

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA (U) EXAMINATIONS

### LEVEL THREE

#### FINANCE – PAPER 14

**WEDNESDAY, 23 JUNE 2004**

#### 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.

## SECTION A

### Question 1

Mary Kima is an ambitious young executive who was recently appointed to the position of Finance Director of Shopcom Ltd a medium listed company in Uganda. The company is a subsidiary of a large South African chain of Supermarkets, Com Rand Plc. Another big subsidiary of Com Rand PLC in Kenya is carrying out a far wide reaching reorganisation process to avoid loss of market due to stiff competition.

Mary Kima, who has been based in Kenya as a Chief Accountant, regards this appointment as a temporary one, enabling her to gain experience before moving to a larger organisation. Her ambition is to leave Com Rand Group in three years time, with its share price standing high. As a consequence, she is particularly concerned that the reported profits of Shopcom Ltd should be as high as possible in her third and final year with the company.

Shopcom Ltd has recently raised Shs 350 billion from a rights issue, and the directors are considering three ways of using these funds. Three projects (X, Y and Z) are being considered, each involving the immediate purchase of equipment costing Shs 350 billion. One project only can be undertaken, and the equipment for each project will have a useful life equal to that of the project, with no scrap value. Mary Kima favours Project Z because it is expected to show the highest accounting profit in the third year. However, she does not wish to reveal her real reasons for favouring Project Z, and so, in her report to the Chairman, she recommends Project Z because it shows the highest internal rate of return. The following summary is taken from her report:

#### Net Cash Flows (Shs billions)

Project	Years								
	0	1	2	3	4	5	6	7	8
<b>X</b>	(350)	100	110	104	112	138	160	180	-
<b>Y</b>	(350)	40	100	210	260	160	-	-	-
<b>Z</b>	(350)	200	150	240	40	-	-	-	-

The Chairman of the Company is accustomed to projects being appraised in terms of payback and accounting rate of return, and he is consequently suspicious of the use of internal rate of return as a method of project selection. Accordingly, the Chairman has asked you for an independent report on the choice of project. The company's cost of capital is 20%. Depreciation is provided for at the rate of 20% on cost per annum.

**Required:**

- (a) Calculate the pay back period of each project. (3 marks)
- (b) Calculate the accounting rate of return for each project. (3 marks)
- (c) Prepare a report for the Chairman with supporting calculations indicating which project should be preferred by the ordinary shareholders of Shop Com Ltd. Your report should give a brief description of Net Present Value (NPV), Internal Rate of Return (IRR), Pay Back Period (PBP) and the Accounting Rate of Return (ARR) and their limitations. (18 marks)
- (d) Discuss the assumptions about the reactions of the stock market that are implicit in Shopcom Ltd's choice of Project Z as earlier suggested by Mary Kima. (4 marks)
- (e) Why do you think the assumptions under (d) above are not justified basing on your knowledge from the stock exchange? (3 marks)
- (f) (i) Explain the term "reorganisation" as used in the opening paragraph above. (3 marks)
- (ii) Why do firms, such as Com Rand PLC's subsidiary in Kenya, undertake reorganisation processes? (3 marks)
- (iii) In any reorganisation plan, it is normally stated that the plan should be FAIR, EQUITABLE and FEASIBLE. Explain each of those terms as used in a reorganisation plan. (3 marks)
- (Total 40 marks)**

**SECTION B****Question 2**

EZY Ltd, a Ugandan company, is considering purchasing an interest in its future rival, Dan Ltd., a Kenyan Company. Competition between the two companies is expected to be very stiff especially with the recent signing of the East African Customs Union Treaty. The Managing Director of EZY Ltd has obtained the most recent income statements and balance sheets of Dan Ltd as shown below:

**DAN LTD****Income Statements for year ended 31 December:**

	<b>2003</b>	<b>2002</b>	<b>2001</b>
	<b>Shs million</b>	<b>Shs million</b>	<b>Shs million</b>
Turn over	19,845	18,900	18,000
Cost of sales	<u>11,890</u>	<u>10,340</u>	<u>10,440</u>
Gross Profit	7,955	8,560	7,560
Distribution costs	1,405	1,670	1,565
Administrative Expenses	<u>1,591</u>	<u>1,503</u>	<u>1,409</u>
Operating Profit	4,959	5,387	4,586
Interest payable on bank overdraft	450	215	104
Interest payable on 12% debenture	<u>600</u>	<u>600</u>	<u>600</u>
Profit before tax	3,909	4,572	3,882
Taxation	<u>1,838</u>	<u>2,000</u>	<u>1,380</u>
	2,071	2,572	2,502
Proposed dividend	<u>1,800</u>	<u>1,693</u>	<u>1,600</u>
Retained profits	<u><u>271</u></u>	<u><u>879</u></u>	<u><u>902</u></u>

