

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

CORPORATE FINANCIAL MANAGEMENT - PAPER 18

WEDNESDAY, 14 DECEMBER 2005

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

TransCom Ltd was incorporated in the year 1999. The company is located in Kampala and specializes in the production of blood testing kits for hospitals- Quickit, over which they have a copyright. They are now faced with challenges of increased competition as a result of regional economic integration. The Managing Director has been to various East and Central African countries, where she has been exploring avenues of expanding business in the region.

A company in neighbouring Rwanda has offered to enter a joint venture with TransCom, and would use the technical expertise and patent rights of TransCom Ltd, and set up a manufacturing operation in Rwanda. It would sell Quickits to Rwanda, a market to which TransCom Ltd has not been exporting. The Rwandan company expects to manufacture the Quickits at 30% less than it costs to manufacture in Uganda due to proximity to key mineral inputs from neighbouring Kisangani (in DRC). The Rwandan company has agreed that it would not export to Uganda within the next five years.

TransCom Ltd's responsibility in the joint venture would be to:

- (i) Provide 40% of the total capital of 460 million Rwandese Francs required to establish production in Rwanda. 60 million Francs of the total capital would be for working capital, the remainder for depreciable non-current assets.
- (ii) Grant full patent rights to produce the Quickits in Rwanda. The patent has five years until it expires.
- (iii) Provide technical expertise to assist in setting up the joint venture.
- (iv) Provide ongoing technical aid.

The joint venture agreement would be for a period of four years, after which time a new agreement would be negotiated, or the Rwandan company would guarantee to buy TransCom Ltd's share of the venture, including future patent rights to produce the Quickits, for a sum of 30 million francs, after any tax liabilities.

The joint venture agreement would provide for equal shares of profits or losses from the venture.

The Quickits are expected to sell in Rwanda for a price (in Year 1) of 7,000 francs per unit. Price will then increase by the expected rate of inflation in Rwanda. 75,000 units are expected to be sold in Rwanda in the first year, rising by 10% per year for the next three years. The joint venture would also sell an expected 20,000 units per year to Burundi at a constant price of US\$ 15 per unit. TransCom Ltd currently exports similar Quickits to Burundi, providing a post-tax contribution of Ushs 210 million per year. Because of the cheaper price of

Quickkits manufactured in Rwanda, it is expected that 40% of these exports would be lost.

Provision of initial technical assistance would cost TransCom Ltd Ushs 120 million, and ongoing aid would cost Ushs 80 million per year in salaries, at current prices. Neither would be tax allowable expenses in Rwanda, although the salaries would be tax allowable in the Uganda. Use of the patent would have no cash cost, but would mean that the patent could not be sold to another Tanzanian company which was willing to pay a constant Ushs 60 million per year for the patent.

Direct costs in Rwanda are expected to be an initial 3,000 francs per unit, and fixed costs 70 million francs per annum; both are expected to increase by the inflation rate in Rwanda. Tax allowable depreciation in Rwanda is available at 50% per year on a reducing balance basis. The corporate tax rate in Rwanda is 25% and in Uganda 30%. A bilateral tax agreement exists between Rwanda and the Uganda. Tax is payable one year in arrears.

Expected inflation rates are 5% per annum in Uganda and 8% per annum in Rwanda, while it is assumed minimal for the USA.

Spot Exchange rates:

Rwandese francs 0.30 / Ushs.

Rwandese francs 540 / US\$.

TransCom Ltd's current after tax cost of capital is 15%. Because of the risk of operating in Rwanda, TransCom Ltd's Finance Director is proposing to use 20% as the cost of capital for the joint venture. TransCom Ltd would finance its capital needs for the new venture with a 9% convertible debenture.

