

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

CORPORATE FINANCIAL MANAGEMENT - PAPER 18

THURSDAY, 16 DECEMBER 2004

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

KND (U) Ltd is a public limited company, specialising in processing of local raw materials, but with significant interests in the communications industry. The company has been in operation since the mid-1980s, and it recently developed a five-year strategic business plan, that provided for major expansion programmes, with a major theme of “maximising shareholder value”.

The General Manager of KND (U) Ltd, Ms J Nkesa, wants to expand into regional markets, which were provided for in the strategic business plan. She is currently focusing on the Tanzanian (Tz) market, where she has immediately made a deal to export goods worth Tz Shs 250 million. The Tanzanian importer is to pay in a month's time. The spot rate of exchange is Tz Shs 0.625 per US\$ 1 between Tanzania and Uganda. The one month rate is Tzsh 0.605 per US\$ 1. To borrow in Tanzanian shillings for one month will cost 0.8% whereas to borrow in Ugandan shillings for one month will cost 1 % of the amount borrowed.

The Managing Director (MD) of KND (U) Ltd has also picked interest in the regional transactions and would like to know how he could be able to predict interest and exchange rates so that he could avoid more volatile markets, and also to know the key influences on these economic variables. He indicates that he has heard that the inflation rate in Tanzania is at an average of 4% while the Ugandan one is reported at 3 % per annum.

The MD's interest in regional markets was increased when he attended the recent African Development Bank (ADB) Annual General Meeting at Speke Resort Munyonyo. A Ugandan State Minister had then commented: “... We must continue to encourage our entrepreneurs to enter regional markets. This meeting has made a significant headway on policies aimed at streamlining the economies of the countries in the region. Our businessmen and women should now be able to enter regional markets without any artificial fears, and should use the common risk hedging mechanisms. ...”.

Preliminary research indicates that KND (U) Ltd shall have the opportunity of investing in any of the following bonds offered by major corporations in Tanzania, whose details are as follows:

Variable/Corporation	TzCorp	TrFirm	GtEnt
Annual Coupon	8.12%	6.5%	7.8%
Maturity Date	30/06/2014	30/06/2014	30/06/2008
Credit Rating	A-	BBB+	A-
Market Price	107.8	93.2	105.83
Yield to Maturity	7.0%	7.5%	6.0%
Redemption Price (Tz Shs)	100	100	100

Required:

- (a) Explain using the information provided above:
- (i) How KND (U) Ltd can use the forward market to hedge their export deal. **(4 marks)**
 - (ii) Show how the money market can be used to hedge the Tzsh 250 million export deal. **(4 marks)**
 - (iii) The maximum amount in Ushs that KND (U) Ltd should offer as discount to try and obtain payment immediately as an alternative to hedging in the markets assuming all other factors remain constant. **(4 marks)**
- (b) Using the purchasing power parity theory, explain to the MD the expected movements in the forex rate in a year's time using the Tzsh / Ush rates. **(4 marks)**
- (c) Explain the following terms and state the circumstances under which each of the techniques might be used:
- (i) Leading and lagging.
 - (ii) Matching in relation to foreign currency receipts and payments. **(6 marks)**
- (d) Following the research commissioned by the MD, he is now focused on opening up a fully-fledged subsidiary in Tanzania, and is concerned about what might affect the success of their new Multi-National Corporation (MNC).
Write a Memo to the MD explaining the internal and external factors likely to affect their new MNC once created. **(11 marks)**
- (e) Outline the likely motives of establishing subsidiaries in Tanzania or elsewhere in the region, and the likely risks such ventures may face. **(12 marks)**
- (f) Giving reasons, advise the management of KND (U) Ltd as to whether or not the bonds of TzCorp should be considered better than those of either TrFirm or GtEnt. **(5 marks)**
- (g) Evaluate whether the market price of GtEnt's bonds shown above is what would be expected from the other company's data. (Assume interest is paid annually) **(5 marks)**
- (h) Would your advice in (g) above, change if the **yield curve** is upward sloping and KND (U) Ltd's Treasury team expect interest rates to fall with medium term interest rates expected to fall more than long-term interest rates. **(5 marks)**
- (Total 60 marks)**

SECTION B**Question 2**

Katamu Sports Ltd. operates a chain of sports shops in the central region of Uganda. The company has 100,000 ordinary shares of Ushs 15,000 each in issue. Profits after taxation for the year ended 31 May 2004 were Ushs 120 million. The Board of Directors plans to expand the company and has decided to raise Ushs 350 million through a rights issue of ordinary shares.

