

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA (U) EXAMINATIONS

### LEVEL THREE

#### FINANCE – PAPER 14

**WEDNESDAY, 22 JUNE 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

Kalangala Ltd is a family controlled company that has grown in ten years from having 10 employees to 400 employees. The company is now considering a listing on the Uganda Securities Exchange through an offer for sale. The company's management has been reminded of the need to have a reliable tool for forecasting the results in future, on time.

Kalangala Ltd's Managing Director believes that, as the company has assets with a book value of Shs 22 billion and reserves of more than Shs 10 billion, the company's value when listed should be at least Shs 32 billion. He proposes that 400,000 shares be issued to the public to raise approximately Shs 2.5 billion for future expansion.

The Company's financial position and performance for the last three years is summarized below:

#### Balance Sheets as at 30 June

	<b>2004</b>	<b>2003</b>	<b>2002</b>
<b>Assets</b>	Shs million	Shs million	Shs million
Non-current assets	12,000	10,000	8,500
<b>Current assets</b>			
Inventories	5,400	4,500	3,600
Trade and other receivables	4,500	3,500	2,800
Cash	<u>100</u>	<u>100</u>	<u>100</u>
<b>Total assets</b>	<u><u>22,000</u></u>	<u><u>18,100</u></u>	<u><u>15,000</u></u>
<b>Equity and Liabilities</b>			
Ordinary shares (Shs 100 per value)	500	500	500
Retained earnings	<u>10,725</u>	<u>9,360</u>	<u>7,800</u>
Shareholders' funds	11,225	9,860	8,300
Borrowings	5,000	3,500	2,000
<b>Current liabilities</b>			
Bank loans	587	500	1,400
Trade and other payables	4,400	3,400	2,500
Current tax	<u>788</u>	<u>840</u>	<u>800</u>
	<u><u>22,000</u></u>	<u><u>18,100</u></u>	<u><u>15,000</u></u>

**Income Statements for the years ended 30 June**

	<b>2004</b>	<b>2003</b>	<b>2002</b>
	Shs million	Shs million	Shs million
Sales	19,000	16,200	13,300
Cost of goods sold	<u>14,400</u>	<u>11,500</u>	<u>9,000</u>
Gross Profit	4,600	4,700	4,300
Administrative costs	950	900	800
Selling, distribution costs	750	700	600
Interest charges	<u>800</u>	<u>700</u>	<u>500</u>
Profit before tax	2,100	2,400	2,400
Taxation	<u>735</u>	<u>840</u>	<u>840</u>
Profit after tax	<u><b>1,365</b></u>	<u><b>1,560</b></u>	<u><b>1,560</b></u>

Additional notes relating to the 2004 financial statements:

- (i) Sales are expected to grow by approximately 20% per year.
- (ii) The company owns a patent which could be sold for Shs 1 billion more than its book value.
- (iii) 2% of the receivables are expected to default.
- (iv) Inventories to the tune of 10% by value are considered to be obsolete.
- (v) Machinery has an estimated realisable value Shs 500 million less than its book value, and buildings Shs 1.5 billion more than their written – down value.
- (vi) Land has never been revalued. Land costing Shs 50 million was purchased 10 years ago and another plot at a cost of Shs 300 million 6 years ago. The value of industrial land has increased by an average of 15% per year during the last 10 years.
- (vii) Kalangala Ltd's management has obtained some financial information on the Securities Exchange about listed companies in the same industry, which have the same number of issued ordinary shares as Kalangala Ltd. To achieve this, management had to study the Nairobi Securities Exchange market as well since the Uganda Securities Exchange had very few.

	<b>Lukaya Investments</b>	<b>Apok Holdings</b>
Market capitalisation	Shs 35 billion	Shs 4.3 billion
Earnings per share	Shs 460	Shs 55
Beta coefficient	1.4	1.35

**Required:**

- (a) Explain the relevance of financial forecasting?  
(2 marks)
- (b) Mention the two methods commonly employed in financial forecasting.  
(2 marks)

