

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA (U) EXAMINATIONS

LEVEL TWO

FINANCIAL ANALYSIS – PAPER 9

TUESDAY, 19 JUNE 2007

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. Tables are provided on page 10.
7. Please read further instructions on the answer book.

SECTION A**Question 1**

- (i) Which of the following statements is true about risk?
- (a) Unsystematic risk gets its name from the fact that it is random in nature.
 - (b) Unsystematic risk is unique to a particular project, and cannot be avoided through diversification.
 - (c) Systematic risk is undiversifiable and is inherent to the entire market.
 - (d) Systematic risk is unique to a particular firm, and can be easily diversified.
- (ii) Which of the following can lead to an increase in the cash operating cycle of a manufacturing firm?
- (a) Increase in inventory turnover.
 - (b) Increase in debtors' turnover.
 - (c) Increase in creditors' turnover.
 - (d) Decrease in manufacturing period.
- (iii) Which of the following statements is true about inflation in investment appraisal?
- (a) Inflation is an external factor and should be ignored in investment appraisal.
 - (b) The cost of capital already reflects the inflation level, and it should be ignored.
 - (c) The inflation rate cannot be predicted with accuracy and it is better left out of investment appraisal.
 - (d) The inflation rate can be used to adjust the nominal cost of capital to get the real cost of capital.
- (iv) Interest coverage for a firm was estimated at 4.5 times. Management plan to increase it to at least 8 times. The following actions were considered:
- (i) Reduce the firm's financial gearing.
 - (ii) Reduce the level of operating overheads.
 - (iii) Increase the number of projects purely financed by loans.
 - (iv) Increase total assets turnover.
 - (v) Reduce level of taxation.

Which of the following combinations will most likely increase the interest coverage ratio as planned?

- (a) (i), (ii), and (iii).
- (b) (i), (ii), and (iv).
- (c) (ii), (iv), and (v).
- (d) (ii), (iii), and (iv).

(v) Which of the following is true about project classification?

- (a) Mutually exclusive projects serve the same purpose but do not compete with each other for resources.
- (b) Mutually exclusive projects cannot be evaluated by payback period since it is not a maximizing method.
- (c) Independent investments serve different purposes and do not compete with each other for resources.
- (d) Independent investments cannot be undertaken at the same time.

(vi) General electronics is the leading importer and distributor of Casio calculators in Kampala. Their annual demand is 30,000 units, ordering costs are Shs 2,000 per order, each unit costs Shs 20,000 and the estimated annual cost of holding each unit of stock is 15% of its purchase cost. What is the economic order quantity, given that lead-time is zero?

- (a) 600 units.
- (b) 300 units.
- (c) 500 units.
- (d) 200 units.

(vii) Which of the following instruments is **NOT** traded on the Uganda Securities Exchange?

- (a) Treasury bills.
- (b) Treasury bonds.
- (c) Corporate bonds.
- (d) Equity shares.

(viii) The following were Anote (U) Ltd's sales and working capital relationships for the year 2006:

Sales to non-current assets ratio:	2.5: 1
Non-current assets to current assets ratio:	2.0: 1
Current ratio:	1.25: 1
Acid test ratio:	0.8: 1

Given that the forecast level of sales for year 2007 is Shs 4 billion, what is the expected level of inventory at the year end?

- (a) Shs 288 million.
 - (b) Shs 412 million.
 - (c) Shs 512 million.
 - (d) Shs 576 million.
- (ix) Which of the following is **NOT** an advantage of a rights issue of shares?
- (a) Shareholders increase their investment at a lower cost than other types of share issues.
 - (b) Shareholders' interests in the company are not diluted by the new shares.
 - (c) Shareholders get free shares since they have an absolute right to the new shares.
 - (d) The rights issue price is usually at a discount, which makes it very attractive.
- (x) Which of the following statements are true?
- (i) "Bulls" expect increases in share prices and so they buy more shares.
 - (ii) "Bears" expect share prices to fall and so they sell their shares.
 - (iii) "Stags" apply for new share issues intending to sell them straightaway.
- (a) (i), (ii), and (iii).
 - (b) (i) and (ii) only.
 - (c) (i) and (iii) only.
 - (d) (ii) and (iii) only.

SECTION B**Question 2**

Noto Cing (U) Limited has been trading since the year 1986, and has been operating profitably over this period. Their total assets to-date amount to Shs 1 billion, with a debt to equity ratio of 60%. The company is now considering listing on the Uganda Securities Exchange (USE).

