

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA (U) EXAMINATIONS

LEVEL THREE

FINANCE – PAPER 14

WEDNESDAY, 15 DECEMBER 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**

Seya Investments Ltd. is a well-established company of close business associates. 85% of its ordinary shares and 50% of its preferred share capital are held by the close business associates, (also called 'Seyas'). The following summarized balance sheet and fair value table refers to Seya Investments Ltd at 30 June 2004.

	NBV Shs billion	Fair Value Shs billion
Assets		
Non-current assets:		
Tangible assets	45	40
Intangible assets	<u>15</u>	<u>-</u>
	60	40
Current assets	<u>55</u>	<u>50</u>
Total Assets	<u>115</u>	<u>90</u>
Equity and Liabilities		
Capital and Reserves:		
Issued capital – (Ordinary shares of Shs 1,000 each)	40	40
Accumulated losses	<u>(21)</u>	<u>(57)</u>
	19	(17)
Non-current liabilities:		
10% preferred shares of Shs. 1,000 redeemable at a premium of 5% (Shs. 10 billion per value)	11	12
8% unsecured loan stock 2005 repayable at a premium of 10% (Shs.35 billion per value)	38	39
Current liabilities	<u>47</u>	<u>56</u>
Total Equity and Liabilities	<u>115</u>	<u>90</u>

Seya Investments Ltd incurred losses for several years due to mismanagement and incompetence. In 2004, the Seyas (or Close Business Associates) had sold a 5% holding in the ordinary shares to RA Ltd another group of Investors and a further 10% holding to outside interests. Prior to this event, all the ordinary shares were held by the Seyas. RA Ltd has indicated to Seya Investment that they wish to increase their interest in Seya Investments Ltd.

Seya Investments Ltd has projected that it will make profits before interest and taxation in the year to 30 June 2005 of Shs 8 billion and that this will increase by 25% per annum. The directors of Seya Investments Ltd initially wanted to carry out a company valuation but have now decided to reconstruct the capital of the company, as this option appears more attractive. They have suggested the following scheme of reconstruction:

- (i) The ordinary shares of Shs. 1,000 are to be reduced to Shs. 200 per share. Additionally 20 million ordinary shares of Shs. 200 each are to be issued for cash. RA Ltd will subscribe for 15 million of these shares and the Seyas will purchase the balance.
- (ii) The holders of the ordinary shares not held by the Seyas or RA Ltd will be offered one new 7% Convertible Cumulative Preferred Share of Shs. 1,000 for every 2 ordinary shares that they own and their ordinary shares will be cancelled.
- (iii) A commercial bank has agreed to subscribe in cash for Shs. 25 billion of new 8% loan stock (secured on the tangible assets) and RA Ltd and the Seyas shareholders will subscribe equally in cash for Shs. 25 billion of new unsecured 10% loan stock. Both issues are at par value.
- (iv) The existing preferred shares held by the Seyas will be cancelled and the balance not held by the Seyas will be repaid along with the 8% loan stock on the following terms:
 - (a) Arrears of accrued preferred dividends included in current liabilities to be cancelled (for 2 years).
 - (b) 10% preferred shares repaid at Shs. 800 per share.
 - (c) Loan stock repaid at par (there is no accrued interest).
- (v) The assets and liabilities are to be shown at fair value in the reconstructed balance sheet and the directors' loans of Shs. 8 billion included in current liabilities are to be written off.
- (vi) RA Ltd. is to pay a non-equity capital contribution to shareholders funds of Shs. 10 billion to Seya Investments Ltd in order to bolster its liquid funds.
- (vii) The bank overdraft included in current liabilities currently stands at Shs. 5 billion.
- (viii) The procedures under the Companies Act have been followed as regards the varying of shareholders' rights.
- (ix) Assume tax rate at 30%.

Required:

- (a) Prepare a balance sheet for Seya Investments Ltd after the implementation of the scheme on the assumption that the proposed scheme was accepted. Show all relevant workings.
(14 marks)
- (b) If the Board had decided to value Seya Investments Ltd, outline the various valuation methods available to them, giving one advantage of each method.
(6 marks)

- (c) Explain, with the aid of examples where necessary, why the following stakeholders will accept the scheme:
- (i) Preferred shareholders (outside). **(2 marks)**
 - (ii) 8% unsecured loan stock. **(3 marks)**
 - (iii) Minority interest (10%) – ordinary shares. **(3 marks)**
- (d) Prepare the forecast profit for the future (2005 to 2007) based upon the projected profit figures. **(6 marks)**
- (e) Using the results in (d) above, compute;
- (i) Return on shareholders' capital invested for the 3 years.
 - (ii) The interest cover for the 3 years. Give your comment on the interest cover figures.

(6 marks)
(Total 40 marks)

SECTION B

Question 2

Fedo Ltd has just recovered from the financial distress currently affecting the industry and is now considering investing in one of the machines to boost future production plans. There are two options available:

- (i) The Super Model machine costing Shs. 88 million.
- (ii) The Regular Model machine costing Shs 50 million.

Both machines would require immediate repayment and in addition an input of Shs 10 million working capital throughout their working lives. Both machines have no expected scrap value at the end of their expected lives of 4 years for the Regular Model and 6 years for the Super Model.

The forecast pre-tax operating net cash flows (Shs '000') associated with the 2 machines are:

	1	2	3	4	5	6
Regular	20,500	22,860	24,210	23,410	-	-
Super	32,030	26,110	25,380	25,940	38,560	35,100

The Super Model was only recently introduced to the market, and has not been fully tested in operating conditions.

Because of the higher risk involved, the appropriate discount rate for the Super Model is believed to be 14% per annum, 2% higher than the discount rate for the Regular Model.

