

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL TWO

CORPORATE FINANCIAL MANAGEMENT - PAPER 12

TUESDAY, 17 JUNE 2008

INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours**.
2. Section **A** has **one** compulsory question carrying 40 marks.
3. Section **B** has **four** questions and only **three** questions are to be attempted. Each question carries 20 marks.
4. Tables are provided on page 9.
5. Please read further instructions in the answer book.

SECTION A

Question 1

Senta Municipal Council (SMC) is one of the largest and busy local governments in central Uganda, having attained municipal status over eight years ago. The council leadership set up a trading company four years ago, to supplement on the incomes and service delivery of the council. This was in the face of increasing demand for services from the council, limited central government financial support and low levels of local revenue generation. The trading company – M/s Seya Trading Limited (STL), is directly under the supervision of the Mayor.

The managers of STL are evaluating a project, code named *Seya2011* that requires an initial investment in equipment of Shs 1,200 million, which it intends to finance 100% by debt. Additional cash flows of Shs 500 million at current levels are expected for three years, at the end of which time the equipment shall be scrapped at 21% of its cost price.

The equipment will attract writing down allowances at 25% on reducing balance basis, which is claimable against taxable profits of the current year, which is about to end. A balancing charge or allowance will arise on disposal. The rate of corporate tax is 30% and tax is payable one year in arrears, and the rate of inflation in Uganda is estimated at 10%.

His worship, the Mayor of SMC, has intimated to the managers of STL, that if need arose, he shall ask the council to approve an issue of a "Municipal Bond", to avail money to them. He estimates that the pre-tax interest rate shall be 20% per annum, and he is upbeat that the issuance shall be highly successful.

More information is also available from published annual reports of STL, and their most recent financial statements are shown below:

Income Statement for the Year Ended 30 September

	2007	2006
	Shs million	Shs million
Revenue	1,428,500	1,250,000
Cost of sales	<u>(860,000)</u>	<u>(718,800)</u>
Gross profit	568,500	531,200
Other income	20,700	13,000
Distribution costs	(152,500)	(128,700)
Administrative expenses	(197,000)	(181,000)
Other expenses	(46,000)	(41,600)
Finance costs	<u>(86,700)</u>	<u>(91,300)</u>
Profit before tax	<u>107,000</u>	<u>101,600</u>
Income tax expense	<u>(26,000)</u>	<u>(23,000)</u>
Profit for the year	<u><u>81,000</u></u>	<u><u>78,600</u></u>

Balance Sheet as at 30 September

	2007	2006
	Shs million	Shs million
ASSETS		
Non-current assets		
Property, plant and equipment	222,900	122,100
Other intangible assets	77,660	52,370
Available for sale investments	<u>69,440</u>	<u>45,530</u>
	<u>370,000</u>	<u>220,000</u>
Current assets:		
Inventories	151,500	104,000
Trade receivables	132,790	92,800
Cash and cash equivalents	<u>2,560</u>	<u>85,900</u>
	<u>286,850</u>	<u>282,700</u>
Total Assets	<u>656,850</u>	<u>502,700</u>
EQUITY AND LIABILITIES		
Equity		
Share capital	96,000	81,000
Other reserves	22,000	26,300
Retained earnings	<u>112,100</u>	<u>31,100</u>
Total equity	<u>230,100</u>	<u>138,400</u>
Non-current liabilities		
10% Debentures	135,000	87,500
Deferred tax	44,550	32,600
Long-term provisions	<u>12,600</u>	<u>18,000</u>
Total non-current liabilities	<u>192,150</u>	<u>138,100</u>
Current liabilities		
Trade and other payables	146,900	136,800
Short-term borrowings	45,000	49,000
Current tax payable	29,500	29,000
Short-term provisions	<u>13,200</u>	<u>11,400</u>
Total current liabilities	<u>234,600</u>	<u>226,200</u>
Total equity and liabilities	<u>656,850</u>	<u>502,700</u>

An Investment Banker has commented on the financial statements of STL that “we expect the company to address the level of financial gearing, as well as put mechanisms to stop the company’s operating gearing from growing by over 25% from the current level, following any debt issuances”.

Required:

- (a) Outline any **four** objectives of an organization like SMC stating how the achievement of each could be measured.
(5 marks)
- (b) Assess whether the *Seya2011* project should be undertaken on the basis of its net present value (NPV). (Your workings should be in Shs '000).
(8 marks)
- (c) Explain why sensitivity analysis should always be undertaken and comment on the sensitivity of the *Seya2011* project to the initial investment.
(4 marks)
- (d) Explain why many companies use their weighted average cost of capital (WACC) to evaluate capital investments, and any **three** assumptions that must hold if they have to use WACC.
(5 marks)
- (e) Evaluate the factors to be considered by STL when deciding between equity and debt capital to finance such huge projects like *Seya2011*.
(5 marks)
- (f) Discuss the merits and demerits of a 'municipal bond' to the SMC over other long-term sources of capital.
(5 marks)
- (g) Comment on STL's financial performance and position on the basis of the company's:
(i) assets turnover;
(ii) return on capital employed (also known as return on investment)
(iii) financial gearing.
(6 marks)
- (h) Explain the meaning of 'operating gearing'.
(2 marks)
- (Total 40 marks)**

SECTION B

Question 2

Nalubaale Bank Limited (NBL), a local commercial bank has been operating in Uganda for the last 8 years. The bank is currently contemplating getting listed on the Uganda Securities Exchange (USE) by the close of year 2008. The reasons for this move are mainly to raise more equity capital, and to enable big institutional shareholders offload their concentration in the Uganda's banking industry – which is currently attracting increasing competition.

