

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA(U) EXAMINATIONS

### LEVEL FOUR

#### CORPORATE FINANCIAL MANAGEMENT - PAPER 18

**THURSDAY, 23 JUNE 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**

- (a) APVA Systems Limited are developing a new telephone switching system that is capable of handling calls from all Ugandan mobile telephone networks at the same time. The initial outlay for this project is Ushs 405 million, of which Ushs 165 million will be provided from internally generated funds, Ushs 150 million from a rights issue and the remainder through a loan at a rate of 14% per annum. The proportion of debt represents the optimum debt capacity of the company.

The expected costs of engineering this project finance are estimated at 2.5% for the rights issue and 1.5% for the term loan. Corporate taxes are payable at the rate of 30% on net operating cash flows. The treasury bills yield is 9%, while the market return is 14 %. An appropriate asset beta for the investment is believed to be 1.5. The project net operating cash flows (after tax) are as follows:

Year	Ushs million
1.	183
2.	192
3.	156

**Required:**

- (i) Estimate the adjusted present value of the project and advise APVA's management whether they should proceed with the investment.  
(10 marks)
- (ii) Why is adjusted present value (APV) deemed to be a more realistic technique of project evaluation?  
(5 marks)
- (b) The value of VAL Investments Ltd's shares was Ushs 75 billion on 1 January 2005. The company planned to raise Ushs 30 billion during the year for new projects.

The capital structure of the company at that date was as follows:

Equity	Ushs 30 billion
Debt	Ushs 45 billion

The coupon rate on new bonds available from the Bank of Uganda is 10%. Equity shares currently selling at Ushs 30,000 per share can be sold for Ushs 27,000 a share. The next dividend is expected to be Ushs 4,000 with a growth rate of 5% per annum. Retained earnings for the year are expected to be Ushs 450 million. The company pays tax at a rate of 30%.

**Required:**

- (i) In order to maintain its capital structure, how much of the new investment must be financed by issue of equity?  
**(5 marks)**
  - (ii) Using the MM theory of capital structure, calculate the cost of both debt and equity.  
**(10 marks)**
  - (iii) Because the company has been growing very fast, the managers are fairly new to the world of investment financing through stock markets.  
Explain why dividends are a cost to the company, and why it is important for dividends to keep on growing. Does dividend policy matter?  
**(10 marks)**
  - (iv) In your assessment, what risks does the company face if the proportion of debt increases? Does capital structure matter?  
**(5 marks)**
- (c) There are several competing views of capital structure and its importance to a firm. These views starting from the traditional view to the Modigliani-Miller propositions, argue for different ways of looking at debt, which has caused a lot of confusion in the mind of your CEO.

**Required:**

Write a memo, explaining the arguments underlying the different points of view presented in these models, and advise the CEO as to how these different views can be reconciled for the benefit of your firm. Assume that you are Pretty Mulungi, the Finance Manager.

**(15 marks)**  
**(Total 60 marks)**

## SECTION B

### Question 2

Buganda Forwarders Ltd (BFL) is negotiating an export contract with a customer in a neighboring country, Kwongo Republic. BFL has not exported to the country before, and is concerned about the risk of late or non-payment for the exports and the foreign exchange risks associated with the Kwongo francs (Kfr). The contract specifies that BFL should receive Shs 55 million Kwongo francs in three months' time. BFL will require short-term finance for the full value of the exports.

Exchange rates	(Kfr/US\$)
Spot	32.34 – 32.89
3 months forward	33.82 – 34.55
6 months forward	35.17 – 35.90

Current short-term Uganda interest rates available to BFL are:

Borrowing 6.5%  
Investing 5.3%

BFL is considering three different ways of protecting against the foreign trade risk:

- (i) Insure the deal with Federo Insurers and undertake a forward market hedge. An insurance policy is available at a cost of 1.25% of the spot Uganda Shilling equivalent of the export value. The policy gives the following protection: 95% cover against non-payment as a result of political actions by a foreign government; 90% cover against other nonpayment. Any payment by the insurer would be after six months.
- (ii) Use the services of a non-recourse export factor. The factor will guarantee that US\$ 1,590,000 is paid in three months' time if the customer pays on time, or US\$ 1,530,000 in six months' time if the customer makes a late payment or defaults. The factor is prepared to provide immediate trade finance of up to 80% of the value of the guaranteed sum, at an interest rate of 6.3%. The factor charges an administration fee of 2.5% of the sum guaranteed.
- (iii) Use a confirmed, irrevocable, documentary letter of credit. The letter of credit would include a 90 day bank bill of exchange that may be immediately discounted in the Kwongo Republic money market at an annual rate of 25%, which is the short term borrowing rate in Kwongo. The fees associated with the letter of credit are US\$ 30,000.

BFL has been advised that there is at least a 5% chance of late payment after six months or default by the client. The Kwongo Government is not expected to take any action that is detrimental to foreign trade during the next six months.

**Required:**

Discuss the advantages and disadvantages of each alternative, and recommend which should be selected. Support your discussion with relevant calculations. State clearly any assumptions that you make.

**(20 marks)****Question 3**

- (a) Uganda Investment Trust is interested in improving the quality of their investment planning. They have approached you to provide them with information regarding the following investment terms:

- (i) Annuities and perpetuities.
- (ii) Yield to maturity.
- (iii) Accounting rate of return and net present value.
- (iv) Time value of money and discount factors.

**Required:**

Write a memo explaining to management of the Trust, the meaning of the above terms and how they can use them in their planning process.

**(8 marks)**

- (b) After appreciating the importance of investment planning, management of the Trust wishes to know whether they should purchase or fabricate their own tools for their manufacturing arm. You are again requested to help them to make a rational decision using the following information:

If the Trust fabricates own equipment, the capital costs are Ushs 100 million, which is incurred immediately in the purchase of various inputs. The equipment would last four years and have a scrap value of Ushs 15 million. Maintenance costs would be Ushs 130 million in year 1, Ushs 140 million in year 2, Ushs 170 million in year 3, and Ushs 180 million in year 4.

If they decide to purchase the equipment outright, the outlays will be Ushs 155 million in years 1 and 2, and Ushs 220 million per year in years 3 and 4. For purposes of analysis, it is assumed that all outlays are incurred at year – end.

The company's current cost of capital is 16%.

**Required:**

Based on the above data, advise management whether to purchase or manufacture their own tools.

**(12 marks)****(Total 20 marks)**

**Question 4**

Multi-Bond (U) Limited have a variety of shareholders, who are keen at learning more about the investments market. They hold a variety of investment securities in the East African region. The Finance Director has asked you to address a planned meeting of their shareholders, and explain to them some key terms common in securities markets.

Meanwhile, the Finance Manager is interested in disposing-off two of their bonds, AB and BB. Bond AB has an annual coupon rate of 6% and Bond BB has an annual coupon of 12%. Both bonds mature in one year and have a per value of Ushs 100 million. The yield to maturity on bonds of this risk class is 10%, and the next coupons are due in one year.

**Required:**

Explain the following issues and their relevance to investment:

- (a) The “beta” attached to a security. **(3 marks)**
- (b) The specific and systematic risk. **(3 marks)**
- (c) Portfolio diversification. **(4 marks)**
- (d) Securitization. **(4 marks)**
- (e) At what price would the bonds AB and BB sell? **(6 marks)**

**(Total 20 marks)**