The company is proposing to finance the purchase of either model with a term loan at a fixed interest rate of 11% per year.

Taxation at 30% is payable on operating cash flows one year in arrears, and capital allowances are at 25% per year on a reducing balance basis.

Required:

- (a) Outline at least 4 indicators of financial distress. **(4 marks)**
- (b) For both the Regular and Super Model machines calculate the;
 - (i) Net Present Value. **(8 marks)**
 - (ii) Profitability Index. **(4 marks)**
- (c) Recommend, with reasons, which of the two models Fedo Ltd should purchase, from your computations in (b) above.

(4 marks)

(Total 20 marks)

Question 3

Due to increased controversy, Ngambo Estates Ltd, a company formed to invest in real estates, decided to re-direct its investment plans to the manufacture of Roofing Tiles. During the first months of operation the company has received a large order and anticipates the need to go to its bank, DELL Ltd, to increase its borrowings. As a result, it has to forecast its cash requirements for January, February and March 2005. Typically, the company collects 20% of its sales in the month of sale, 70% in the subsequent month, and 10% in the second month after the sale. All sales are credit sales.

Below is the balance sheet of Ngambo Estates Ltd as at 31 December 2004 (half of December was estimated but no variances are expected from the actual).

	Shs million
Share capital	100
Retained earnings	1,439
Non current liabilities:	
Bank borrowings	450
	<u>1,989</u>
Non current assets:	
Property, plant and equipment	<u>1,836</u>
Current assets:	
Inventories	545
Trade and other receivables	530
Cash	50
	<u>1,125</u>
Current liabilities:	
Trade and other payables	360
Accruals	212
Bank borrowings	400
	<u>972</u>
Net current assets	<u>153</u>
	<u>1,989</u>

Additional information:

- (a) Purchases of raw materials to produce roofing sheets are made in the month prior to the sale and amount to 60% of sales in the subsequent month.
- (b) Payments for these purchases occur in the month after the purchase.
- (c) Labour costs, including overtime, are expected to be Shs. 150 million in January, Shs. 200 million in February, and Shs. 160 million in March.
- (d) Selling, administrative, taxes, and other cash expenses are expected to be Shs 100 million per month for January through March. Actual sales in November and December and projected sales for January through April are as follows:

Month	Shs million	Month	Shs million
November	500	February	1,000
December	600	March	650
January	600	April	750

Required:

- (a) Prepare a cash budget for the months of January, February and March.
(8 marks)
 - (b) Determine the amount of additional bank borrowings necessary to maintain a cash balance of Shs. 50 million at all times.
(4 marks)
 - (c) Prepare a proforma balance sheet as at 31 March 2005.
(8 marks)
- (Total 20 marks)**

Question 4

- (a) At a recent investment workshop, the Chairman of Dondi Group announced that their Board was considering two methods of raising Shs. 360 billion required in their current investment expansion programme;
 - (i) The group can sell to the public through investment bankers.
 - (ii) The group could also sell through rights and not using investment bankers.

Required:

Give the advantages and disadvantages of using either of the methods.

(6 marks)

- (b) Porto Ltd, a subsidiary of Dondi Group at present has total credit sales of Shs. 10 billion per year. Its average collection period is 60 days. The current bad debt loss ratio on these sales is 2%. Porto Ltd is considering a change in credit standards that would result in an increase of Shs 500 million. Porto Ltd's ratio of variable costs to sales is 70% and it can

accommodate the incremental sales with existing capacity, for incremental sales. The other net working capital investment requirements are 30% of sales and the required rate of return on investment in receivables is 15%. Porto Ltd is now considering a change in credit terms.

The average collection period would increase to 70 days, and the new bad debt ratio loss which applies to all sales i.e old and incremental, would be 3%.

Required:

- (i) Ascertain the incremental investment from lengthening credit terms. **(8 marks)**
 - (ii) Advise Porto Ltd on whether it should implement the new policy? **(6 marks)**
- (Total 20 marks)**

SECTION C

Question 5

During a recent seminar organized by the Institute of Certified Public Accountants of Uganda, one of the participants suggested new areas that should be addressed by the Institute in future seminars, namely;

- (i) Barriers to market entry for small firms.
- (ii) Preparation of a Prospectus.
- (iii) Use of ratio analysis in the comparison of the performances of companies in the same industry.

Required:

You are one of the 5 Resource persons who have been requested by the Institute to prepare parts of each of the above-suggested topics as follows;

- (a) To outline the barriers to market entry for a small firm. **(6 marks)**
 - (b) To mention the components a company prospectus (company seeking to sell shares to the public). **(8 marks)**
 - (c) To outline the limitations of using ratios to compare performance of different companies. **(6 marks)**
- (Total 20 marks)**

Question 6

On 19 October 2004, a financial reporter for The New Vision newspaper held an interview with the Director in Charge of Financial Markets at Bank of Uganda. Below are extracts of the Director's analysis:

"Buying government treasury bonds is arguably one of the most risk-free investments one can ever undertake". "Bonds are bought and sold at a negotiated price. The interest earned will depend on the coupon interest rate and whether the bid was priced at a discount or premium", he further explained.

Required:

- (a) Explain the phrase "treasury bonds". **(2 marks)**
 - (b) Mention the various categories of government bonds currently issued by Bank of Uganda. **(4 marks)**
 - (c) Explain the following phrases:
 - (i) "Bond priced at a discount". **(2 marks)**
 - (ii) "Bond priced at par value". **(2 marks)**
 - (iii) "Bond priced at a premium". **(2 marks)**
 - (d) Give four advantages of Bonds. **(8 marks)**
- (Total 20 marks)**