If the company is successful in raising this amount, it expects to increase its profits after taxation by 55% in the forth-coming year. The Board of Directors wishes to maintain a dividend pay-out ratio of 35%. They also believe they shall continue to achieve a return of 20% on all new investments for the indefinite future. The required rate of return for ordinary shareholders is estimated at 16%.

The company has appointed financial advisers to assist in the rights issue. These advisers have suggested that the new shares should be issued at a price, which assumes the market value of the business following the issue is 20% lower than the value suggested by the information provided above. It is believed that this discounted price would provide the necessary incentive for investors to take up the rights offer.

Ignore share issue costs.

Required

- (a) Calculate the total market value of the share of Katamu Sports Ltd. assuming the company is successful in raising the finance required
(5 marks)
 - (b) Calculate the:
 - (i) price at which a rights share should be issued.
 - (ii) number of rights shares to be issued by Katamu Sports Ltd to raise the finance required by the company.
(5 marks)
 - (c) Assuming the company wanted to raise the finance in form of venture capital, outline the issues that the venture capitalist would consider before granting their request.
(5 marks)
 - (d) Discuss the reasons why many companies in Uganda may find it difficult to raise capital in the form of corporate bonds.
(5 marks)
- (Total 20 marks)**

Question 3

Wiloxo (U) Ltd is a carpentry company, which is owned and managed by two carpentry specialists. Although sales have remained stable at Ushs 2.5 billion per annum in recent years, the level of debtors has increased significantly. A recent financial report submitted to the owners indicates an average settlement period for debtors of 60 days compared to an industry average of 40 days. The level of bad debts has also increased in recent years and the company now writes off approximately Ushs 13 million worth of bad debts each year.

The recent problems experienced in controlling credit have led to a liquidity crisis for the company. At present, the company finances its debtors by a bank overdraft bearing an interest rate of 14% per annum. However, the overdraft limit has been exceeded on several occasions in recent months and the bank is now demanding a significant decrease in the size of the overdraft.

To comply with this demand, the owners of the company have approached a Factor who has offered to make an advance equivalent to 85% of trade debtors, based on the assumption that the level of debtors will be in line with the industry average. The Factor will charge an interest rate of 12% per annum for this advance. The Factor will take over the sales ledger of the company and for this service, will charge a fee based on 2% of sales. The company believes that the services offered by the Factor should eliminate bad debts and should lead to administrative cost savings of Ushs 21 million per annum.

On the other hand, a prospective financier has indicated willingness to negotiate with management on possible terms for financing. He has proposed for now, that Wiloxo (U) Ltd should indicate whether they may prefer a **fixed charge** or **floating charge** on assets secured, and the range of **collars, caps, or floors** that they are currently experiencing on their finances.

Required:

- (a) Calculate the effect of employing a debt factor on the net profit of Wiloxo (U) Ltd and discuss your findings.
(10 marks)
- (b) Illustrate the relevance and application of “**fixed charge or floating charge on assets secured**”, and “**collars, caps and floors**” as used in the last paragraph of the extract above.
(10 marks)

(Total 20 marks)

Question 4

Mr Batwara, the Managing Director of IGS Investments Ltd, is unhappy with his Finance Manager, on seeing that she did not take into account the inflation rate while compiling data for a project under appraisal. He said, “I can see that you have estimated the cash flows at a steady rate of Ushs 800 million for the four years. I actually told you that the expected inflation rate is 3.7% per annum for the next few years. You know we have to make an immediate outlay of Ushs 2.5 billion. We need to establish the worthiness of this project on the basis of Net Present Value (NPV), rather the Accounting Rate of Return (ARR) or Internal rate of Return (IRR), and therefore we cannot ignore inflation”.

The market rate of return for this level of risk is 12%.

Required:

- (a) Demonstrate to the Managing Director that the same NPV would be obtained whether the cash flows were inflated and discounted at the market rate, or the un-inflated cash flows were discounted at a real rate. State the limitation of the latter approach.
(10 marks)
- (b) Explain why IGS Investments Ltd prefers the NPV approach to the ARR and the IRR.
(4 marks)
- (c) Briefly explain what would happen to a project's IRR if the company's cost of capital increases, and outline the key issues that would cause such an increase in the company's cost of capital.
(6 marks)

(Total 20 marks)