**Balance Sheets as at 31 December:**

	<b>2003</b>	<b>2002</b>	<b>2001</b>
<b>ASSETS</b>	<b>Shs million</b>	<b>Shs million</b>	<b>Shs million</b>
<b>Non-current Assets:</b>			
Property, plant and equipment	20,211	21,141	20,356
<b>Current Assets:</b>			
Inventories	3,995	2,663	1,775
Trade receivables	<u>3,164</u>	<u>2,260</u>	<u>1,440</u>
Cash and bank	<u>55</u>	<u>53</u>	<u>50</u>
	<u>7,214</u>	<u>4,976</u>	<u>3,265</u>
	<u><u>27,425</u></u>	<u><u>26,117</u></u>	<u><u>23,621</u></u>
<b>EQUITY AND LIABILITIES</b>			
<b>Equity and reserves:</b>			
Share capital	8,000	8,000	8,000
Accumulated profits	<u>7,584</u>	<u>7,313</u>	<u>6,434</u>
	<u><u>15,584</u></u>	<u><u>15,313</u></u>	<u><u>14,434</u></u>
<b>Non-current Liabilities:</b>			
12% debentures (2005-8)	5,000	5,000	5,000

<b>Current Liabilities:</b>	<b>Shs million</b>	<b>Shs million</b>	<b>Shs million</b>
Trade payable	446	388	390
Bank overdraft	3,400	2,300	1,300
Taxation	1,195	1,420	897
Proposed dividends	<u>1,800</u>	<u>1,696</u>	<u>1,600</u>
	<u>6,841</u>	<u>5,804</u>	<u>4,187</u>
<b>TOTAL EQUITY AND LIABILITIES</b>	<b><u>27,425</u></b>	<b><u>26,117</u></b>	<b><u>23,621</u></b>

**Required:**

- (a) You are the Management Accountant of EZY Ltd and the Managing Director has now requested you to prepare a report commenting on the financial position of Dan Ltd for the years ending 31 December 2002 and 2003. Your report should make use of the relevant ratios and other financial statistics where appropriate.
- (14 marks)**
- (b) Highlight any two areas that require further investigation from your report in (a) above.
- (3 marks)**
- (c) Assuming EZY Ltd and Dan Ltd decided to merge, give three benefits that would accrue to the shareholders of both companies.
- (3 marks)**
- (Total 20 marks)**

**Question 3**

- (a) Amanda, a CPA(U) Level 3 student, has just got a new job as an Assistant Corporate Finance Manager with Natural Oil Company in Kalangala District. The company is vigorously expanding and as a result, it needs an additional Shs 7.5 billion in working capital immediately. It has been determined that there are three feasible sources of funds:
- (i) Trade Credit: The company buys materials worth about Shs 5 billion per month on terms of 3/30, net 90. Discounts are taken.
  - (ii) Bank loan: The firm's bank, Tick Bank Uganda Ltd, will lend Shs 10 billion at an interest of 13%. A 10% compensating balance will be required, which otherwise would not be maintained by the company.
  - (iii) A factor, the only one now operating in Mbale Town, will buy the company's receivables (Shs 10 billion per month), which have a collection period of 60 days. The factor will advance up to 75% of the face value of receivables at 12% on an annual basis. The factor will also charge at 2% fee on all account receivables purchased. It has been estimated the factor's services will save the company a credit department expense and bad debt expenses of Shs 150 million per month.

**Required:**

The Finance Director has requested Amanda to evaluate the best alternative based on the annual percentage cost. However, Amanda being new in the office appears confused and has now asked you for assistance in evaluating the best alternative for Natural Oil Company.

**(12 marks)**

- (b) Geneso Ltd has achieved earnings of Shs 800,000,000 this year. The company intends to pursue a policy of financing all its investment opportunities out of retained earnings. There are considerable investment opportunities, which are expected to be available indefinitely. However, if Geneso Ltd does not exploit any of the available opportunities, its annual earnings will remain at Shs 800,000,000 in perpetuity. The following figures are available:

<b>Proportion of earnings retained</b>	<b>Growth rate in earnings</b>	<b>Required rate of return by shareholders</b>
<b>%</b>	<b>%</b>	<b>%</b>
0	0	14
25	5	15
40	7	16

The rate of return required by shareholders would rise if earnings are retained, because of the risk associated with the new investments.

**Required:**

What is the optimum retentions policy for Geneso Ltd from the above alternatives?

**(8 marks)****(Total 20 marks)**

**Question 4**

Mr. Kuku, a newly qualified graduate, works at Pembe Ltd, a medium manufacturing company. The Finance Director of Pembe Ltd has asked Mr. Kuku to submit the company's projected income statement for the January – June 2004 period and the balance sheet as at that date.

