

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL TWO

CORPORATE FINANCIAL MANAGEMENT - PAPER 12

THURSDAY, 09 DECEMBER 2010

INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours 15 minutes**.

The first 15 minutes of this examination have been designated for reading time. You may not start to write your answer during this time.

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. Relevant formulae and tables are provided on pages 10 - 12.
5. Please read further instructions on the answer book, before attempting any question.

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SECTION A**Question 1**

Shauri Holdings Limited (SHL) was incorporated in the year 2002, as a special purpose vehicle (SPV) for the construction and management of a major shopping arcade in downtown Kampala. To date, the company owns and manages over 400 rentable shop and office spaces. The company is listed on Kikuubo Securities Exchange (KSE) since July 2008. A recent analysis of its shareholders' register indicates that the company is currently owned 45% by a local financial institution (core investor), and the rest by close to 1,200 other minority shareholders.

At the most recent annual general meeting (AGM) held in May 2010, the chairman of the board of directors announced major initiatives contained in a new strategic business plan that were expected to make the company's share price more predictable and to appreciate by at least 120% over the next 5 years. Some of these initiatives, as contained in the chairman's report, are reflected in the following paragraphs (extracts), regarding dividends, capital structure, and alternative financing options.

Dividends for the year ended 31 March 2010

"We have considered the results for the just ended financial year and the prevailing financial and macroeconomic variables. It is our belief that this is not the right time to pay out additional dividends. We therefore recommend no additional dividends for the year ended 31 March 2010. You will recall that we declared and paid an interim dividend of Shs 111 per share six months ago; that now becomes the final dividend. The estimated benefits of this move are expected to be felt in the coming years, and the company shall aim at growing dividends by at least 8% per annum over the foreseeable future ..."

New changes regarding share capital and gearing

"We recommend that a 'three to five' rights issue be made this month at a 60% discount. The proceeds are to be used partly (45%) for the repayment of the floating rate bond (based on the 182-day treasury bill rate + 2.25%), and the balance (55%) to be invested in a new housing estate code-named 'Najjera Low Cost Estate' serviced by a shopping centre complex and managed by SHL ..."

SHL's capital structure as at 31 March 2010 was as follows:

	Shs million
Ordinary share capital	40,000
Share premium	5,000
12% preference shares	25,000

Corporate bond (floating
rate)

30,000
100,000

The following information was available regarding SHL's securities:

- (a) The nominal value of a share is Shs 1,000 and it is currently (since March 2010) trading at Shs 1,500 per share. The Shs 100 nominal value preference shares are currently trading at Shs 96 a share.
- (b) The corporate bond interest rate is adjusted every 1 of June and 1 December. The bond is redeemable at par in September 2011. The 182-day treasury bill rate was 11.75% at the 1 December 2009 interest rate adjustment. The bond is currently trading at par.

Convertible bond Vs redeemable bond

"We plan to issue a Shs 20 billion convertible bond in the last quarter of the year 2010. It is estimated that this shall save SHL enormous amounts of resources especially in interest costs, and provide sound security to investors. Indeed, this is one of the initiatives we are taking to reduce the company's cost of capital over the current strategic business plan period ..."

The Finance Director has, however, anonymously indicated (in an interview with the press after the AGM) that he believes a redeemable bond would be the best option. He suggests that a 4-year redeemable bond should be used to finance the Najjera low cost project, and the company divests out of the project after construction, given that demand for outright purchase by prospective homeowners is always assured.

Ownership versus leasing of equipment

"We have also reviewed our 'leasing and ownership policy', and we have established that it is cheaper to lease than purchase majority of the company's maintenance equipment. The board recommends a change in the current policy.

Below is the particular information the board had analysed to come to the lease-purchase/own conclusion above:

The purchase cost of a new machine is Shs 850 million. This could be financed by a loan from one of the new banks in Kikuubo, at an interest rate of 20% per annum. Leasing cost for the same machine would be annual lease rentals of Shs 190 million payable in advance. The machine is readily available from Downtown Leasing (U) Limited. The machine has a five-year useful life with scrap value (if bought) of Shs 170 million.

Other information

SHL is profitable (i.e. can use all tax allowances), pays tax one year in arrears, and machines of this type qualify for a writing-down

allowance of 25% on a reducing balance basis. SHL's corporation tax rate is 30%.

