

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA (U) EXAMINATIONS

LEVEL TWO

FINANCIAL ANALYSIS – PAPER 9

WEDNESDAY, 23 JUNE 2004

INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours**
2. Attempt **all** questions in Section **A**, any **three** questions from Section **B** and **one** question from Section **C**.
3. Section **A** has **ten** compulsory questions; each carrying 2 marks.
4. Section **B** has **four** questions and only **three** questions are to be attempted. Each question carries 20 marks.
5. Section **C** has **two** questions and only **one** question is to be attempted. Each question carries 20 marks.
6. Please read further instructions on the answer book.

SECTION A**Question 1**

- (i) Which of the following classes of risk cannot generally be avoided, hedged and / or mitigated?
- (a) Financial risk.
 - (b) Business risk.
 - (c) Interest rate risk.
 - (d) Currency risk.
- (ii) Which of the following instruments are on the Ugandan money market?
- (i) Treasury bills.
 - (ii) Stocks.
 - (iii) Certificates of deposit.
 - (iv) Bonds.
 - (v) Commercial paper.
 - (a) (i), (ii), (iv) and (v).
 - (b) (i), (iii) and (v).
 - (c) (i), (iv) and (v).
 - (d) (i), (iii), (iv) and (v).
- (iii) Which of the following is not a relevant measure of short-term solvency?
- (i) Debtors' turnover.
 - (ii) Current ratio.
 - (iii) Acid test ratio.
 - (iv) Interest cover.
 - (v) Gearing ratio.
 - (a) (i), (iv) and (v).
 - (b) (iv) and (v).
 - (c) (i) and (iv).
 - (d) (i), (ii), (iii) (iv) and (v).
- (iv) Dividend policy of a firm is influenced by all the following except:
- (a) Covenants lenders may put on dividend payments.
 - (b) Growth prospects and need for funding.
 - (c) Prospects of an economic slump and need to keep higher reserves.
 - (d) Sustainability of the dividend in future.
- (v) Eunice would like to purchase a two year bond. The bond has a coupon rate of 10% and interest is to be paid semi-annually. She would like to have a yield to maturity of 13%. How much should she quote per Shs 100?
- (a) Shs 94.861.
 - (b) Shs 87.000.
 - (c) Shs 74.000.

- (d) Shs 99.740.
- (vi) Which of the following is correct about the asset based valuation method of valuing a company?
- (a) The published balance sheet is useless since the recorded figures are always far different from the market values.
 - (b) While using book values of assets, accumulated depreciation is ignored since different companies use different depreciation methods.
 - (c) The most recent balance sheet is used, and the net worth is adjusted to reflect market values of assets rather than depreciated historical costs.
 - (d) Intangible assets particularly goodwill on the balance sheet should be included in the value even if it is not purchased.
- (vii) Uganda Fruits Ltd has three investment opportunities, but has a limited investment budget for the current year and will not be able to invest in all profitable opportunities.

The details of the project are as follows:

	Initial outlay Shs million	Total present value Shs million
Apples	300	385
Guavas	360	440
Pineapples	240	315

Assuming the company wants to maximise the value of its shareholders, what should be the order of priority for the three projects?

	Order of priority		
	Apples	Guava	Pineapple
(a)	1	2	3
(b)	3	1	2
(c)	3	2	1
(d)	2	3	1

- (viii) NetPV Ltd used the Net Present Value and Internal Rate of Return methods of investment appraisal to evaluate a project that has an initial capital outlay and net cash inflows over its life. After the evaluation had been undertaken, it was discovered that the cost of capital had been incorrectly estimated, and that the correct cost of capital figure was actually lower than that used.

What will be the effect on the NPV and the IRR figures on correction of this error?

	NPV	IRR
(a)	Decrease	Decrease.
(b)	Decrease	Increase.
(c)	Increase	No change.
(d)	Increase	Decrease.

- (ix) Return on capital employed may not be improved by:
- (a) Increasing the asset turnover.
 - (b) Better management of working capital.
 - (c) Avoiding all sorts of credit.
 - (d) Improving on the utilisation of assets.
- (x) The shares of UAA (U) Ltd have a beta of 0.6 and the shares of UBB (U) Ltd have a beta of 2.0. Investors expect a rate of return of 6% from the shares of UAA (U) Ltd and the expected returns to the market are 8%.

Using the Capital Assets Pricing Model, what will be the expected rate of return for investors in UBB (U) Ltd?

- (a) 14%.
- (b) 13%.
- (c) 12%.
- (d) 10%.