- (c) Explain the advantages and disadvantages to Kalangala Ltd of obtaining a stock exchange listing.  
(6 marks)
- (d) Give the types of issue costs that are associated with obtaining a stock exchange listing?  
(3 marks)
- (d) Acting as an external consultant to Kalangala Ltd. You have been requested to do the following;
- (i) Evaluate the Managing Director's assessment of the company's value.  
(5 marks)
- (ii) Comment on the suggestion by the Managing Director to issue 400,000 new shares.  
(3 marks)
- (iii) Produce a revised estimate of Kalangala Ltd's value using asset basis and P/E ratio methods.  
(14 marks)
- (e) As an external consultant, you have also been requested to offer some financial advice on the profitability of Kalangala Ltd for the years 2002 to 2004 and the way forward.  
(5 marks)

**(Total 40 marks)**

## SECTION B

### Question 2

Bamuturaki Manufacturing Co. Ltd., continuously experiences cash inflow – outflow problems. The company installed a semi-automatic machine only two years ago but now a more advanced model has arrived on the market. This advanced model will not only produce the current volume of the company's product more efficiently, but it will allow an increased output of the product. The Finance Director now predicts a better and improved management of cash inflows/out flows.

The existing machine had cost Shs 32,000,000 and was being depreciated over a ten-year period using the straight-line method, at the end of which it would be scrapped. The market value of this machine is currently Shs 15,000,000 and there is a prospective purchaser interested in acquiring it.

The advanced model now available costs Shs 110,000,000 (at Mombasa Port). Transportation from Mombasa to Kampala, the site, costs Shs 9,500,000. Installation of the new machine on the site costs Shs 4,000,000. Because of its more complex mechanism, the advanced model is expected to have a useful life of only 8 years. A scrap value of Shs 20,500,000 is considered reasonable. A

comparison of the existing and advanced model now available shows the following:

	<b>Existing machine</b>	<b>Advanced model</b>
Capacity per annum.	200,000 Units	230,000 Units
Selling Price per Unit	Shs 950	Shs 950
Production costs per unit:		
Labour	Shs 120	Shs 80
Materials	Shs 480	Shs 460
Fixed overheads, (allocation of portion of company's fixed overheads)	Shs 250	Shs 160

The Sales Director is of the opinion that the additional output could be sold at Shs, 950 per unit. If the advanced model were to be run at the old production level of 200,000 units per annum, the operators would be freed for a proportionate period of time for reassignment to the other operations of the company. The company's cost of capital is 15%.

**Required:**

- (a) Outline to the Finance Director the possible methods of improving the inflow-outflow cash pattern. **(4 marks)**
  - (b) Compute the:
    - (i) Pay Back Period. **(3 marks)**
    - (ii) Net Present Value of the advanced model. **(7 marks)**
  - (c) (i) What recommendation would you make on the acquisition of the advanced model? **(4 marks)**
    - (ii) What other considerations are relevant? **(3 marks)**
- (Total 20 marks)**

**Question 3**

Green Label Ltd. was established in 2000 to sell a range of computer software to small businesses. Since its incorporation, the business has grown rapidly and demand for its products continue to rise. The most recent financial statements for the company are set out below:

**Balance Sheet as at 31 March 2005**

	<b>Shs' 000</b>	<b>Shs' 000</b>
Non current assets		84,000
Current assets:		
Inventories	26,000	
Trade and other receivables	<u>59,000</u>	
	<u>85,000</u>	
Current liabilities:		
Trade and other payables	88,000	
Proposed dividends	1,000	
Taxation	6,000	
Bank overdraft	<u>10,000</u>	
	<u>105,000</u>	
		<u>(20,000)</u>
		<u>64,000</u>
Borrowings (long term)		20,000
Ordinary shares		25,000
Retained earnings		<u>19,000</u>
		<u>64,000</u>

**Income Statement for the year ended 31 March 2005**

	<b>Shs' 000</b>	<b>Shs' 000</b>
Sales		660,000
Cost of Sales:		
Opening Inventories	22,000	
Purchases	<u>426,000</u>	
	448,000	
Closing inventories	<u>26,000</u>	<u>422,000</u>
		238,000
Expenses		<u>221,000</u>
Net profit before tax		17,000
Tax		<u>6,000</u>
Net profit after tax		11,000
Proposed dividends		<u>1,000</u>
Retained profit for the year		<u>10,000</u>

The company is family owned and controlled. Since incorporation, it has operated without employing a qualified accountant. However, the Managing Director recently attended a seminar organized by the ICPAU and became concerned with the financial position of the company and therefore decided to appoint a recently qualified CPA as the Financial Controller.

