

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA(U) EXAMINATIONS

### LEVEL TWO

#### CORPORATE FINANCIAL MANAGEMENT - PAPER 12

**THURSDAY, 16 JUNE 2011**

#### 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 9 - 11.
5. Please read further instructions on the answer book, before attempting any question.

**SECTION A****Question 1**

Sendi Company Limited (SCL) is a listed company dealing in the manufacture of toiletry products. The company has prepared the following draft financial statements for the year that has just ended.

Statement of Comprehensive Income for the year to 31 December:

	2010 Shs million	2009 Shs million
Turnover	9,600	8,640
Cost of sales	<u>(5,568)</u>	<u>(4,500)</u>
Gross profit	4,032	4,140
Operating expenses	<u>(3,408)</u>	<u>(3,000)</u>
Profit before interest and tax	624	1,140
Interest Expense	<u>(156)</u>	<u>(102)</u>
Profit before tax	468	1,038
Taxation	<u>(140)</u>	<u>(280)</u>
Profit after tax	328	758
Dividends	<u>(300)</u>	<u>(340)</u>
Retained profit	<u>28</u>	<u>418</u>
Statement of Financial Position	Shs million	Shs million
Non-current assets	2,250	2,000
Current assets:		
Inventory	1,660	1,500
Accounts receivable	2,110	2,200
Cash	<u>780</u>	<u>700</u>
	<u>4,550</u>	<u>4,400</u>
Current liabilities:		
Trade payables	750	700
Dividends	300	400
Bank overdraft	<u>450</u>	<u>350</u>
	<u>1,500</u>	<u>1,450</u>
Net current assets	<u>3,050</u>	<u>2,950</u>
Total assets less current liabilities	5,300	4,950
10% irredeemable debentures	<u>(1,200)</u>	<u>(1,200)</u>
	<u>4,100</u>	<u>3,750</u>
Capital and reserves:		
Ordinary shares, par value 500	1,000	1,000
Accumulated profits	<u>3,100</u>	<u>2,750</u>
	<u>4,100</u>	<u>3,750</u>

SCL pays interest on its overdraft at an annual rate of 6%.

SCL plans to invest Shs1 billion in a new product range and has forecast the following financial information:

Year	1	2	3	4
Sales volume (units)	70,000	90,000	100,000	75,000
Selling price (Shs/unit)	40,000	45,000	51,000	51,000
Variable costs (Shs/unit)	30,000	28,000	27,000	27,000

Incremental cash

Fixed costs (Shs '000' / year)	500,000	500,000	500,000	500,000
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The above cost forecasts have been prepared on the basis of current prices and no account has been taken of inflation of 4% per annum on variable costs and 3% per annum on fixed costs. Working capital investment accounts for 20% of the proposed initial investment and machinery for 80%. Working capital requirements will be constant until year 3 when the required working capital will be 10% of that year's sales. SCL uses a four-year evaluation period for capital investment purposes, but sales of the product are expected to continue even after the lapse of the four years, so working capital will remain in the business. The company pays tax on profits in the year in which the liability arises at an annual rate of 30% and claims capital allowances on machinery on a 25% reducing balance basis. No balancing allowance will arise in year 4.

Average data on companies similar to SCL

Interest cover 6 times

Long-term debt/ equity (book value basis) 50%

Long-term debt/ equity (market value basis) 25%

The company's ordinary shares are currently trading on the stock market at Shs 1,800 per share. The dividend paid by the company has increased at a constant rate of 5% per annum in recent years and, in the absence of further investment, the directors expect this dividend growth rate to continue for the foreseeable future. It has been suggested that the proposed Shs 1 billion investment could be financed by a new issue of corporate bonds with an interest rate of 12% per annum, redeemable after 4 years, although the finance manager feels that this is not the right timing to issue a bond given that the past and current information about the company may not be favourable. The existing debentures of the company are trading at Shs 93 per Shs 100 nominal and it is expected that the bond issue will be at the same price, with interest payments being made semi annually.

