

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL TWO

CORPORATE FINANCIAL MANAGEMENT - PAPER 12

TUESDAY, 9 DECEMBER 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 8.
5. Please read further instructions in the answer book.

SECTION A

Question 1

Girimbe Textiles Limited (GTL) was incorporated in Uganda in 1998 and employs 800 workers. GTL is listed on the Kampala Securities Exchange. It is a large company in Uganda. Its major business hub is lower quality fabrics that appeal to most people in the region due to their affordability. It has a good reputation as a producer of cheap and affordable clothing all over Uganda.

GTL plans to raise Shs 10 billion for expanding its existing business to the Greater East African region as a way of reaping benefits from the East African Community common market. It has been suggested that the money could be raised by issuing 9% loan notes redeemable in ten years' time.

Current financial information on GTL is as follows:

Income Statement Extracts

Year ended 31 December	2007	2006	2005	2004
	Shs million	Shs million	Shs million	Shs million
Profit before interest and tax	7,000	5,300	4,500	4,200
Interest	<u>(500)</u>	<u>(500)</u>	<u>(500)</u>	<u>(500)</u>
Profit before tax	6,500	4,800	4,000	3,700
Tax	<u>(1,950)</u>	<u>(1,440)</u>	<u>(1,200)</u>	<u>(1,110)</u>
Profit after tax	4,550	3,360	2,800	2,590
Dividends	<u>(910)</u>	<u>(840)</u>	<u>(700)</u>	<u>(777)</u>
Retained profit	<u>3,640</u>	<u>2,520</u>	<u>2,100</u>	<u>1,813</u>

Balance Sheet Extract for the year ended 31 December 2007

	Shs million
Non-current assets	20,000
Current assets	<u>20,000</u>
Total assets	<u>40,000</u>
Equity and liabilities	
Ordinary shares, Shs 1,000 par value	15,000
Retained earnings	<u>22,500</u>
Total equity	<u>27,500</u>
10% loan notes	5,000
9% preference shares, (Shs 1,000 par value)	<u>2,500</u>
Total non-current liabilities	<u>7,500</u>
Current liabilities	<u>5,000</u>
Total equity and liabilities	<u>40,000</u>

The current ex-div ordinary share price is Shs 4,500 per share. An ordinary dividend of Shs 350 per share has just been paid. The current ex-div preference share price is Shs 762. The loan notes are secured on the existing non-current

assets of GTL and are redeemable at par in eight years' time. They have a current ex-interest market price of Shs 105 per Shs 100 nominal.

GTL pays income tax at an annual rate of 30%. The expansion of business is expected to increase profit before interest and tax by 12% in the first year. GTL has no overdraft.

You have also obtained from the Uganda Investment Authority, figures relating to financial ratios of the average cloth production sector.

- Financial gearing: 45% (prior charge capital divided by equity capital on a book value basis).
- Interest coverage: 12 times.

Required:

- (a) Compute the current weighted average cost of capital (WACC) of GTL using book values for weighting. **(9 marks)**
- (b) Discuss whether, in financial management theory, GTL should reduce its weighted average cost of capital to a minimum level. **(8 marks)**
- (c) Evaluate and comment on the effects, after one year, of the loan notes issue and the expansion of business on the following ratios:
- (i) Interest coverage;
 - (ii) Financial gearing;
 - (iii) Earnings per share.
- (8 marks)**
- (d) GTL uses its estimated WACC to evaluate capital investments using discounted cash flow (DCF) methods, which it believes offer the best way of evaluating the profitability of investment projects. As part of its investment appraisal process, it also calculates the payback period of projects. Suggest reasons for GTL calculating the payback period as well as doing DCF calculations. **(5 marks)**
- (e) GTL Management has excluded at an early stage the option of raising new long term capital in the form of a rights issue of shares to fund the debt redemption. Suggest possible reasons for GTL excluding this option. **(6 marks)**
- (f) Elaborate on the major challenges of getting venture capital finance in a developing country like Uganda. **(4 marks)**

(Total 40 marks)

Question 2

The financial management team of Kabindi Investments Limited (KIL) are concerned that the company is not adequately taking account of risk when evaluating investment projects. They have undertaken a study to investigate different ways of reflecting risk in the evaluation process. As part of their study, KIL have estimated figures having a bearing on the risk of three investment projects that are currently under consideration. These figures, together with the capital investment and estimated returns on projects, are shown below:

Project	Investment (Shs million)	Return (r)	δp	$\rho_{p,m}$
P	3,000	7%	10%	0.1
Q	4,000	13%	5%	1.0
R	5,000	12%	4%	0.8

The values of δp have been estimated to provide a measure of risk and represent the standard deviation of the return (measured in the same units as return, r). The values of $\rho_{p,m}$ represents the correlation between the return on a project and the market return. The market return is 14% (with a standard deviation, δm of 5%) and the risk-free rate of return is 5.5%.