Required:

- (a) Compute SHL's weighted average cost of capital as at 31 March 2010.
(8 marks)
 - (b) Explain why rights issues are commonly used in raising equity capital.
(5 marks)
 - (c) Re-evaluate the lease or buy decision of equipment similar to the one in the case study, using an after tax discount rate of 14%.
(8 marks)
 - (d) As a finance manager, draft a report for discussion at the next senior management meeting, and in the report:
 - (i) outline steps /strategies a company should take to reduce its weighted average cost of capital.
(6 marks)
 - (ii) discuss the advantages to SHL and the investor of issuing convertible bonds (as opposed to other forms of debt).
(6 marks)
 - (iii) discuss any **three** factors that influence the dividend decision and any **three** circumstances when a scrip dividend may be desirable.
(7 marks)
- (Total 40 marks)**

SECTION B**Question 2**

Secure Transporters Limited (STL) is a 10-year old general transportation company, operating on various routes connecting the major towns and cities in the East African region. The company is currently facing pressures of declining profitability and an impending financial distress situation. Whereas some members on the management team blame their woes on lack of financial discipline and unethical behaviour, they have together designed a new 5-year plan, aimed at shoving off any takeover bids and revamping the company's profit levels.

The strategies so far agreed upon focus on expanding the sales and marketing team with the aim of growing sales volumes, and consolidating their extensive presence in the region. It is estimated that this will enable the company to grow annual sales by 10% per annum over the next five years, which are projected to amount to Shs 20 billion for the year ending 31 December 2010.

The following assumptions/strategies have also been agreed, as initially suggested by the company's financial controller (FC):

- (i) Maintain the growth of operating expenses at the current proportion.
- (ii) Achieve a profit before tax to sales ratio of 20%. Corporation tax is at the rate of 30%.
- (iii) Maintain the 'net assets turnover' ratio at about 0.60 times.
- (iv) Maintain a dividend payout ratio of 60% over the 5-year period.
- (v) Maintain gearing levels (measured by debt to debt plus equity) at a maximum of 40%.

Required:

- (a) Explain any **five** ways of overcoming financial distress.
(5 marks)
- (b) Prepare a five-year forecast statement of comprehensive income and forecast statement of financial position summary.
(6 marks)
- (c) Comment on the company's assumptions / strategies suggested by the FC against your forecasts.
(4 marks)
- (d) Explain the ethical issues facing corporate finance managers, and any three steps professional bodies like ICPAU should take to curb their prevalence.
(5 marks)

(Total 20 marks)

Question 3

Buzz Financial Services Limited (Buzz) is a small microfinance company operating in Central Uganda. The management of Buzz had been contemplating a United States dollar (USD) denominated loan from a certain development bank in the Middle East until the Uganda shilling (UShs) started depreciating against the US dollar in the later half of year 2009. They have now decided to raise money locally, to avoid any foreign exchange risks.

They are now planning to issue a bond with par value of UShs 1 billion in January 2011, redeemable in January 2017 at par. The coupon is planned to be 12%, payable annually in January.

During the preparation process, the management team was informed that investors may not necessarily pay the par value for such a security - especially given that they will determine their yield to maturity (YTM). The lead advisor cited the international financial turmoil, and the current yield curves in Uganda. However, the majority in management believe the bond issue shall be highly successful since the market rate for a security of this risk class is currently as low as 10% - though it may change any time.

Required:

- (a) Calculate the price investors will pay for this bond at the time of issue - in order to earn a 2% above the coupon;
(5 marks)
- (b) Estimate the bond's value in the secondary market in January 2014 if investors wanted to earn a return equivalent to the coupon rate - assuming the next coupon payment is in a year's time.
(5 marks)
- (c) Explain the would-be impact on Buzz if they had borrowed the money in USD and the Uganda shilling depreciated significantly.
(5 marks)
- (d) Briefly explain the theoretical relationships between inflation, interest, and foreign exchange rates, restricting your examples to the UShs and USD.
(5 marks)

(Total 20 marks)

Question 4

Real Return Trust Limited (RR-Trust) is a unit trust, incorporated in Uganda in the year 2007. The trust had close to 300 unit holders at the end of its financial year on 30 September 2010, with total assets amounting to Shs 2.56 billion.

The board of RR-Trust is currently faced with declining investment income, which has been largely attributed to the turbulence in the global financial markets, increasing oil and food prices, and partially to a non-aggressive investment strategy. The board recently decided to be a little more aggressive but cautious in risk-taking, in order to make sure that returns to their investors are not compromised. They would like management to advise them in more detail on all risks associated with any new investments under consideration.