**Required:**

- (a) Explain the difficulties that may be encountered in determining the cost of capital for a private limited company.  
(6 marks)
- (b) With reference to the finance manager's statement, explain the concept of market efficiency, clearly distinguishing between technical and fundamental analysis.  
(7 marks)
- (c) Using SCL's current average cost of capital before the bond issue, evaluate the viability of the proposed investment.  
(13 marks)
- (d) Explain the concept of 'yield to maturity' and compute the yield to maturity on the proposed bond issue.  
(6 marks)
- (e) Evaluate the effect of the new issue on:
  - (i) interest cover.
  - (ii) gearing.
  - (iii) share price.

(8 marks)

(Total 40 marks)

**SECTION B**

**Question 2**

Riotess Company Limited (RCL) operates a chain of stores for ladies' clothes in various parts of Uganda. For the year ended 31 December 2010, the company reported after tax profits of Shs 250 billion. The company has 200 million Shs 500 shares in issue and a price earnings (P/E) ratio of 7.8 times. RCL has a subsidiary company, Pepperess Co. Limited (PCL), which offers hire purchase facilities to customers wishing to buy its more expensive designer labels.

The subsidiary has grown steadily and now offers hire purchase facilities to customers of other retailers as well as those of RCL. For the year that has just ended, the subsidiary contributed Shs 30 billion of the total after tax profits of RCL.

RCL is now considering a demerger and a separate stock exchange listing for the subsidiary. The financial advisers of RCL have suggested that PCL should be floated with a share capital of 40 million Shs 500 ordinary shares and that the shareholders of RCL should receive one share in PCL for every 5 shares held.

The financial advisers expect that the P/E ratio of the newly-listed company will be somewhere between 12 and 14 times. The P/E ratio of RCL is expected to reduce to 7.0 times as a result of the demerger.

Ignore taxation.

**Required:**

- (a) Distinguish between a divestment and a demerger.  
**(4 marks)**
- (b) Discuss the possible advantages and disadvantages of a demerger for the shareholders of a company.  
**(6 marks)**
- (c) Compute the likely effect of the demerger on the wealth of a shareholder holding 5,000 ordinary shares in RCL, assuming that the P/E ratio of PCL will be at the:
  - (i) lower end and;
  - (ii) higher end of the financial advisers' expectations and comment on your findings.**(10 marks)**

**(Total 20 marks)**

**Question 3**

Poor Assist Charity (PAC) has its main objectives as the reduction of poverty and hunger in poor countries like Uganda, besides the management of emergency programmes to cope with the consequences of disasters such as floods and droughts. Most of its funding is from donations, government and other public entities. To supplement its income, PAC operates a chain of retail stores manned mainly by voluntary staff and for their premises; they normally pay below market price rent. PAC's other permanent staff are employed in the management of medium to long-term development programmes, crisis management and fund raising.

**Required:**

- (a) Discuss the relevance of the principles and methods of corporate financial management, to the activities of PAC.  
**(14 marks)**
- (b) Explain how net present value relates capital investment decisions to the primary financial objective of a public limited company.

**(6 marks)**  
**(Total 20 marks)**

**Question 4**

Kalembe Manufacturers Limited produces packaging materials for a diverse number of customers. The business has grown rapidly in the past five years and has reached a point where a significant amount of finance is needed to secure future growth.

The Board recently decided to list the business on the Uganda Securities Exchange and is currently examining the full implications of this decision on its operations. An important issue to be confronted is future dividend policy. To date, the business has been focusing on future growth and dividend policy has been viewed as relatively unimportant. The Chairman has argued, however, that a securities exchange listing must alter the way in which the business views dividend policy. The Chief Executive, on the other hand, has argued that dividend policy should not be an urgent issue as the company has many other burning issues to address, especially on whether to go through the whole initial public offer process or to use private placement for their proposed share issue.

