

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

CORPORATE FINANCIAL MANAGEMENT - PAPER 18

THURSDAY, 24 JUNE 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

The senior management team of Uganda Sports Press Association (USPA) recently held a day-long meeting trying to agree on how to invest their spare cash, having recently secured some major funding for their annual events. The first item on the agenda was to form a trading limited company USPA-P Ltd, which was adopted with little debate.

The Chairman, having some experience in financial management matters allowed members to suggest all sorts of avenues, provided that such avenues made “business sense”. He explained that he needed avenues that can ensure their money at least maintains its value. He noted that what matters in the “subsidiary” company was maximising shareholders’ wealth. The sponsors, being businessmen and women would be happy with this.

One senior journalist informed the committee that the Bank of Uganda recently issued 2-year, 3-year and 5-year Treasury bonds with coupon rates of 10.25%, 10.50% and 10.75% respectively. He said, “in my opinion, I consider this a rather much safer investment. The “coupon rate” on the bonds is good, and the ‘yield to maturity’ for those who participated in the primary auction was an average of 15%. ...this security has actually brought yield curves to normalcy”.

The Chairman agreed they must explore this Treasury bond thing. He however said diversification was a must, at which a member submitted the following project proposal, assuring the meeting it was backed by research and was ‘original’.

The Company can invest in manufacture of sports equipment (Coded: Sport-Equip) for a total initial investment of Shs 500 million, with the following revenues and costs:

Year	2006	2007	2008	2009	2010
	Shs million	Shs million	Shs million	Shs million	Shs million
Sales	450	510	520	560	610
Costs	(260)	(300)	(350)	(400)	(450)
Depreciation	(100)	(100)	(100)	(100)	(100)
Interest	<u>(50)</u>	<u>(50)</u>	<u>(50)</u>	<u>(50)</u>	<u>(50)</u>
Profit before tax	<u>40</u>	<u>60</u>	<u>20</u>	<u>10</u>	<u>10</u>

The company would need to finance the project partly using internally generated funds and the balance would be borrowed. The interest cost shown above shows the cost associated with this borrowing. The company would pay tax at a rate of 30% payable one year after the accounting period end, and the depreciation is the same as the writing down allowance for tax purposes. The company’s cost of capital is expected to be 15%.

A member remarked that, “.. being a new company, borrowed capital is going to be much more costly than you think. ...in any case, with the current competition, this project is more risky than is apparent”.

Some members are now rather confused, and their only hope is in you, a Level 4 CPA(U) student, and they require some clarifications. The matters for which clarification is required are set out below.

Required:

- (a) Explain to the members the meaning of the following terms:
- (i) Coupon rate.
 - (ii) Yield to maturity.
 - (iii) Yield curve.
- (6 marks)**
- (b) USPA-P Ltd participated in the primary auction for the 5-year treasury bond at the end of March 2004, and the company requires a minimum return of 15% and required a maturity value of Shs 400 million.
- Assuming that interest is paid annually, how much did the company invest?
- (6 marks)**
- (c) If USPA-P Ltd bought the same bond in the same week of auctioning from UJA Ltd at Shs 360 million, what would be the yield to maturity using the same assumptions?
- (9 marks)**
- (d) Advise USPA-P Ltd if they should undertake the sport-equip project. Derive the Adjusted Present Value (APV) and explain to the directors the difference between Net Present Value (NPV) and APV.
- (15 marks)**
- (e) Why should a company use a higher discount rate for more risky projects?
- (6 marks)**
- (f) Explain at least four approaches that USPA-P Ltd should use to mitigate the risk associated with long-term projects like Sports-equip.
- (8 marks)**
- (g) Assuming USPA-P Ltd wanted to raise more funds to expand their investment portfolio, explain why they may or may not issue corporate bonds, and what they could do to raise venture capital.
- (10 marks)**
- (Total 60 marks)**

SECTION B**Question 2**

UgaBrew Ltd is a medium sized un-quoted beverages manufacturer. The company proposes to obtain a listing on the Uganda Securities Exchange, and issue shares to raise fresh capital.

