

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA (U) EXAMINATIONS

LEVEL TWO

FINANCIAL ANALYSIS – PAPER 9

WEDNESDAY, 14 DECEMBER 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) Below are the points prepared by a CPA student for group discussion:

- (i) Time value of money.
- (ii) Rate of inflation.
- (iii) Risk.

Which of the following statements summarizes the student's points?

- (a) The points relate to methods of appraising investments.
- (b) They are factors that influence the real growth rate of an economy.
- (c) They relate to the basic assumptions of Capital Assets Pricing Model (CAPM).
- (d) They constitute the required rate of return.

(ii) Which of the following is a mismatch?

- (a) Over the counter.
- (b) Market order.
- (c) Limit order.
- (d) Short sale.

(iii) Ratios which indicate the efficiency with which management is using the firm's resources are called:

- (a) Gearing ratios.
- (b) Activity ratios.
- (c) Profitability ratios.
- (d) Liquidity ratios.

(iv) Which of the following is the overall objective of a firm?

- (a) Profit maximization.
- (b) Wealth maximization.
- (c) Welfare of the society.
- (d) Maximization of employees' welfare.

(v) Which of the following statements is correct?

- (a) Beta (β) measures the covariance between risk and return on a security.
- (b) Risk and return are not directly related.
- (c) Risk and return are positively related.
- (d) Unsystematic risk can be eliminated by diversification and therefore does not affect a security's return.

- (vi) Which of the following statements is false?
- (a) Hard capital rationing refers to externally imposed limits on investment expenditure in the presence of positive NPV projects.
 - (b) Hard and soft capital rationing occur when funds are not available to finance all wealth-enhancing projects.
 - (c) Soft capital rationing refers to internal management limits on investment expenditure despite the availability of positive NPV projects.
 - (d) Soft capital rationing refers to internal management imposed limits on investment expenditure in the absence of positive NPV projects.
- (vii) Select the best combination of factors that a financial institution must consider before granting any credit facility:
- (i) Number and qualifications of all firm's employees.
 - (ii) Firm's cash flow projections.
 - (iii) Firm's credit rating / worthiness.
 - (iv) Availability of security.
 - (v) Marital status of all bank accounts' signatories.
- (a) (i), (ii) and (iii).
 - (b) (ii), (iii) and (iv).
 - (c) (iii), (iv) and (v).
 - (d) (i), (iii) and (v).
- (viii) Eni Ara (U) Ltd has just completed a Ushs 3.5 billion project that will yield Ushs 650 million every year forever (starting a year from now). Another company FDCO (U) Ltd, whose cost of capital is 15%, is considering taking over the project. What is the present value of this project in view of FDCO (U) Ltd?
- (a) Ushs 4,643 million.
 - (b) Ushs 4,150 million.
 - (c) Ushs 3,500 million.
 - (d) Ushs 1,143 million.
- (ix) Which of the following is not an advantage of debt finance?
- (a) Debt has a lower cost than equity finance.
 - (b) Debt holders generally do not have votes.
 - (c) Interest payment is tax deductible.
 - (d) Most debt finance (over 70%) does not require security.

- (x) The Uganda Ginners Ltd. has UShs 500,000,000 in equity and UShs 1,000,000,000 of 8% irredeemable debentures in issue. The debentures have a market price of UShs 92 per UShs 100 of nominal value.

Given that the corporation tax rate is 30% and the required rate of return on equity is 15%, determine the company's cost of debt.

- (a) 8.0%.
- (b) 5.6%.
- (c) 8.7%.
- (d) 10.3%.

SECTION B

Question 2

- (a) Explain the term "financial assets" and list three main risks associated with financial assets. (5 marks)
- (b) List and explain any five properties, which determine the attractiveness of financial assets. (10 marks)
- (c) Kaaita (U) Limited is a public company limited by shares. During the year ended 30 November 2005, the company paid a dividend of UShs 60,000,000. It is expected that the company's dividend will grow by 10% per annum forever. The shareholders are currently expecting a return of 25%. An investor would like to know the total market value of Kaaita (U) Ltd.

Required:

Using the dividend growth model, compute the expected market value of the company.

(5 marks)
(Total 20 marks)

Question 3

The newly appointed Finance Manager for Good Timbers Ltd (GTL) is facing pressure from colleagues to do something fundamental about the company's working capital management. They are concerned that there is heavy investment in working capital as the cash cycle is generally too long.

The following figures are available from the company's books:

Description	1 September 2004	31 August 2005
	UShs 000	Ushs 000
Inventory	75,000	90,000
Accounts receivable	105,000	124,000
Trade payables	60,000	55,600

Total turnover for the year to 31 August 2005 was US\$ 460 million, while purchases were US\$ 360 million. You may assume that all sales were on credit, while 70% of the purchases were on credit.

