

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA (U) EXAMINATIONS

### LEVEL THREE

#### FINANCE – PAPER 14

**WEDNESDAY, 14 DECEMBER 2005**

#### 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

Budo Oil Ltd. is a medium scale company that has been operating for five years in East Africa. During one of the Board meetings, one of the outspoken directors suggested that Budo Oil Ltd. would grow much faster due to synergy effect if it merged or took over another company. He went on to enumerate the advantages of growth by acquisition. However, the idea was not taken up by the majority of the directors. They instead opted for Bank financing.

The company employs 40 people, and turnover during the last financial year was Shs. 875,000,000. The Board of Directors has now been asked by the company's bank to provide medium-term financial plans for each of the next three years and to clarify the company's financial objectives.

The Board has decided that the primary financial objectives should be to achieve a return on capital employed (defined as earnings before interest and tax related to shareholders' equity) of 20% per year for each of the first two years, rising to 25% per year in year three, and also to increase dividends per share by 10% per year. The current dividend per share is Shs. 2,500.

Statistical analysis by one of the company's Managers has produced the following relationships for the last two financial years:

| <b>Cost of goods sold</b>           | <b>75% of sales</b>            |
|-------------------------------------|--------------------------------|
| Other expenses (excluding interest) | Shs. 5,000,000 + 18% of sales  |
| Cash (at year end)                  | Minimum 1% of sales            |
| Receivables (at year end)           | Shs. 10,000,000 + 20% of sales |
| Inventories (at year end)           | Shs. 12,000,000 + 25% of sales |
| Payables (at year end)              | 35% of sales                   |

Net non-current assets are currently Shs. 410,000,000, and cash Shs. 9,000,000. Sales, at current prices, are expected to increase by 15% per year for three years depending upon how quickly the economy recovers from a recession.

Existing machinery can only satisfy a demand of up to Shs. 1,100,000,000 per year (current prices), and the purchase of new machinery at a cost of Shs. 200,000,000 (current prices) would be necessary to satisfy higher levels of demand.

The company's current capital structure is:

|   |                |
|---|----------------|
|   | Shs. 000       |
| Ordinary shares (Shs. 50,000 par value) | 200,000        |
| Reserves                                | 149,000        |
| 12% bank loan                           | <u>180,000</u> |
|   | <u>529,000</u> |

No overdraft finance is currently used, but a Shs. 50,000,000 facility exists for short-term financing. The current overdraft interest rate is 10% per year, and interest on any new longer-term debt would be 11% per year.

Additional information:

- (i) Corporation tax is at the rate of 20%.
- (ii) If external finance is required debt will be used wherever possible as the existing shareholders, who are mainly directors, do not have the funds to subscribe for further equity capital. Any new equity that was necessary would be sought from a venture capital organisation.
- (iii) Restrictive covenants on the existing bank loan limit the current ratio to a minimum of 1.3 to 1, and gearing (total loans to shareholders' equity) to a maximum of 80%.
- (iv) Cash is kept in a non-interest bearing current account.

**Required:**

- (a) Explain why Synergy might exist when Budo Oil Ltd. merges with or takes over another company. **(4 marks)**
- (b) Outline the advantages of growth by acquisition as pointed out by the director in the opening paragraph. **(4 marks)**
- (c) (i) Define Venture Capital. **(2 marks)**  
 (ii) If a Venture Capital organisation is to be used by Budo Oil Ltd., what pre-conditions might be advanced by the venture capitalist? **(4 marks)**
- (d) From the information given about Budo Oil Ltd., produce proforma income statements for the next three years. **(10 marks)**
- (e) The bank officials have further asked the directors of Budo Oil Ltd. to present a schedule of funding requirements for the next three years. As a consultant to Budo Oil Ltd., you have been requested to help the directors in preparing the schedule.

**Required:**

Prepare a schedule of funding requirements for the next three years.

- (f) (i) Comment on the current dividend policy of Budo Oil Ltd. **(8 marks)**  
**(2 marks)**  
 (ii) What advice would you give to the management of Budo Oil Ltd. about its current cash management policy? **(2 marks)**

- (g) Compute Budo Oil Ltd's return on capital over the next three years.