One big institutional shareholder has said that they want to 'diversify better', and mitigate risk. Their contention is based on statements that their representatives on the NBL board of directors frequently make in their annual reports; *"all rational investors form well diversified portfolios to eliminate systematic risk"*. They also say that the return on their NBL investment does not reflect the increasing risk in the sector, quoting a statement that *"the risk premium built into the required rate of return on securities should reflect a reward for systematic risk"*.

The Finance Director of NBL on his part is happy about the intended listing, and was recently quoted in the local press as saying, " we shall be able to prove our shareholder wealth-maximizing strategies at the bank, especially given that the capital asset pricing model (CAPM) shall now be fully applicable to our shares".

Required:

- (a) Discuss any **three** examples of CAPM's practical application. (5 marks)
 - (b) Evaluate the underlying assumptions of CAPM. (5 marks)
 - (c) Briefly discuss the statements attributed to the NBL Board members in the second paragraph above (also in italics). (5 marks)
 - (d) According to one proposition made by Modigliani and Miller, "the total value of any company is independent of its capital structure". To what extent would you agree with this proposition in the real world situation? (5 marks)
- (Total 20 marks)**

Question 4

Ayar Agric Group (AAG) is a listed company on the Uganda Securities Exchange (USE). AAG operates a number of commercial agricultural farms with a variety of foodstuffs, with over 45% of the output sold in the export market. The company has been conducting negotiations with Bora Hotels Limited (BHL) aimed at combining their businesses soon. BHL operates a chain of 5-star hotels in Uganda and the Democratic Republic of Congo. Financial analysts have argued that the transaction is a takeover, given that BHL has been persistently experiencing a number of “financial distress” symptoms in recent months.

It has been estimated that the merger would result in after tax savings of Shs 230.0 million per annum indefinitely – as a result of streamlining some business processes. However, investment analysts have estimated that the price earnings ratio of AAG would fall by 20% following a successful merger.

The following data is also available from financial reports of the two companies:

	AAG	BHL
	Shs million	Shs million
Turnover	11,570	5,800
Profit after tax	2,800	1,160
Dividends	1,220	522
Share capital	4,000	2,200

The price earnings ratio of AAG is currently 29, while that of listed companies similar in size and business to that of BHL is 21. The nominal value of the shares of AAG and BHL is Shs 2,000 each.

Assume the price earnings ratio of AAG to be 2/3 of that of listed companies in similar business.

Required:

- Explain the meaning and any **three** common causes of ‘financial distress’.
(4 marks)
- Calculate the number of AAG shares that must be issued to acquire BHL at a 25% premium above its current market price.
(8 marks)
- Discuss reasons why AAG may pay a premium above the market price in order to acquire BHL.
(4 marks)
- Give any **four** reasons why shares rather than cash may be used as a bid consideration in such takeover transactions.
(4 marks)

(Total 20 marks)

Question 5

At the release of the most recent Treasury bond auction results, the Bank of Uganda's Director of Financial Markets was quoted as saying, "We have witnessed significant growth in the financial markets – both the primary and secondary markets – in Uganda over the last five years. The number of non-institutional participants in this auction is further evidence of this, and reflects macro economic stability in the economy. We still call upon all persons to continue participating in these markets for the good of our economy.

We plan to issue longer-term securities more often, ... so that the yield curve can become more normal and stable, and further contribute to the desired market efficiency. I am glad that our counterparts in the public and private sectors are also doing many things to promote this market efficiency".

An extract from the press release is shown below:

BANK OF UGANDA	
TREASURY BOND AUCTION RESULTS	
ISSUE NO: FXD 4/2008/3 YRS; HELD ON APRIL 30, 2008	
TENOR:	3 YEARS
COUPON INTEREST RATE:	10.25%
PRICE RANGE:	95.615 – 89.388
WEIGHTED AVERAGE PRICE (WAP):	92.601
YIELD TO MATURITY AT WAP:	13.32%
OFFERED:	60,000,000,000
TENDERED	75,592,000,000
BID TO COVER RATIO:	1.260

Adapted from **The New Vision**: Friday, May 2, 2008, page 40.

Assume coupon interest is paid semi-annually.

Required:

- Determine the yield to maturity for an investor who tendered for Shs 100,000,000 in maturity value at the lowest accepted bid price.
(6 marks)
 - Explain why a yield curve is 'normally' upward sloping.
(4 marks)
 - Explain the meaning and relevance of market efficiency in financial management.
(5 marks)
 - Explain the role of financial markets in corporate financial management.
(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