Two securities; Invest 01 and Invest 02 are currently being considered for investment, and the following information has been provided to RR-Trust about them, assumed to have no correlation between them:

Security	Possible rates of return %	Probability of occurrence
<i>Invest 01</i>	25	0.4
	20	0.2
	15	0.4
<i>Invest 02</i>	30	0.2
	25	0.6
	20	0.2

Required:

- Explain any **five** key considerations an investor should make in building a portfolio of investments.
(5 marks)
- Calculate the expected return for each investment, and expected return for a portfolio composed of 30% Invest 01 and 70% Invest 02.
(5 marks)
- Calculate and comment on the risk (as measured by the standard deviation of the returns) of each security and the said two-security portfolio.
(6 marks)
- Explain any **three** advantages and at least **one** limitation to RR-Trust of diversifying their investment portfolio.
(4 marks)

(Total 20 marks)**Question 5**

The following information was extracted from the 2009 annual reports of Ayo Clays Ltd and Safe Tours Ltd, both listed firms but operating in different industry sectors. In their annual reports, one of the companies had emphasised how inflation had impacted on their operations, and assured investors that their expansion programmes would soon yield tangible results against all odds.

Statement of comprehensive income (extracts)

	Ayo Clays Ltd Shs million	Safe Tours Ltd Shs million
Turnover (gross)	14,206	6,560
Cost of sales	<u>(10,256)</u>	<u>(3,232)</u>
Gross profit	<u>3,950</u>	<u>3,328</u>
Profit before taxation	<u>1,072</u>	<u>950</u>
Profit after tax	<u>845</u>	<u>653</u>

Statement of financial position (extracts)

	Ayo Clays Ltd Shs million	Safe Tours Ltd Shs million
Assets		
Non-current assets	19,969	4,080
Current assets	<u>2,691</u>	<u>1,160</u>
Total assets	<u>22,660</u>	<u>5,240</u>
Equity and liabilities		
Share capital (Shs 500 per share)	2,500	650
Share premium	650	315
Revaluation reserves	6,562	245
Retained earnings	3,120	790
Proposed dividends	<u>650</u>	<u>220</u>
	<u>13,482</u>	<u>2,220</u>
Long-term borrowings	5,050	1,950
Deferred income taxes	2,054	312
Current liabilities	<u>2,074</u>	<u>758</u>
	<u>9,178</u>	<u>3,020</u>
Total equity and liabilities	<u>22,660</u>	<u>5,240</u>
Market capitalization (Shs million)	19,250	3,835

Required:

- (a) Prepare a report for a prospective investor, specifically advising him/her on the company which possesses better financial strength. Include the following in your report:
- (i) assets turnover and its impact on the overall results in the firms.
 - (ii) the firms' dividend yield and the return on equity.
 - (iii) the effect of inflation on ratio analysis.
 - (iv) any reasons why your report may or may not be entirely reliable.

(15 marks)

- (b) In your view, explain the likely impact the international financial crisis may have had on corporate financial management in Uganda.

(5 marks)

(Total 20 marks)

You may use the following list of financial formulae:
The capital asset pricing model

$$E r_i = R_f + \beta_i (E r_m - R_f)$$

The asset beta formula

$$\beta_a = \left(\frac{V_e \beta_e}{V_e + V_d (1-T)} \right) + \left(\frac{V_d (1-T) \beta_d}{V_e + V_d (1-T)} \right)$$

