

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA (U) EXAMINATIONS

LEVEL TWO

FINANCIAL ANALYSIS – PAPER 9

WEDNESDAY, 22 JUNE 2005

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) The Bank of Uganda and Uganda Bankers' Association introduced an Electronic Fund Transfer (EFT) system in August 2003. Which of the following statements is false about the EFT system?
- (i) The system does not use cheques.
 - (ii) The system can be used by schools, universities and other institutions to streamline the process of payments.
 - (iii) A payer without a bank account can transfer money provided he deposits enough cash.
 - (iv) Utility companies for water and electricity that receive periodic payments can improve efficiency of debt collection.
- (a) (i) and (ii).
 - (b) None of the above.
 - (c) (i) and (iv).
 - (d) (i), (ii), (iii) and (iv).
- (ii) Which of the following statements accurately reflects an assertion of the weak form of the efficient markets hypothesis?
- (a) Investors have access to all relevant information.
 - (b) The price of a share will fluctuate randomly around its 'true value'.
 - (c) Over the long term, the expected return from all shares will be the same.
 - (d) Past movements in share prices cannot be used to predict future movements in share prices.
- (iii) Investors have an expected rate of return of 8% from the share of Anote Limited, which have a beta of 1.2. The expected returns to the market are 7%.
- What will be the expected rate of return from ordinary shares in Rigel Limited, which have a beta of 1.8?
- (a) 9.0%.
 - (b) 10.5%.
 - (c) 11.0%.
 - (d) 12.6%.
- (iv) Which of the following securities is cross listed on all the three stock exchanges of East Africa?
- (a) Uganda Clays Ltd.
 - (b) British American Tobacco Uganda.
 - (c) Kenya Airways.
 - (d) Uganda Breweries Ltd.

- (v) A four-year investment project is expected to cost Ushs 1.2 billion, with expected annual cash inflows of Ushs 400 million. The company's weighted average cost of capital is 8%. What is the projects internal rate of return?
- (a) 12.59%.
 - (b) 33.33%.
 - (c) 16.00%.
 - (d) None of the above.
- (vi) Which of the following will reduce financial gearing of a company, holding other factors constant?
- (a) Script dividend and a Stock split.
 - (b) Stock dividend and a downward revaluation of non current assets.
 - (c) A rights issue and an upward revaluation of non current assets.
 - (d) A mixture of a cash dividend and a stock dividend.
- (vii) Bank risks which generally occur as a result of the uncertainty about timing and amount of cash outlays that a bank may need are known as:
- (a) The amount of capital that minimizes cost of debt that maximizes returns to the shareholders.
 - (b) The debt to equity ratio at which the value of the firm is minimized.
 - (c) The mix of debt, preferred stock, and common equity that minimizes the weighted cost of its capital employed.
 - (d) The level of debt and equity that minimizes the cost of borrowing.
- (viii) Which of the following considerations is irrelevant in assessing how to invest short-term cash surpluses?
- (a) The risks associated with calling in the investment early.
 - (b) The length of time for which the funds are available.
 - (c) The return offered on the investment in relation to the investment involved.
 - (d) The return offered in the capital markets.

The following information relates to questions (IX) and (X):

In Kamp Republic, the risk free rate of return is 12%, while the market rate is 16%. The company A's beta (β) is 1.6 and B's is 0.8. Both companies recently paid a dividend of KRShts 500 per share, which is expected to continue indefinitely.

- (ix) What is the estimated expected return for company A and B respectively?
- (a) 18.4%; 15.2%.
 - (b) 17.6%; 16.8%.
 - (c) 13.6%; 12.8%.
 - (d) 28.0%; 14.0%.

- (x) What is the share price for company A and company B?
- (a) KPShs 2,216; KPShs 3,319.
 - (b) KPShs 2,717; KPShs 3,289.
 - (c) KPShs 8,000; KPShs 4,000.
 - (d) KPShs 2,000; KPShs 1,000.

SECTION B

Question 2

The following information was extracted from the books of Good Rations Ltd, for the years 2003 and 2004:

Balance Sheet, as at 31 December 2004

	2004	2003
ASSETS	Note Ushs million	Ushs million
Non-current Assets		
Property, Plant & Equipment	14,050	10,272
Good will	<u>4,600</u>	<u>5,000</u>
	<u>18,650</u>	<u>15,272</u>
Current Assets		
Inventories	2,393	530
Trade and other receivables	22,292	19,671
Prepayments	2,100	2,560
Cash and Bank	<u>5,500</u>	<u>2,108</u>
	<u>32,285</u>	<u>24,869</u>
Total Assets	<u>50,935</u>	<u>40,141</u>
EQUITY AND LIABILITIES		
Capital and reserves		
Issued Capital	<u>5,000</u>	<u>5,000</u>
Retained Earnings	<u>21,900</u>	<u>13,831</u>
	<u>26,900</u>	<u>18,831</u>
Non-current liabilities		
Mortgages	<u>13,000</u>	<u>16,000</u>
Current liabilities		
Trade and other payables	5,835	2,310
Short-term borrowings	<u>5,200</u>	<u>3,000</u>
	<u>11,035</u>	<u>5,310</u>
Total Equity and Liabilities	<u>50,935</u>	<u>40,141</u>