Required:

- (a) Give **five** advantages that accrue to a company like Noto Cing on being listed on a securities exchange such as the USE?
(5 marks)
 - (b) What are the challenges of being listed on a securities exchange?
(4 marks)
 - (c) What factors should be considered in setting a price of Noto Cing (U) Ltd's shares during the initial public offer?
(5 marks)
 - (d) Explain the implications of market efficiency for corporate finance managers.
(6 marks)
- (Total 20 marks)**

Question 3

- (a) Comment on the following statements:
 - (i) "We use payback primarily as a method of coping with risk".
(4 marks)
 - (ii) "Shs 100 now is worth more than Shs 100 at some future time".
(4 marks)
- (b) A local micro-finance company has been offering her customers to lend them Shs 1,000,000 on condition that they repay Shs 1,643,000 at once after 3 years. Assuming no fees and other costs in the arrangement of the facility, what is the compound rate of interest on the loan?
(4 marks)
- (c) A four year project is expected to cost Shs 600 million, of which 20% is working capital, (and recoverable at the end of the project), and the balance is depreciable. The project is expected to yield annual profits before depreciation of Shs 280 million in years 1 and 2, and Shs 160 million in years 3 and 4. The company's cost of capital is 15%, and uses straight-line depreciation, which is also acceptable for tax purposes.

Required:

Compute:

- (i) the project's accounting rate of return, assuming no taxes.
- (ii) the project's net present value assuming a tax rate of 30%.

(8 marks)**(Total 20 marks)****Question 4**

CHOGM (U) Ltd had the following data extracted from their income statement and balance sheet at their most recent accounting date (31 May 2007).

	Shs (million)
Sales	2,500
Purchases	1,075
Trade receivables	620
Trade payables	259
Inventory	207

The company's gross profit margin for the year was estimated at 45%. All sales and purchases were made on credit.

Required:

- (a) Explain the dangers of holding inadequate working capital in a business.
(4 marks)
- (b) Explain **four** dangers of holding excessive working capital to a firm.
(4 marks)
- (c) Explain the implications of an increasing cash operating cycle to a firm.
(4 marks)
- (d) Estimate the CHOGM (U) Ltd's cash operating cycle, and comment about it.

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

Question 5

- (a) The following information and balance sheet relate to Uganda General Transporters Limited (UGTL).

	2006	2005
Revenue (Shs million)	6,380	6,440
Gross profit margin	48%	52%
Net profit margin	6%	5%
Dividend pay out ratio	40%	40%
Market capitalization (Shs million)	1,280	1,170

The company is listed on the KCC Securities Exchange and has 50,000 shares in issue.

Uganda General Transporters Limited
Balance Sheet as at 31 December 2006

	2006	2005
	Shs '000'	Shs '000'
Assets		
Non-current Assets		
Property, plant & equipment	311,320	292,500
Intangible assets	<u>63,500</u>	<u>56,200</u>
	<u>374,820</u>	<u>348,700</u>
Current Assets		
Inventories	153,652	137,530
Trade receivables	12,300	10,660
Cash and cash equivalents	<u>17,450</u>	<u>21,500</u>
	<u>183,402</u>	<u>169,690</u>
Total assets	<u>558,222</u>	<u>518,390</u>
Equity and Liabilities		
Attributable to equity holders		
Share capital	95,000	95,000
Other reserves	32,186	21,800
Retained earnings	<u>34,984</u>	<u>33,580</u>
	<u>162,170</u>	<u>150,380</u>
Non-current liabilities		
Long-term borrowings	76,000	69,500
Deferred tax	<u>12,950</u>	<u>12,450</u>
	<u>88,950</u>	<u>81,950</u>

	2006 Shs 000	2005 Shs 000
Current liabilities		
Trade and other payables	194,602	168,560
Short-term borrowings	<u>112,500</u>	<u>117,500</u>
	<u>307,102</u>	<u>286,060</u>
Total Equity and Liabilities	<u>558,222</u>	<u>518,390</u>

Required:

Compute:

- (i) Assets turnover.
- (ii) Return on equity.
- (iii) Dividend yield.
- (iv) Price-earnings ratio.

(8 marks)

- (v) Explain the term “liquidity” and how it can be measured.