**(4 marks)**

**(Total 40 marks)**

## SECTION B

### Question 2

- (a) Katrina, a graduate of CPA(U), recently joined Budu Ltd., a manufacturing company. The company's Board is currently faced with a decision of choosing between two mutually exclusive projects. The Board is interested in choosing the better alternative of the two. Katrina, the new Assistant Finance Manager has been presented with the following information about the projects:

Project XX requires a cash outlay of Shs. 100,000,000 and cash running expenses of Shs. 35,000,000 per year. On the other hand, project YY will cost Shs. 150,000,000 and require cash running expenses of Shs. 20,000,000 per year. Both the machines have an eight-year life. Project XX has a Shs. 14,000,000 salvage value. The company's tax rate is 30% and has a 10% required rate of return. Assume depreciation on straight line basis and no tax on salvage value of assets.

#### Required:

- (i) Which project should Katrina recommend to the Board?  
**(8 marks)**
- (ii) Why do investment decisions require special attention in business organisations?  
**(2 marks)**
- (b) Your Managing Director has just attended a meeting with an investment analyst who has suggested that your company's shares are overvalued by 10%. The data used by the investment analyst in her calculations is shown below:

| Year | Total dividends<br>Shs. million | No. of shares | Total earnings<br>Shs. million |
|------|---------------------------------|---------------|--------------------------------|
| 2000 | 5,680                           | 28,600,000    | 18,260                         |
| 2001 | 6,134                           | 28,600,000    | 21,320                         |
| 2002 | 8,108                           | 35,000,000    | 26,710                         |
| 2003 | 10,007                          | 40,000,000    | 28,620                         |

Your company's current share price is Shs. 645 and the cost of equity is estimated to be 12.5%.

#### Required:

- (i) What valuation method was used by the investment analyst?  
**(2 marks)**

- (ii) Prepare a brief report to the Managing Director outlining whether or not the company's shares are likely to be overvalued. Relevant calculations should form part of your report.

**(8 marks)**  
**(Total 20 marks)**

### Question 3

- (a) Give **four** sources of funds that increase cash in a cash flow statement.  
**(4 marks)**
- (b) Explain the following:
- (i) Aging of accounts.
  - (ii) Trend analysis.
- (2 marks)**
- (c) Mr. Batwa, the Managing Director of Egabudde Ltd., is uncertain about the financial status of the company in the last 3 years i.e. 30 September 2003 to 30 September 2005. He has now presented to you the summarized financial statements over the last 3 years below;

#### Summarized Financial Statements of Egabudde Ltd.

|                        | 30 Sept. 2003    | 30 Sept. 2004    | 30 Sept. 2005    |
|------------------------|------------------|------------------|------------------|
|                        | Shs. '000        | Shs. '000        | Shs. '000        |
| Cash                   | 30,000           | 20,000           | 5,000            |
| Trade receivables      | 200,000          | 260,000          | 290,000          |
| Inventory              | 400,000          | 480,000          | 600,000          |
| Net non-current assets | <u>800,000</u>   | <u>800,000</u>   | <u>800,000</u>   |
|                        | <u>1,430,000</u> | <u>1,560,000</u> | <u>1,695,000</u> |
| Trade payables         | 230,000          | 300,000          | 380,000          |
| Accruals               | 200,000          | 210,000          | 225,000          |
| Bank borrowings        | 100,000          | 100,000          | 140,000          |
| Long term loan         | 300,000          | 300,000          | 300,000          |
| Common stock           | 100,000          | 100,000          | 100,000          |
| Retained earnings      | <u>500,000</u>   | <u>550,000</u>   | <u>550,000</u>   |
|                        | <u>1,430,000</u> | <u>1,560,000</u> | <u>1,695,000</u> |
| Sales                  | 4,000,000        | 4,300,000        | 3,800,000        |
| Cost of goods sold     | 3,200,000        | 3,600,000        | 3,300,000        |
| Net profit             | 300,000          | 200,000          | 100,000          |

#### Required:

- (i) Using the relevant ratios, analyze the company's financial condition and performance over the last 3 years and comment on them.