Income Statement, for period ended 31 December 2004

	2004	2003
	Ushs million	Ushs million
Revenue	77,883	70,184
Cost Of sales	<u>(27,675)</u>	<u>(36,429)</u>
Gross profit	50,208	33,755
Distribution costs	(19,670)	(11,300)
Administrative costs	(16,560)	(10,200)
Other operating expenses	<u>(2,450)</u>	<u>(2,900)</u>
Profit from operations	11,528	9,355
Income tax expense	<u>(3,459)</u>	<u>(2,807)</u>
Net profit for the period	<u>8,069</u>	<u>6,548</u>

Additional Information:

- (i) The nominal value per share is Ushs 10,000 while the current market value per share is Ushs 40,000.
- (ii) The company paid Ushs 1.0 billion in dividends for year 2003, and has declared Ushs 1.4 billion for the year 2004.

Required:

- (a) Compute: Return on capital employed; Asset turnover; Earnings per share; Dividend per share and the dividend yield.
(10 marks)
- (b) Comment on Good Rations Limited's profitability over the two years.
(5 marks)
- (c) Outline measures that any company facing liquidity problems can take to overcome them.
(5 marks)

(Total 20 marks)**Question 3**

- (a) Explain three functions of a Finance Manager.
(6 marks)
- (b) Explain the terms:
 - (i) Present value
 - (ii) Annuity.
(3 marks)
- (c) Give three reasons for time preference of money.
(3 marks)
- (d) Mr. Markot was given redeemable bonds that pay nominal interest of 12% payable twice a year. The bonds mature in three years, when he shall receive the principal sum of Ushs 25 million. If the current rate for such investment is 10%, what is the present value of the future receipts? (Ignore taxation).
(4 marks)

- (e) Assuming the bond in (d) above is irredeemable, compute the present value of its future receipts.

(4 marks)

(Total 20 marks)

Question 4

- (a) Why do long-term capital projects require more careful planning than shorter projects?

(4 marks)

- (b) Distinguish between an independent project and a mutually exclusive project.

(2 marks)

- (c) Give one advantage and one disadvantage of:

- (i) Accounting Rate of Return and
- (ii) Net Present Value appraisal techniques

(4 marks)

- (d) Wekembe Enterprises are preparing their new five-year plan. They are faced with a choice between two mutually exclusive projects code named Nalubaale and Bujjagali. The following are the **cash flows** for the five-year projects:

	Nalubaale Shs million	Bujjagali Shs million
Initial investment	-500	-650
<i>Cash inflows:</i>		
Year 1	200	340
Year 2	200	300
Year 3	200	150
Year 4	150	150
Year 5	150	100
Scrap value	0	50

All the initial investment is depreciable. The company's cost of capital is 14%.

Required:

Evaluate the Nalubaale and Bujjagali projects using the Accounting Rate of Return and Net Present Value appraisal techniques. Basing on your results, advise management on the project to choose.

(12 marks)

(Total 20 marks)

Question 5

- (a) Trade credit is a cost free source of finance.
Explain why businesses give trade credit.
(6 marks)
- (b) Explain the concept of working capital and state six factors that influence the working capital needs of a business.
(6 marks)
- (c) ICPAU has registered 300 CPA(U) students for Financial Analysis examination. The cost of printing one examination question paper is Shs 1,200. The cost of holding one examination question paper if a student does not sit the examination is Shs 400. The normal time lag between placing an order for printing and receiving the question paper is estimated to be 14 days.

Required:

- (i) Determine the economic order quantity that ICPAU should order.
(4 marks)
- (ii) Determine the frequency at which ICPAU should make orders.
(4 marks)
(Total 20 marks)

SECTION C

Question 6

- (a) Explain the purpose of security markets.
(6 marks)
- (b) Explain why a company like The New Vision Printing and Publishing Co. Ltd should seek listing on the Uganda Securities Exchange.
(10 marks)
- (c) Why are many Ugandan companies not listed on the Uganda Securities Exchange?
(4 marks)
(Total 20 marks)

Question 7

- (a) Distinguish between systematic and unsystematic risks.
(6 marks)
- (b) Explain the term portfolio diversification.
(4 marks)
- (c) Explain the role of financial institutions in the Ugandan economy.
(10 marks)
(Total 20 marks)