(4 marks)

- (b) What is financial gearing and how is it relevant in financial management?

(4 marks)

- (c) Briefly explain **four** factors that influence a company’s capital structure.

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

SECTION B

Question 6

Explain the following:

- (a) The aims and objectives of a business firm.
(5 marks)
 - (b) Any **three** types of risk and their implications to a firm. (Do not discuss the systematic and unsystematic risks).
(5 marks)
 - (c) Limitations of portfolio analysis in financial management decisions.
(5 marks)
 - (d) The Modigliani and Miller theory.
(5 marks)
- (Total 20 marks)

Question 7

- (a) List and explain **five** advantages that will accrue to Uganda for hosting the Commonwealth heads of government meeting (CHOGM) later this year.
(5 marks)
- (b) Explain **five** roles that the Uganda Investment Authority (UIA) plays in the economic development of Uganda.
(5 marks)
- (c) Bank of Uganda has issued circulars and notices to the public with the intention of limiting cheque transactions to less than Shs 20,000,000 with effect from 1 July 2007. It has actually advised the public to make use of the electronic funds transfer system.

Required

Explain the advantages and disadvantages of an electronic funds transfer system.

(10 marks)
(Total 20 marks)

Table 1: PVIF- Present Value of Shs 1 Due at the End of n Periods

Period	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.847	0.833
2	0.842	0.826	0.812	0.797	0.783	0.769	0.756	0.743	0.718	0.694
3	0.772	0.751	0.731	0.712	0.693	0.675	0.658	0.641	0.609	0.579
4	0.708	0.683	0.659	0.636	0.613	0.592	0.572	0.552	0.516	0.482
5	0.650	0.621	0.593	0.567	0.543	0.519	0.497	0.476	0.437	0.402
6	0.596	0.564	0.535	0.507	0.480	0.456	0.432	0.410	0.370	0.335
7	0.547	0.513	0.482	0.452	0.425	0.400	0.376	0.354	0.314	0.279
8	0.502	0.467	0.434	0.404	0.376	0.351	0.327	0.305	0.266	0.233
9	0.460	0.424	0.391	0.361	0.333	0.308	0.284	0.263	0.225	0.194
10	0.422	0.386	0.352	0.322	0.295	0.270	0.247	0.227	0.191	0.162
11	0.388	0.350	0.317	0.287	0.261	0.237	0.215	0.195	0.162	0.135
12	0.356	0.319	0.286	0.257	0.231	0.208	0.187	0.168	0.137	0.112
13	0.326	0.290	0.258	0.229	0.204	0.182	0.163	0.145	0.116	0.093
14	0.299	0.263	0.232	0.205	0.181	0.160	0.141	0.125	0.099	0.078
15	0.275	0.239	0.209	0.183	0.160	0.140	0.123	0.108	0.084	0.065

TABLE 2: PVAF - Present Value of an Annuity of Shs 1 per Period for n Periods

Period	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.847	0.833
2	1.759	1.736	1.713	1.690	1.668	1.647	1.626	1.605	1.566	1.528
3	2.531	2.487	2.444	2.402	2.361	2.322	2.283	2.246	2.174	2.106
4	3.240	3.170	3.102	3.037	2.974	2.914	2.855	2.798	2.690	2.589
5	3.890	3.791	3.696	3.605	3.517	3.433	3.352	3.274	3.127	2.991
6	4.486	4.355	4.231	4.111	3.998	3.889	3.784	3.685	3.498	3.326
7	5.033	4.868	4.712	4.564	4.423	4.288	4.160	4.039	3.812	3.605
8	5.535	5.335	5.146	4.968	4.799	4.639	4.487	4.344	4.078	3.837
9	5.995	5.759	5.537	5.328	5.132	4.946	4.772	4.607	4.303	4.031
10	6.418	6.145	5.889	5.650	5.426	5.216	5.019	4.833	4.494	4.192
11	6.805	6.495	6.207	5.938	5.687	5.453	5.234	5.029	4.656	4.327
12	7.161	6.814	6.492	6.194	5.918	5.660	5.421	5.197	4.793	4.439
13	7.487	7.103	6.750	6.424	6.122	5.842	5.583	5.342	4.910	4.533
14	7.786	7.367	6.982	6.628	6.302	6.002	5.724	5.468	5.008	4.611
15	8.061	7.606	7.191	6.811	6.462	6.142	5.847	5.575	5.092	4.675