

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

CORPORATE FINANCIAL MANAGEMENT - PAPER 18

WEDNESDAY, 20 JUNE 2007

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

SECTION A

Question 1

Inter-clays Bank Ltd (IBL) is a multi-national corporation operating in Uganda since the pre-independence days. The company's mission is "providing the best financial services in Uganda". The company recently acquired Source of Progress Bank Ltd (SBL), a local financial institution with the reputation of providing innovative financial services for all social classes of people in Uganda.

The Executive Director (ED) for Finance of IBL was recently asked to explain the basis and challenges of the acquisition transaction. His response was, "... our diversification and expansion program shall continue. We always ensure that we respond to the ever increasing competition proactively. We are pursuing similar moves in the two other East African countries, and we cannot go wrong. Our team follows a **thorough** investment appraisal process for all our investment decisions. One key decision is the appropriate mix of debt and equity in financing this expansion programme. Many factors always come into play in a bid to maximize the shareholders' value".

A lead consultant in the acquisition transaction also recently commented: "... SBL was a good target in my clients' expansion programme. We also made sure that all potential problems and risks in the acquisition were anticipated and addressed in time. My clients were clear of all the limitations of organic growth, and they had to make this strategic move".

The following data, which were compiled by the consultant, were partly used to support the acquisition:

	IBL	SBL
	Shs million	Shs million
Operating profit	16,100	7,500
Operating overheads	<u>(5,793)</u>	<u>(2,792)</u>
Profit before tax	10,307	4,708
Taxation	<u>(3,607)</u>	<u>(1,648)</u>
Profit after tax	<u><u>6,700</u></u>	<u><u>3,060</u></u>
	Shs	Shs
Earnings per share (pre-acquisition)	1,340	2,550
Market price per share (pre-acquisition)	20,100	28,050
Estimated market price (post acquisition)	23,610	-

It was on the basis of the above information that the directors of IBL agreed to exchange 3 IBL shares for every 2 SBL shares.

The following additional synergetic information was later made available regarding the transaction, all values being after the appropriate taxes:

- (i) The acquisition could result into an increase in the total after tax cash flows of Shs 2.85 billion a year indefinitely.
- (ii) Rationalization of the branch network of the combined entity would allow disposal of some non-core assets worth Shs 1.8 billion to be disposed off at the end of Year 1.
- (iii) Redundancy payments would total Shs 3.5 billion immediately and Shs 4.8 billion at the end of the second year.

IBL's cost of capital is estimated to be 13% per annum.

Required:

- (a) Explain why multi-national corporations set up subsidiaries abroad.
(5 marks)
- (b) Discuss an investment appraisal process that would mirror what the ED-Finance has referred to as "**thorough**".
(5 marks)
- (c) Discuss the considerations that must be considered in deciding the appropriate mix of finances.
(5 marks)
- (d) Critically assess the validity of the consultant's estimates of the post acquisition value, showing all relevant calculations.
(6 marks)
- (e) Evaluate whether the additional synergetic information justifies a "2 for 1" share exchange.
(7 marks)
- (f) Elucidate potential problems of an acquisition (or a merger) that the consultant has said were "well anticipated".
(5 marks)
- (g) Discuss the considerations that a company pursuing organic growth should take into account; and the circumstances under which growth by acquisition is most appropriate.
(8 marks)
- (h) Discuss the main aspects of managing risk that a bigger IBL Group could adopt.
(5 marks)
- (i) The IBL Board have approved plans to give the general Ugandan public a chance to own part of their ever-growing business through an initial public offer (IPO). Outline the steps that the company may go through to the end of that IPO.
(6 marks)

- (j) Explain the importance of market price of a share on one hand, and the relevance of capital structure to a company like IBL on the other hand.

(8 marks)

(Total 60 marks)

SECTION B

Question 2

Solar-Lite Ltd is a company based in Uganda. The company has been contracted to import and install 1,200 units of solar / wind-supported streetlights in Kampala's central division, ahead of the CHOGM summit later this year. The company would like to borrow Shs 1.5 billion now for a six-month period. The money is to be used for a two-thirds conditional down payment before the company's supplier in Kibanda Republic makes shipment. Two alternatives being considered are to borrow either locally from Uganda or from Kibanda Republic, where the local currency is the Kibanda Rupee (Kru); and where interest rates are lower than in Uganda.