Required:

- (a) Explain the term “cash operating cycle”, and its relationship with ‘investment in working capital’.
(4 marks)
 - (b) Estimate the cash operating cycle for GTL.
(6 marks)
 - (c) Why may companies find problems getting trade credit?
(4 marks)
 - (d) Explain four considerations a company will make while assessing credit customers, and any four sources of such information.
(6 marks)
- (Total 20 marks)**

Question 4

Multiple Concepts (U) Ltd is considering a number of projects for their various arms of business, three of which are outlined below;

Project A: The project costs US\$ 810 million, and is expected to generate net cash inflows of US\$ 340 million, 310 million, 290 million, and 270 million over its life of 4 years. A Ugandan financier has shown interest in funding this project.

Project B: The project has the following annual cash inflows: US\$ 400 million, 370 million, 350 million, and 310 million over its 4-year life. They are negotiating with a contractor over the total project costs, while a financier has agreed to finance the project at 12%.

Project C: This involves purchase of a machine at US\$ 500 million. It is expected to provide cash flows US\$ 350 million each in years 1 and 2, and US\$ 300 million each in years 3 and 4. The project has a scrap value of US\$ 80 million.

Required:

- (a) What is Project A’s IRR, and what are the implications of your answer to the project’s cost of funds?
(6 marks)
- (b) Determine the maximum amount which the company should pay for Project B?
(6 marks)
- (c) What is Project C’s ARR?
(6 marks)
- (d) Compare and contrast IRR with ARR.
(2 marks)

(Total 20 marks)

Question 5

The Directors of Madit Traders Union (MTU) are in the process of re-organizing the company, but want to be sure about the current financial performance before they take far-reaching actions. They have provided you with the following information, to assist them to analyze performance and advise them accordingly.

Balance Sheet as at 30th November

	2005	2004
	Shs 000	Shs 000
Freehold land and buildings	772,000	840,735
Fixtures and fittings	275,600	252,000
Motor vehicles	<u>169,000</u>	<u>145,000</u>
	<u>1,216,600</u>	<u>1,237,735</u>
Current assets:		
Inventory	335,000	274,000
Trade receivables	<u>268,000</u>	<u>245,600</u>
	<u>603,000</u>	<u>519,600</u>
Less current liabilities		
Trade payables	157,531	301,000
Proposed dividend	112,000	116,500
Taxation	69,555	88,951
<u>Bank overdraft</u>	<u>140,670</u>	<u>10,000</u>
	<u>479,756</u>	<u>516,451</u>
Net current assets/(liabilities)	<u>123,244</u>	<u>3,149</u>
	<u>1,339,844</u>	<u>1,240,884</u>
Long-term liabilities and capital:		
10% Debentures	485,000	645,000
Ordinary Shares -par value Shs 500	500,000	500,000
Retained earnings	<u>354,844</u>	<u>95,884</u>
	<u>1,339,844</u>	<u>1,240,884</u>

Income Statement for year ended 30 November

	2005	2004
	Shs 000	Shs 000
Sales	3,056,000	2,845,000
Less: Cost of sales	<u>(1,680,800)</u>	<u>(1,479,400)</u>
Gross profit	1,375,200	1,365,600
Administration expenses	<u>(377,000)</u>	<u>(391,000)</u>
Selling and distribution	<u>(486,000)</u>	<u>(371,000)</u>
Earnings before interest and tax	512,200	603,600
Interest charges payable	<u>(48,500)</u>	<u>(64,500)</u>
Net profit before taxation	463,700	539,100
Corporation tax	<u>(92,740)</u>	<u>(118,602)</u>
Net profit after taxation	370,960	420,498
Proposed dividend	<u>(112,000)</u>	<u>(116,500)</u>
Retained profit for the year	<u><u>258,960</u></u>	<u><u>303,998</u></u>

Required:

- (a) Compute any one relevant ratio in the following categories:
- (i) Profitability ratios. **(2 marks)**
 - (ii) Liquidity ratios. **(2 marks)**
 - (iii) Activity ratios. **(2 marks)**
 - (iv) Gearing ratios. **(2 marks)**
 - (v) Investment ratios. **(2 marks)**
- (b) What are the implications of increased “gearing” to a company? **(5 marks)**
- (c) Explain the measures the company should take to improve gearing and profitability ratios. Give two measures in each case. **(5 marks)**
- (Total 20 marks)**

SECTION C**Question 6**

- (a) State and explain four roles of the Capital Markets Authority in the development of Uganda’s economy. **(10 marks)**
- (b) What are the main limitations to the development of capital markets in Uganda? **(4 marks)**
- (c) Explain any three types of securities traded on the Uganda Securities Exchange, giving one advantage of each. **(6 marks)**
- (Total 20 marks)**

Question 7

- (a) What are the main government policies that may affect private businesses, and how?

(8 marks)

- (b) What are the main risks that investors or companies may face in a country like Uganda, and how do they manage them?

(6 marks)

- (c) Explain the term “capital structure”, and its relevance to the financial management of a company?

(6 marks)

(Total 20 marks)