Key information concerning the business for the past five years is as follows:

Year ended 31 May	Profits after tax Shs million	Ordinary dividends Shs million	Ordinary shares in issue
2006	1,140	480	1,500,000
2007	990	550	2,200,000
2008	1,232	1,056	2,200,000
2009	2,520	384	3,200,000
2010	2,800	1,360	3,400,000

**Required:**

- (a) Discuss the dividend policy followed by Kalembe Manufacturers Limited over the past five years.  
**(5 marks)**
- (b) Evaluate the views expressed by the chairman and chief executive and discuss the key points to be taken into account when establishing an appropriate dividend policy for the company.  
**(10 marks)**
- (c) Differentiate between private placement and initial public offer for sale as methods of issuing shares.  
**(5 marks)**

**(Total 20 marks)**

**Question 5**

Mangolian Co. Ltd is a listed company based in Uganda. It manufactures small electrical components for farming and industrial machinery which it sells within the East African Community. Assume the date today is 1 June and Mangolian Co. Ltd has sold components worth Hong Kong Dollars (HK\$) 30 million to a company based in Hong Kong, which it will ship in a month's time and for which payment is expected two months after shipment. It is expecting a receipt of Euro (€) 2 million from a French company in six months' time. Mangolian Co. Ltd also expects to make a total payment of HK\$ 50 million to a number of Hong Kong based companies in three months' time.

Mangolian Co. Ltd accounts for all its cash inflows and outflows in Uganda Shillings (Shs) and uses the money markets to hedge its currency exposures. Information currently available to the company is as follows:

**Exchange Rates (per Shs 1)**

Spot:

€/Shs	0.00033–0.00036
HK\$/Shs	0.0027–0.0031

Three months:

€/Shs	0.00036–0.00039
HK\$/Shs	0.0025–0.0033

**Interest Rates (per quarter)**

	Borrowing	Investing
Uganda	4.80%	2.00%
Eurozone	2.70%	2.30%
Hong Kong	2.30%	1.95%

Mangolian Co. Ltd incurs commission costs of Shs 1.8 million per foreign exchange transaction when using the money markets. It has no spare cash in any of the countries and any money required would need to be borrowed. In the future, the company is considering the use of futures contracts or forward markets to hedge currency exposure.

**Required:**

- (a) Show how money markets would be used to hedge currency exposure to the above transactions.  
(10 marks)
  - (b) Explain the common challenges of currency hedging to corporate finance managers in less developed countries.  
(5 marks)
  - (c) Explain the concept of securitization as a means of raising funds.  
(3marks)
  - (d) Give **two** advantages associated with this method of raising funds.  
(2 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

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

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	0.857	0.842	0.826	0.812	0.797
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751	0.731	0.712
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683	0.659	0.636
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621	0.593	0.567
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564	0.535	0.507
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513	0.482	0.452
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467	0.434	0.404
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424	0.391	0.361
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386	0.352	0.322
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350	0.317	0.287
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319	0.286	0.257
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290	0.258	0.229
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263	0.232	0.205
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239	0.209	0.183

	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	0.641	0.624	0.609	0.593	0.579	0.564	0.551	0.537	0.524
4	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482	0.467	0.451	0.437	0.423
5	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402	0.386	0.370	0.355	0.341
6	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335	0.319	0.303	0.289	0.275
7	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279	0.263	0.249	0.235	0.222
8	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233	0.218	0.204	0.191	0.179
9	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194	0.180	0.167	0.155	0.144
10	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162	0.149	0.137	0.126	0.116
11	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135	0.123	0.112	0.103	0.094
12	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112	0.102	0.092	0.083	0.076
13	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093	0.084	0.075	0.068	0.061
14	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078	0.069	0.062	0.055	0.049
15	0.160	0.140	0.123	0.108	0.095	0.084	0.074	0.065	0.057	0.051	0.045	0.040

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
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870