SECTION B

Question 2

- (a) Explain four major objectives of a firm . (8 marks)
- (b) The following financial statements were extracted from the books of Uganda Clay Products Ltd (UCPL) as at 31 May:

Income Statement for the year ending 31 May

	2004 Shs '000	2003 Shs '000
Sales	875,800	798,500
Gross profit	330,200	299,850
Admin, selling & other expenses	(203,000)	(196,000)
Earnings before interest and tax	127,200	103,850
Interest charges payable	(22,500)	(25,600)
Net profit before taxation	104,700	78,250
Corporation tax	(16,000)	(23,000)
Net profit after taxation	88,700	55,250
Proposed dividend	(23,000)	(26,300)
Retained profit for the year	<u>65,700</u>	<u>28,950</u>

Balance Sheet as at 31 May

ASSETS	2004	2003
Non-current assets:	Shs '000	Shs '000
Freehold land and buildings	154,300	134,000
Plant, equipment and machinery	<u>95,600</u>	<u>97,000</u>
	<u>249,900</u>	<u>231,000</u>
Current assets:		
Inventory	123,450	156,200
Accounts receivables	<u>131,200</u>	<u>108,280</u>
	<u>254,650</u>	<u>264,480</u>
Total assets	<u>504,550</u>	<u>495,480</u>
EQUITY & LIABILITIES		
Equity & reserves:		
Ordinary shares @ Shs 50	40,000	40,000
Revaluation reserve	42,200	36,200
Accumulated profits	<u>156,230</u>	<u>127,280</u>
	<u>238,430</u>	<u>203,480</u>
Non-current liabilities:		
8% Debentures	75,000	121,300
Current liabilities:		
Trade payables	97,000	81,000
Other payables	22,000	77,200
Bank overdraft	<u>72,120</u>	<u>12,500</u>
	<u>191,120</u>	<u>170,700</u>
Total Equity and Liabilities	<u>504,550</u>	<u>495,480</u>

Required:

- (i) Calculate the asset turnover, debt-equity ratio, return on capital employed and dividend cover. (8 marks)
- (ii) Comment on the profitability of Uganda Clay Products Ltd on the basis of the information given above. (4 marks)
- (Total 20 marks)**

Question 3

- (a) Explain the key responsibilities of a finance manager. (6 marks)
- (b) Explain the term “invoice discounting”. Give one advantage and one disadvantage of its use as a way of improving cash flows. (5 marks)
- (c) Explain three sources of finance that an investor in the education sector may need to access for further expansion, explaining why you consider each of them appropriate. (9 marks)

(Total 20 marks)**Question 4**

A member of the Uganda Grain Traders Association (UGTA) has come to you saying that he has problems securing purchases on credit, yet all his customers insist on buying on credit. He is complaining, "... it has destabilised my cash operating cycle. It has caused a mismatch between my funding and application of funds. I wish my customers understood how expensive it is to finance credit sales".

He provides you with the following figures to prove his point.

Description	1 June 2003	31 May 2004
Inventory	55,000	65,000
Accounts receivable	95,000	106,000
Trade payables	30,000	45,500

Total turnover for the year to 31 May 2004 was Shs 460 million, while purchases were Shs 380 million. You may assume that all sales were on credit, while 60% of the purchases were on credit.

Required:

- (a) Explain the term "cash operating cycle", and estimate the cash operating cycle for the UGTA member.
(8 marks)
- (b) Why do you think the above mentioned member of UGTA has problems getting credit?
(4 marks)
- (c) What are the key considerations when a company is assessing credit customers, and where can it obtain such information?
(8 marks)

(Total: 20 marks)**Question 5**

BNKCOM Ltd is considering a project with an expected life of four years. The investment has a total initial cost of Shs 26.3 billion. The company can raise Shs 9.6 billion from internally generated funds to finance the project. Shs 9 billion will be raised from the issue of shares and the remainder from a fixed rate term loan at 14% per annum. This financing shall not alter the capital structure of the company, which is now at its optimum level.

Costs of arranging the term loan are estimated to amount to 2%. The Treasury Bill rate is now at 10%, the market return is 16% and the appropriate asset beta for this investment is estimated at 1.4.

The following are the expected cash flows from the project:

Year:	1	2	3	4
Cash flow in Shs billion:	8.2	19.6	7.8	6.8

Required:

- (a) How much money does the company need to borrow?
(2 marks)
 - (b) Calculate the cost of capital that the company should use in investment appraisal.
(3 marks)
 - (c) Calculate the project's Internal Rate of Return (IRR).
(12 marks)
 - (d) Would you recommend the company to go ahead with the project and why?
(3 marks)
- (Total 20 marks)**

SECTION C**Question 6**

- (a) Give four types of financial institutions.
(2 marks)
 - (b) Explain the role that financial institutions play in the development of an economy.
(6 marks)
 - (c) What are the contributions of a well developed securities exchange to any country?
(6 marks)
 - (d) Explain why many Ugandan companies are not listed on the Uganda Securities Exchange.
(6 marks)
- (Total 20 marks)**

Question 7

- (a) What risks are associated with acquisition of funds external to the economy?
(10 marks)
 - (b) What are the main risks that investors or companies face in a country like Uganda, and how do they manage them?
(10 marks)
- (Total 20 marks)**