The exchange / interest rates are as follows:

Kru/Shs spot	2.40 – 2.45
Kru /Shs 6 months forward	3 – 1 cents premium
Kibanda rupees interest rates	9.5%
Uganda shillings interest rates	12.5%

Some Councillors of Kampala Central Division have openly said they are uncomfortable with the Kibanda Republic technology. They have observed that another company should have been considered for the contract. They, however, admit that such a company does not locally exist, and it would necessitate foreign direct investment (FDI). The Councillors have been told that FDI is usually limited by political risks, and that Uganda still has a lot to do about such risks. They want to know what these risks are, and what the government can do about them.

Required:

- (a) Advise Solar-Lite Ltd whether to borrow from Kibanda Republic or from Uganda, showing necessary workings.
- (7 marks)**
- (b) Explain how a cap, a floor, and a collar can be used to mitigate risks associated with corporate finance.
- (6 marks)**
- (c) Assess the political risks of foreign direct investment, and show how a destination country could reduce such risks.

(7 marks)

(Total 20 marks)

Question 3

Cem-Com Ltd is a major distributor of cement in Uganda. The company has in the past had difficulties establishing a credit policy that is profitable, dynamic and that would stand the test of time. The company's current price and cost structures are as given below:

	Shs per unit
Selling price	18,000
Variable costs	(16,200)
Fixed costs apportionment	<u>(1,350)</u>
Net profit	<u><u>450</u></u>

Cem-Com Ltd has an annual turnover of Shs 8.2 billion, and an average collection period for debtors of one month.

The Board of Cem-Com Ltd would like to extend their business to Southern Sudan. A basic survey has revealed that this new business would produce an additional 30% of current turnover, but would require 2½ months credit to customers. On the other hand, inventory and trade payables would rise by Shs 950 million and Shs 350 million respectively.

The cost of financing any increase in working capital is 12% per annum.

Required:

- (a) Discuss the main elements of a credit policy, relating them to a wholesale company like Cem-Com Ltd. **(6 marks)**
- (b) Analyse the profitability of the new business assuming:
- (i) only Sudanese customers take 2½ months credit period.
 - (ii) all customers demand 2½ months credit period.
- (8 marks)**
- (c) Discuss other considerations the Board of Cem-Com Ltd should make before expanding into Southern Sudan assuming the venture is profitable. **(6 marks)**
- (Total 20 marks)**

Question 4

M/S Odaa Ltd is a fast growing company in the tour and travel industry, and was established in 2003. The company's management are currently encountering difficulties in raising more finance. The situation is further complicated by the scarcity, variability of costs, and the different attributes of the alternative financial instruments. Management are also not sure about how they can deploy such expensive finances since the company's profitability has been going down.

The firm's management are also considering the purchase of equipment worth Shs 500 million, with a useful life of 4 years. The equipment has a scrap value of Shs 40 million, and is expected to generate incremental cash flows estimated at Shs 210 million for each of the four years. They have the option to purchase it using a four-year bank loan at a pre-tax interest rate of 9.5%, or using a finance lease with rentals of Shs 140 million payable at the end of each of the four years.

The company is currently ungeared. Shareholders expect to earn a return of 12% after taxes. The corporation tax rate is 30% payable one year in arrears. A 25% writing-down allowance (on reducing balance basis) is available on such equipment.

The Board of Directors of M/S Odaa Ltd are unsure whether to sanction the purchase, and if so, how it should be financed. Board members are also wondering why the different financial institutions charge different interest rates on lending, and why management has never considered issuing a corporate bond.

Required:

Prepare a report to be discussed at the next Board meeting addressing the following concerns of the Board:

- (a) Whether the equipment should be purchased, and if so, how it should be financed.
(10 marks)
- (b) Explain possible reasons that make different financial institutions charge different rates of interest.
(5 marks)
- (c) Whether corporate bonds are or are not an appropriate source of finance for M/S Odaa Ltd.
(5 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