The Gordon model

$$P_0 = \frac{D_0 (1+g)}{r_e - g}$$

Purchasing power parity and interest rate parity

$$S_1 = S_0 \frac{(1+i_c)}{(1+i_b)} \quad S_1 = S_0 \frac{(1+r_c)}{(1+r_b)}$$

Present value interest factor of \$1 per period at i% for n periods, PVIFA (i,n).												
Period	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909	0.901	0.893
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.856	0.840	0.824	0.810	0.797
3	0.971	0.942	0.915	0.889	0.864	0.840	0.817	0.795	0.774	0.754	0.735	0.717
4	0.961	0.922	0.887	0.853	0.821	0.791	0.763	0.737	0.712	0.688	0.666	0.646
5	0.951	0.902	0.869	0.837	0.807	0.779	0.754	0.730	0.707	0.685	0.664	0.645
6	0.942	0.883	0.852	0.822	0.794	0.768	0.744	0.721	0.699	0.678	0.658	0.640
7	0.933	0.875	0.845	0.816	0.789	0.764	0.741	0.719	0.698	0.678	0.659	0.642
8	0.923	0.866	0.837	0.809	0.783	0.759	0.737	0.716	0.696	0.677	0.659	0.643
9	0.914	0.858	0.830	0.803	0.778	0.755	0.734	0.714	0.695	0.677	0.659	0.644
10	0.905	0.849	0.822	0.796	0.772	0.750	0.730	0.711	0.693	0.676	0.659	0.645
11	0.896	0.841	0.815	0.790	0.767	0.746	0.727	0.709	0.692	0.676	0.660	0.647
12	0.887	0.833	0.808	0.784	0.762	0.742	0.724	0.707	0.691	0.676	0.661	0.648
13	0.879	0.826	0.802	0.778	0.757	0.738	0.721	0.705	0.690	0.676	0.662	0.649
14	0.870	0.818	0.795	0.772	0.752	0.734	0.718	0.703	0.689	0.676	0.663	0.650
15	0.861	0.810	0.788	0.766	0.747	0.730	0.715	0.701	0.688	0.676	0.664	0.651

	13%	14%	15%	16%	17%	18%	19%	20%	21%	22%	23%	24%
1	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833	0.826	0.820	0.813	0.806
2	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694	0.683	0.672	0.661	0.650
3	0.693	0.675	0.658	0.642	0.626	0.610	0.595	0.580	0.566	0.552	0.539	0.526
4	0.613	0.592	0.573	0.555	0.538	0.521	0.505	0.489	0.474	0.460	0.446	0.432
5	0.543	0.519	0.497	0.477	0.458	0.440	0.423	0.407	0.392	0.378	0.365	0.351
6	0.480	0.453	0.432	0.413	0.395	0.378	0.362	0.347	0.333	0.320	0.307	0.294
7	0.425	0.400	0.377	0.357	0.339	0.323	0.308	0.294	0.281	0.269	0.257	0.245
8	0.376	0.351	0.329	0.309	0.291	0.275	0.260	0.247	0.235	0.224	0.213	0.202

Corporate Financial Management - Paper 12

9	0.33 3	0.30 8	0.28 4	0.26 3	0.24 3	0.22 5	0.20 9	0.19 4	0.18 0	0.16 7	0.15 5	0.14 4
10	0.29 5	0.27 0	0.24 7	0.22 7	0.20 8	0.19 1	0.17 6	0.16 2	0.14 9	0.13 7	0.12 6	0.11 6
11	0.26 1	0.23 7	0.21 5	0.19 5	0.17 8	0.16 2	0.14 8	0.13 5	0.12 3	0.11 2	0.10 3	0.09 4
12	0.23 1	0.20 8	0.18 7	0.16 8	0.15 2	0.13 7	0.12 4	0.11 2	0.10 2	0.09 2	0.08 3	0.07 6
13	0.20 4	0.18 2	0.16 3	0.14 5	0.13 0	0.11 6	0.10 4	0.09 3	0.08 4	0.07 5	0.06 8	0.06 1
14	0.18 1	0.16 0	0.14 1	0.12 5	0.11 1	0.09 9	0.08 8	0.07 8	0.06 9	0.06 2	0.05 5	0.04 9
15	0.16 0	0.14 0	0.12 3	0.10 8	0.09 5	0.08 4	0.07 4	0.06 5	0.05 7	0.05 1	0.04 5	0.04 0

Corporate Financial Management - Paper 12

Present value interest factor of an (ordinary) annuity of \$1 per period at i% for n periods, PVIFA (in).

Period	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.678	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.877	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Period	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106

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4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.69 0	2.63 9	2.58 9
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.12 7	3.05 8	2.99 1
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.49 8	3.41 0	3.32 6
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.81 2	3.70 6	3.60 5
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.07 8	3.95 4	3.83 7
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.30 3	4.16 3	4.03 1
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.49 4	4.33 9	4.19 2
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.65 6	4.48 6	4.32 7
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.79 3	4.61 1	4.43 9
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.91 0	4.71 5	4.53 3
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.00 8	4.80 2	4.61 1
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.09 2	4.87 6	4.67 5
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.16 2	4.93 8	4.73 0
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.22 2	4.99 0	4.77 5
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.27 3	5.03 3	4.81 2
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.31 6	5.07 0	4.84 3
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.35 3	5.10 1	4.87 0