Required:

- (a) Discuss the advantages and disadvantages of establishing international operations by means of joint ventures.
(10 marks)
- (b) Evaluate whether or not TransCom Ltd should participate in the joint venture in Rwanda using the financial data provided above. State clearly any assumptions that you may make.
(25 marks)
- (c) What other relevant factors would influence the decision in (b) above?
(10 marks)
- (d) Explain the key distinguishing characteristics of convertible debentures as opposed to a bank loan.
(5 marks)
- (e) If the required capital was to be raised by 50% through internally generated funds, and the rest through leasing, assess the issues that might arise.
(10 marks)

(Total 60 marks)

SECTION B**Question 2**

Kasese Liquors Ltd (KLL) has accepted an order to export 4,500 cases of Kasese Waragi to Arusha (Tanzania) 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. KLL 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 KKL is undecided on whether to cover the currency risk of the transaction through the forward foreign exchange market or the money market. He is also undecided about 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 follows:

	Tzsh/Ushs
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% per annum.
Deposit rate 8% per annum.

Required:

- (a) Illustrate how a money market hedge or forward market hedge would be used, and recommend the best option. 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 KLL had sold Tanzanian Shillings three months forward, what action could they now take to retrieve the situation? Assume there is no insurance protection.
(4 marks)
- (c) Distinguish between a banker's acceptance and short-term export credit insurance, explaining the advantages of each.
(4 marks)

(Total: 20 marks)

Question 3

- (a) Explain the implications to a company, about “fixed charges” and “floating charges” on assets secured when raising finances. (4 marks)
- (b) Discuss the relevance of: a cap, a floor and a collar while negotiating credit or borrowing contracts. (6 marks)
- (c) Buildex Ltd is a construction company that is owned and managed by two civil engineers. Although sales have remained stable at US\$ 3.2 billion per annum in recent years, the level of debtors has increased significantly. A recent financial report submitted to the owners indicates an average settlement period for debtors of 60 days compared to an industry average of 45 days. The level of bad debts has also increased in recent years and the company now writes off approximately US\$ 65 million worth of bad debts each year.

The recent problems experienced in controlling credit have led to a liquidity crisis for the company. At present, the company finances its debtors by a bank overdraft bearing an interest rate of 14% per annum. However, the overdraft limit has been exceeded on several occasions in recent months and the bank is now demanding a significant decrease in the size of the overdraft.

To comply with this demand, the owners of the company have approached a factor who has offered to make an advance equivalent to 80% of trade debtors, based on the assumption that the level of debtors will be in line with the industry average. The factor will charge a rate of interest at 12% per annum for this advance. The factor will take over the sales ledger of the company and for this service, will charge a fee based on 2.5% of sales. The company believes that the services offered by the factor should reduce bad debts to 1.5% of sales, and should lead to administrative cost savings of US\$ 28 million per annum.

Required:

Calculate the effect on the net profit of Buildex Ltd of employing a debt factor, and discuss your findings.

(10 marks)
(Total 20 marks)

Question 4

- (a) Explain the implications of the efficient market hypothesis for the managers of a company that is listed on the Uganda Securities Exchange.

(10 marks)

- (b) Abotte Ltd is in the air service industry and has invested heavily in a new fleet in recent years. The new fleet has been financed through long-term borrowing, which has proved to be a financial burden, as profits have not grown as quickly as expected. The company has 50,000 ordinary shares of Ushs 10,000 each, and Ushs 9 billion of loan capital, at a floating interest rate, currently at 14% pa. The Board of Directors of Abotte Ltd has decided to reduce the burden of debt by raising Ushs 2.5 billion through a rights issue and then using the amount raised to redeem some of the loan capital.

Profits after taxation for the year to 30 June 2005 were Ushs 800 million and the Board expects to achieve a 25% increase in this figure in the forthcoming year, assuming the rights issue is successful and operational targets are met.

The Board has recently committed the company to a dividend payout ratio of 25% for future years and believes that dividend growth can be sustained at 5% per annum for the indefinite future.

The Board believes that the rights shares should be issued at a 30% discount to the current market value in order for the issue to be successful. Ignore share issue costs.

Shareholders have a required rate of return of 12%.

Required:

Assuming a successful rights issue is made, advise the board the price at which a rights share in Abotte Ltd should be issued; and the number of rights shares that should be issued to raise the finance required.

(10 marks)**(Total 20 marks)**