**(12 marks)**

- (ii) Give two dangers of over-relying on ratio analysis.

**(2 marks)**

**(Total 20 marks)**

#### **Question 4**

- (a) Distinguish between an investment banker and an investment broker.

**(4 marks)**

- (b) Viena Uganda Ltd., a newly established company has branches in 56 districts. The company currently has a centralized billing system. Payments are made by all customers to the central billing location. It requires, on the average, 4 days for customers' mailed payments to reach the central location. An additional 1½ days are required to process payments before a deposit can be made. The firm has a daily average collection of Shs. 500,000,000. The company has recently investigated the possibility of initiating 'a new collection' system. It has estimated that with such a system, customers' mailed payments would reach the receipt location 2½ days sooner. Further, the processing time could be reduced by 1 additional day, because each 'new collection centre would pick up mailed deposits twice daily.

#### **Required:**

- (i) Determine the reduction in cash balances that can be achieved through the use of a new collection system.

**(5 marks)**

- (ii) Determine the opportunity cost of the present system, assuming a 5% return on short-term investments.

**(3 marks)**

- (iii) If the annual cost of new collection system were Shs. 75,000,000, should such a system be initiated?

**(3 marks)**

- (iv) Give five sources of information relevant in assessing the credit worthiness of a customer.

**(5 marks)**

**(Total 20 marks)**

**SECTION C****Question 5**

- (a) The following was an abstract from the New Vision newspaper of 8 November 2005.

**Bank of Uganda:  
Financial News Report:**

The following were the developments in the financial market interest rates:

| Rates at   | Oct 26, 2005 | Nov. 02, 2005 |
|--|--------------|---------------|
| 2-year Treasury bond Annualised yield.<br>(Primary market) | 14.67        | 14.67         |
| (Secondary market)   | 13.92/13.67  | 13.60/13.30   |
| 3-year Treasury bond Annualised yield.<br>(Primary market) | 15.29        | 15.29         |
| (Secondary market)   | 15.22/14.97  | 14.80/14.55   |

**Required:**

- (i) Explain the difference between Primary market and Secondary market as used in the abstract above.  
(4 marks)
- (ii) What role do the Government of Uganda Treasury Bonds play in the economy?  
(4 marks)
- (b) Explain the meaning of the following phrase; “A Sweetener when selling debt.”  
(2 marks)
- (c) Give the weakness of the dividend valuation model.  
(4 marks)
- (d) During a recent budget speech by the Minister of Finance, Planning and Economic Development, he said that the government of Uganda has a number of options recognized internationally which can be used to reduce the current debt problem.

**Required:**

Explain four methods which the government can employ to reduce the debt problem.

(6 marks)  
(Total 20 marks)

**Question 6**

- (a) Give four advantages of obtaining a stock exchange listing on the Uganda Securities Exchange.

**(4 marks)**

- (b) Your Managing Director has just returned from the ICPAU Annual Seminar held in Entebbe. His main area of interest was a topic on “Market Efficiency”. He is now puzzled as he was told in the seminar that if markets are efficient all investments have an expected NPV of zero, yet his finance manager has told him that it is essential for the company to maximize its expected NPV. He also wonders how recent stock market volatility can be explained if the market is efficient.

**Required:**

Produce a brief report for the Managing Director outlining his concerns, and the importance of market efficiency to capital investment decisions.

**(10 marks)**

- (c) Mr. Omanywa is the Managing Director of Kamu Kamu Pharmaceuticals (U) Ltd. He also holds the position of Secretary on the Uganda Pharmaceutical Board. This Board among other things is responsible for the importation of all the Pharmaceutical products into the country. Recent reports in the media have expressed concern about the continued importation into the country of some sub-standard drugs. The office of the IGG has now taken up the matter and has appointed a commission of inquiry into the matter. Among the strong five commission team, is the Finance Director of Kamu Kamu Pharmaceuticals (U) Ltd., Mr. Mukasa Dema, a well known and highly respected professional.

**Required:**

- (i) Explain the financial ethical issues involved here.

**(4 marks)**

- (ii) What would be the right course of action for Mr. Mukasa Dema to take in this case?

**(2 marks)****(Total 20 marks)**