Required:

- (a) Compute the beta for each of the three projects.
(6 marks)
 - (b) Using the capital asset pricing model (CAPM), show for each project whether its return justifies its risk, and use the results of your computations to recommend the best investment.
(7 marks)
 - (c) Explain the difference between business risk, financial risk and systematic risk.
(3 marks)
 - (d) Evaluate the major implications of an efficient market to financial managers of listed companies.
(4 marks)
- (Total 20 marks)**

Question 3

Zamunda Enterprises Limited (ZEL) is a privately owned processed-food manufacturing company operating in Uganda. Its products have received good response from customers within the East African region. In a bid to respond to the opportunities in the East African Community, the company has ordered for the construction of a new factory in Rwanda. The contractor has asked for a down payment of Rwanda Francs (RF) 1.5 billion representing 50% of the total cost, due to be paid to the contractor in two months' time.

ZEL has no spare cash other than for normal working capital needs, but expects to receive Ushs 950 million from the sale of spare land and buildings in two months' time.

The current rates in the foreign exchange markets are as follows:

	RF/Ushs
Spot	0.4590-0.5120
One month forward	12 - 15 Basis points discount
Two months forward	40 - 50 Basis points discount

Current rates in the bank market rates p.a. are as follows:

	Borrowing	Lending
Ushs	10%	4%
RF	9%	5%

Required:

- (a) Suggest reasons why ZEL may wish to grow in the proposed way, and the major challenges it may face.
(5 marks)
- (b) Illustrate the options for managing transaction risk available to ZEL managers using the foreign exchange market data above.
(7 marks)
- (c) Explain the difference between netting and matching as tools of hedging foreign exchange risk.
(4 marks)
- (d) Briefly explain the theoretical relationship between inflation, interest rates and foreign exchange rates, restricting your examples to Ushs and RF.

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

Question 4

The financial management team of Mapenzi Forwarders Ltd (MFL) are discussing how the company should appraise new investments. There is a difference of opinion between two managers. The Chief Accountant believes that net present value (NPV) should be used because positive NPV investments are quickly reflected in increases in the company's share price. The Financial Management Specialist states that NPV is not good enough as it is only valid in potentially restrictive conditions and should be replaced by APV (adjusted present value).

GM Tambuka, the head of the financial management team, has produced estimates of relevant cash flows and other financial information associated with a new investment. These are shown below:

	Shs million			
Year	1	2	3	4
Investment post tax operating cash flows	1,250	1,400	1,600	1,800

Notes:

- (i) The investment will cost Shs 5.4 billion payable immediately, of which Shs 600 million will be for working capital and Shs 400 million for issue costs (75% of issue costs is for equity, and 25% for debt). Issue costs are not tax allowable.
- (ii) Expected company gearing after the investment will be 60% equity, 40% debt at market value.
- (iii) The investment equity beta is 1.5.
- (iv) Debt finance for the investment will be an 8% fixed rate debenture.
- (v) The investment does not qualify for capital allowances.
- (vi) The corporate tax rate is 30%. Assume that tax is payable in the year that the taxable cash flow arises.
- (vii) The risk-free rate is 4% and the market return 13%.
- (viii) The after tax realizable value of the investment as a continuing operation is estimated to be Shs 1.5 billion (including working capital) at the end of year 4.

Required:

- (a) Compute the NPV and APV of the proposed investment.
(14 marks)
 - (b) Briefly discuss the validity of the views of the two managers, using your computations in (a) to illustrate and support the discussion.
(6 marks)
- (Total 20 marks)**

Question 5

- (a) Define and explain the major importance of financial forecasting to a corporation.

(4 marks)

- (b) Describe any **three** tools used in financial forecasting.

(6 marks)

- (c) There has been growing concern in recent years that companies should not only concentrate on profitability but should also ensure that the process of realizing these profits is ethical and sustainable to the environment at large.

Discuss and provide examples of the non-financial and ethical issues that can influence objectives of a firm and the impact these issues may have on the achievement of the financial objectives like shareholder wealth maximization.

(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