He is to help manage the financial affairs of the business. Soon after joining the company, the Financial Controller called a management meeting and at this meeting stated that, in his opinion, the company was over trading.

**Required:**

- (a) Explain the term “over trading”? (2 marks)
  - (b) What are the possible consequences of “over trading”? (3 marks)
  - (c) Mention the main causes of over trading and how can management of a business overcome the problem of over trading? (4 marks)
  - (d) Use financial ratios for Green Label Ltd which you believe would be useful in detecting whether the company was over trading. Explain the significance of each ratio you calculate. (8 marks)
  - (e) Differentiate between an aggressive strategy and the matching approach in financing working capital needs. (3 marks)
- (Total 20 marks)**

**Question 4**

- (a) The Giggs Company Ltd is planning to request a line of credit from its bank. The following sales forecasts have been made for 2005 and 2006:

	<b>Shs' 000</b>
November 2005	300,000
December 2005	480,000
January 2006	350,000
February 2006	270,000
March 2006	180,000
April 2006	340,000
May 2006	400,000
June 2006	550,000
July 2006	320,000

The expected sales collections are estimated as follows:

- 20% collected within the month of sale.
- 70% collected the month following the sale.
- 10% collected the second month following the sale.
- Payments for labour and raw materials costs are typically made during the month following the month in which these costs are incurred.

Total labour and raw material costs for each month are estimated as follows:

	<b>Shs ' 000</b>
November 2005	200,000
December 2005	350,000
January 2006	280,000
February 2006	220,000
March 2006	175,000
April 2006	210,000
May 2006	300,000
June 2006	200,000
July 2006	250,000

General and administrative salaries will amount to approximately Shs 30,000,000 a month; lease payments under long-term lease contracts will be Shs 20,000,000 a month; depreciation charges are Shs 20,000,000 a month; miscellaneous expenses will be Shs 1,500,000 a month; income tax payments of Shs 75,000,000 will be due in both March and June. Cash on hand on 1 January 2006, will amount to Shs 50,000,000, and a minimum cash balance of Shs 80,000,000 should be maintained through the cash budget period.

**Required:**

- (i) Prepare a monthly cash budget for the first six months of 2006. **(8 marks)**
  - (ii) For each month during the period, prepare an estimate of required financing which Giggs Company Ltd will need to borrow or will have available to invest. **(6 marks)**
- (b) Apex Ltd acquired a loan of Shs 200 million at an interest rate of 10% per annum and the loan is to be repaid in twelve monthly installments but interest is calculated on the original amount. However, there is no compensating balance required.



**Required:**

- (i) Assuming the bank deducts interest in advance, compute the effective rate of interest. **(4 marks)**
  - (ii) Explain the phrase “compensating balance” as used in the extract above. **(2 marks)**
- (Total 20 marks)**

**SECTION C**

**Question 5**

- (a) Due to the recent rampant collapse of a number of business firms globally, the Institute of Certified Public Accountants of Uganda requested a Financial Analyst to discuss the vital topic, “Business Failure”. Being one of the participants of that important workshop, you have now been asked by your Head of Department, who did not attend, to do the following:
  - (i) Give three types of business failure. **(3 marks)**
  - (ii) Outline six symptoms of business failure. **(6 marks)**
  - (iii) List seven solutions to business failure. **(7 marks)**
- (b) Native Ltd, one of the leading companies in herbal medicines, is considering a merger with Sandoz Pharmacies Ltd. Both companies have been in existence for over 10 years.

**Required:**

Outline the benefits for such a merger.

**(4 marks)**  
**(Total 20 marks)**

**Question 6**

- (a) Outline three characteristics of traditional small firms. **(3 marks)**
  - (b) List some of the common problems of traditional small firms. **(4 marks)**
  - (c) Explain the following:
    - (i) Insider dealings. **(3 marks)**
    - (ii) Standards of fairness in re-organization. **(3 marks)**
    - (iii) Oversubscription privilege. **(3 marks)**
    - (iv) Preemptive right. **(2 marks)**
    - (v) Cumulative voting for directors. **(2 marks)**
- (Total 20 marks)**