The company's most recent net profit after tax was Shs 684 million. The following is the summarised balance sheet at the end of that year:

ASSETS:	Shs million
Non-current assets:	
Land and buildings	2,650
Plant and machinery	<u>1,070</u>
	3,720
Current assets:	
Inventory	1,200
Accounts receivable	1,500
Short-term investments	100
Cash	<u>40</u>
Total Assets	<u>6,560</u>
EQUITY AND LIABILITIES:	
Capital and Reserves:	
Ordinary shares of Shs 5,000 each	1,200
Accumulated profits	1,760
Non-current Liabilities:	
12% debentures	1,240
Current Liabilities:	
Trade payables	1,010
Bank overdraft	1,100
Other payables	250
	<u>2,360</u>
Total Equity and Liabilities	<u>6,560</u>

Additional information:

- Market value of land and buildings is estimated at Shs 3 billion, while that of machinery is Shs 950 million. Inventory includes Shs 25 million of absolute stock which is saleable at 40% of book value. 15% of the accounts receivable are considered doubtful.
- The capital investment after the new issue is expected to increase after-tax profits by Shs 340 million in the first year. They plan to maintain their pay out ratio at 40%, and the amount of dividend paid out is expected to grow at an average rate of 6% per annum for the foreseeable future.

- To arrive at the pricing for the new issue, it is proposed that they value the shares on the basis of similar quoted companies in the same industry, and the following companies are considered broadly similar in size and gearing levels:

	EZ Drinks Ltd	Wa Beverages Ltd
Share price (Shs)	12,000	5,500
Earnings per share (Shs)	2,400	1,920
Equity beta	1.1	1.9

- The Treasury Bond's current yield is 10% per annum, and is expected to remain fairly stable for the foreseeable future. The average market return in Uganda is estimated tax 18% per annum.

Required:

- On the basis of at least three valuation methods, advise the managers of UgaBrew Ltd, on the current value per share of their company.
(12 marks)
- Which of the valuation methods in (a) above would you recommend as most reliable, and why?
(4 marks)
- For the method you have recommended in (b) above, how many shares should they issue in order to raise Shs 800 million, assuming issue costs amount to 1.5%.
(4 marks)

(Total: 20 marks)

Question 3

At a seminar hosted by the Uganda Bankers Association on Capital Markets Development, a discussant made the following remark, "... the development of the financial sector and the Ugandan economy in general shall greatly depend on how fast the capital markets develop. Unfortunately, even in developed countries, these markets remain inefficient, and the efficient market hypothesis is just that; a hypothesis ...". You attended the seminar.

You are required to write a memo to your Managing Director on the following:

- Outline the major functions played by capital markets, and explain the importance of each function for corporate financial management.
(8 marks)
- Describe the Efficient Market Hypothesis (EMH) and explain how relevant the hypothesis is to the Ugandan situation, in the context of the remarks of the discussant.
(12 marks)

(Total 20 marks)

Question 4

Kasese Liquors Limited has accepted an order to export 4,500 cases of Kasese Whisky to Arusha (Tanzanian) at a price of Tanzanian Shillings 150,000 per case. The goods are to be shipped immediately, but payment is only expected in 3 months' time. Kasese Liquors operates a bank overdraft account that is fully drawn, and the company has no spare cash to finance the credit period. The company borrows at 2% above, and can deposit at 2% below, the current Bank of Uganda special exporters' rate of 6%.

The Finance Director of Kasese Liquors Limited is undecided on whether he should cover the currency risk of the transaction through the forward foreign exchange market or the money market. He is also undecided on whether to insist on a Banker's acceptance, or to take out short-term export credit insurance.

Exchange rates for the Tanzanian shilling in the Kampala market are as below:

	Tzsh/Shs
Spot	0.59 – 0.61
1 month forward	0.62 – 0.67
3 months forward	0.69 – 0.73

Deposit and lending rates for short-term funds in the Tanzanian financial market are as follows:

Borrowing rate	16% p.a.
Deposit rate	8% p.a.

Required:

- (a) Advise the Finance Director whether the forward market or the money market would offer the cheaper hedge; your recommendations should be supported by appropriate calculations. State the main limitations/risks of each of the two strategies.

(12 marks)

- (b) After one month it is found that the consignment has gone astray, and the Tanzanian buyer consequently cancels the order. If Kasese Liquors had sold Tanzanian Shillings three months forward, what action could they now take to retrieve the situation? Assume there is no insurance policy.

(3 marks)

- (c) Distinguish between a banker's acceptance and short-term export credit insurance, explaining the advantages of each.

(5 marks)**(Total 20 marks)**