that rate for the foreseeable future. The average market return is estimated at 16% per annum.

**Required:**

- (a) Using at least 3 valuation methods, advise your fellow students what the NSF Ltd could have paid in exchange for the shares. (15 marks)
- (b) Explain the reliability of your estimations and whether the actual price could have been more likely higher or lower than your estimates. (5 marks)

(Total 20 marks)

**Question 3**

- (a) Tri-Goa Ltd has in issue 12% Debentures with a nominal value of Shs 100,000, which have a market value of Shs 92,000, and the company is tax-exempt.

**Required:**

Calculate the cost of capital if the debenture is:

- (i). Irredeemable  
(ii). Redeemable at par after 10 years.

**(7 marks)**

- (b) Tri-Goa Ltd specialises in a single product, and makes all sales on credit to their customers (who are mainly small businesses in local and export trade). The cost structure of the product is as follows:

	Ushs '000	Ushs '000
Selling price		25.0
Less:		
Material costs	7.5	
Variable labour costs	8.0	
Fixed cost apportionment	5.5	<u>21.0</u>
		<u>4.0</u>

The company's debtors are grouped into four (4) distinct categories, with the following attributes:

Category	Bad debts	Average collection period (No. of days)
A	2.5%	15
B	3.0%	30
C	5.0%	40
D	7.5%	60

The company's management is exploring ways of increasing the level of sales to be able to continue servicing loans that were acquired at its set-up. A proposal has been made to spend an additional Ushs 800 million on advertising, which would increase sales by Ushs 4 billion in the forthcoming year.

The additional sales would comprise 15% category A debtors, 30% category C debtors, and the rest category D debtors. Production capacity at their Kampala Industrial Area factory is sufficient to deal with this increase in sales if required.

The company can access bank overdraft facilities at 15% per annum, and taxation is to be ignored.

**Required:**

- (i) What effect will the increase in advertising expenditure have on profit in the forthcoming year, and should the proposal be adopted?

**(9 marks)**

- (ii) What are the main sources of information in appraising new credit customers?

**(4 marks)**

**(Total 20 marks)**

**Question 4**

- (a) While addressing a group of recently qualified CPA(U) graduates and their guests at Grand Imperial Hotel, Kampala, the Chief Guest said: "We expect you to adhere to the requirements of ICPAU's Code of Conduct, because this will enhance development and the profession's respect in this country".

Later, some guests were heard asking what the Code of Conduct was all about, why Finance Managers should be rigid with such codes, and the relationship between the Code of Conduct and the country's development.

**Required:**

Prepare a brief report, addressing the concerns of the guests.

**(10 marks)**

- (b) On his recent tour of the Uganda Investment Authority offices, the Minister of State for Investments met a number of potential investors, who intimated to him that they consider political risk of investing in Uganda so high, and that they were yet to conclude on how much they should 'risk' in Uganda.

**Required:**

Explain the term "Political Risk of Foreign Direct Investment", and how the Ministry of Finance should lobby the Government of Uganda to reduce it (if it can be reduced).

**(10 marks)**

**(Total 20 marks)**