Mr. Kuku has now come to you for assistance since he cannot put all the data together to generate the required reports. However, he had prepared some preliminary working schedules as shown below:

**Schedule of Sales Receipts (Shs million)**

	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Total Sales	300	350	250	200	250	300	350	380
Credit Sales	270	315	225	180	225	270	315	342
Collections, 1 month	-	243	283.5	202.5	162	202.5	243	283.5
Collections, 2 months	-	-	<u>27</u>	<u>31.5</u>	<u>22.5</u>	<u>18</u>	<u>22.5</u>	<u>27</u>
Total collections			310.5	234	184.5	220.5	265.5	310.5
Cash Sales			<u>25</u>	<u>20</u>	<u>25</u>	<u>30</u>	<u>35</u>	<u>38</u>
Total Sales receipts			<u>335.5</u>	<u>254</u>	<u>209.5</u>	<u>250.5</u>	<u>300.5</u>	<u>348.5</u>

**Schedule of Disbursements for Purchases and Expenses (Shs million)**

	Dec	Jan	Feb	Mar	Apr	May	June
Purchases	<u>100</u>	<u>80</u>	<u>100</u>	<u>120</u>	<u>140</u>	<u>150</u>	<u>150</u>
Cash payment for purchases	-	100	80	100	120	140	150
Wages	70	80	80	90	90	95	100
Other expenses	-	<u>50</u>	<u>50</u>	<u>50</u>	<u>50</u>	<u>50</u>	<u>50</u>
Total cash expenses		<u>230</u>	<u>210</u>	<u>240</u>	<u>260</u>	<u>285</u>	<u>300</u>

**Note:** Accrued wages and other expenses are expected to be Shs 240 million at 30 June 2004.

**Schedule of Cash Disbursements (Shs million)**

	Jan	Feb	Mar	Apr	May	June
Total Cash Expenses	230	210	240	260	285	300
Capital Expenditures	-	150	50	-	-	-
Dividend payments	-	-	20	-	-	20
Income taxes	<u>30</u>	<u>-</u>	<u>-</u>	<u>30</u>	<u>-</u>	<u>-</u>
Total cash disbursements	<u>260</u>	<u>360</u>	<u>310</u>	<u>290</u>	<u>285</u>	<u>320</u>

**Schedule of Net Cash Flows and Cash Balance (Shs million)**

	Jan	Feb	Mar	Apr	May	Jun
Total cash receipts	335.5	294	209.5	250.5	300.5	348.5
Total cash disbursements	<u>260</u>	<u>360</u>	<u>310</u>	<u>290</u>	<u>285</u>	<u>320</u>
Net cash flows	75.5	(66)	(100.5)	(39.5)	15.5	28.5
Opening cash without financing	<u>100</u>	<u>175.5</u>	<u>109.5</u>	<u>9</u>	<u>(30.5)</u>	<u>(15)</u>
Closing cash without financing	<u>175.5</u>	<u>109.5</u>	<u>9</u>	<u>(30.5)</u>	<u>(15)</u>	<u>13.5</u>

**Additional Information:**

- (i) Pembe Ltd offers terms of net 30. From past experience, 90% of receivables are collected on average 1 month from the date of the sale, and 10% are collected 2 months from the date of the sale, with no bad debts.
- (ii) 10% of total sales are cash sales.
- (iii) Pembe Ltd intends to sell Shs 40 million of used equipment in February.
- (iv) Production normally occurs in the month preceding forecasted sales. All the wages relate directly to production.
- (v) Assume Pembe Ltd has an inventory turnover ratio of 3.39.
- (vi) Depreciation of Shs 110 million is expected for the January – June period.
- (vii) Pembe Ltd has no tax allowances.
- (viii) Assume an income tax rate of 40%.
- (ix) Pembe Ltd has a policy of maintaining a minimum cash balance of Shs 75 million.
- (x) Below is an extract of the previous balance sheet as at 31 December 2003.

<b>Assets</b>		<b>Liabilities</b>	
	Shs million		Shs million
Cash	100	Bank borrowings	50
		Trade payables	200
Receivables	342	Accrued wages and expenses	250
Inventory	<u>350</u>	Income tax payable	<u>70</u>
Current assets	792	Current liabilities	570
Non-current assets	<u>800</u>	Share holders' equity	<u>1,022</u>
Total assets	<u>1,592</u>	<b>Total Equity and Liabilities</b>	<u>1,592</u>

**Required:**

- (a) From the data provided by Kuku, prepare Pembe Ltd's Projected Income Statement for the January – June 2004 period.

**(6 marks)**

- (b) Prepare Pembe Ltd's projected balance sheet as at 30 June 2004.

**(14 marks)****(Total 20 marks)**



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

“The importance of a comprehensive business plan cannot be over emphasized. Much hinges on it: Outside funding, credit from suppliers, management of your operations and finances, promotion and marketing of your business, and achievement of your goals and objectives. The business plan is a necessity. If a person who wants to start a business cannot put a business plan together, he or she is in trouble,” said one of the leading financial management consultants at a one day workshop at Hotel Africana in March 2004.

**Required:**

Describe each of the components of a business plan, giving specific examples where necessary.

**(20 marks)****Question 6**

- (a) (i) Explain the term ‘off balance sheet finance’.  
**(2 marks)**
- (ii) Why do firms normally employ such financing procedures?  
**(2 marks)**
- (iii) List five common forms of off balance sheet finance and briefly explain how they are employed in off balance sheet financing.  
**(10 marks)**
- (b) Despite the importance of ‘small businesses’ to the Ugandan economy, recent statistics have revealed a high closure or winding up rate in this sector.

**Required:**

Outline the causes for the high rate of closure of small businesses in Uganda.

**(6 marks)****(Total 20 marks)**