MACHAKOS UNIVERSITY

University Examinations for 2018/2019 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF BANKING, ACCOUNTING & FINANCE

FOURTH YEAR SPECIAL/SUPPLEMENTARY EXAMINATION FOR

BACHELOR OF COMMERCE

BAC 407: FINANCIAL STATEMENT ANALYSIS

DATE: 23/7/2019 **TIME: 8.30-10.30 AM**

INSTRUCTIONS: Attempt Question One and any other Two Questions

QUESTION ONE (30 MARKS)

a) Define **An Asset** and Differentiate between **Current Assets and Long Live Assets**. (5 marks)

b) What is a Statement of Financial Position and how would it be useful to an Investor? (5 marks)

The following data relates to Welness Company Ltd. for the year to 31 December 2015:

	Sh. 000
Sales	30,000
Total assets	25 678
Retained earnings	177
Total liabilities	5 044
Working capital	1 777
Earnings before interest and tax	2 605
Market value of equity	10 098
Book value of total liabilities	5 044

Required :

Using the Altmans Z-score model assess the financial health of the company. (10 marks)

c) Explain the following terms as used in Lease Financing

   i. Finance Lease

   ii. Operating Lease

   iii. Leveraged Lease (3 marks)

d) A Company that extracts natural gas and oil has a drilling platform in the Caspian Sea. It is required by legislation of the country concerned to remove and dismantle the platform at the end of its useful life. Accordingly, the Company has included an amount in its accounts for removal and dismantling costs, and is depreciating this amount over the platform's expected life.

   The Company is carrying out an exercise to establish whether there has been an impairment of the platform.

   i. Its carrying amount in the balance sheet is Kshs.3m

   ii. The Company has received an offer of Shs.2.8m for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its life.

   iii. The present value of the estimated cash flows from the platform's continued use is Kshs.3.3m

   iv. The Carrying amount in the balance sheet for the provision for dismantling and removal is currently Kshs.0.6m

Required:

I. Calculate the value of the drilling platform that should be in the balance sheet. (4 marks)

II. Calculate the value of the impairment loss (3 marks)

QUESTION TWO

a) ABC ltd has 2 000,000 ordinary shares of Sh.10 each fully paid on 1st January 2015, the company issued a further 1 000,000 shares of Sh.10 each at a market price of Sh. 15 each. As at 31st December 2015 the shares were 50% paid up. The average market price per share during the year was Sh. 20. The net profit for the year 2015 was Sh.8m.

Required:

i. Basic EPS (3 marks)

ii. Diluted EPS (3 marks)

b) The information below relates to the inventory transactions of Beta Ltd for the year ended 31 December 2017.

Date	Activity	Units acquired at cost	Units sold at Retail	Inventory
1January 25January 14March 17June 28September 30November	Opening Inventory Purchases Sales Purchases Purchases Sales	10@9,100 15@10,600 20@11,500 10@11,900	 20@1,300 23@1,500	10 Units 25 Units 5 Units 25 Units 35 Units 12Units
		55 Units	43Units	12 Units

Beta Ltd uses the perpetual inventory system and updates its inventory account continually to reflect purchases and sales. Total expenses amount to Shs.45, 000 and income tax is 30%.

Required:

Using FIFO and LIFO calculate

i. Cost of goods sold (6 marks)

ii. Value of closing inventory (6 marks)

From your results above, what is the effect of each of the inventory valuation methods on the profits? (2 marks)

QUESTION THREE (20 MARKS)

You are a professional Financial Consultant and your client is interested in acquiring a 30% shareholding in the ordinary share capital of Maendeleo Chap Chap ltd, a private company. The following is the latest balance sheet of Maendeleo Chap Chap ltd as at 31 August 2014:

Fixed Assets:	**shs.**	**shs.**
Freehold property – at cost		555,000
Plant and machinery – cost	1,530,000	
Less depreciation to date	450,000	1,080,000
		1,635,000
Current Assets Stock	1,515,000	
Debtors	2,055,000	
Cash	630,000	
	4,200,000	
Current liabilities		
Creditors	2,661000	
Taxation	570,000	
Proposed dividend	234,000	
	3,465,000	735,000
Net Asset		2,370,000

Financed by:	Shs.
Authorized and issued share capital:	
22,500 10% preference shares @ sh. 20 each	450,000
22,500, ordinary shares @ shs. 20 each	450,000
Profit and loss Account	750,000
12% debentures 2022/10	720000
	2,370,000

You are also given the following information

Year ending	net profit	rate of dividend Sh. %
2012	810,000	Nil
2013	573,000	25
2014	1,196,250	45
2015	1,350,000	directors forecast

A professional valuation estimated the current market value of freehold property at sh. 930,000. The plant and machinery is considered fairly valued at net book figures. The debentures are secured by a fixed charge. The directors have anticipated that it will be their policy for the foreseeable future to retain 75% of the available profits. The corporation's tax rate is 35%.

Required:

a) Compute a value for the ordinary shares of the company using:

   i. The dividend yield method. Assume a dividend yield of 20% (gross). (3 marks)

   ii. Net assets basis. (4 marks)

   iii. Price- Earnings ratio basis. Assume a price- Earning ration of 2.5 (3 marks)

b) Advice your client. (3 marks)

QUESTION THREE.

The following are Financial Statements of Markup Corporation Ltd, a motivated Company in the Konza Techno City for the Years ending 31 December 2016 and 2017.

Mark up Corporation

Balance sheet

For Years 2016 and 2017(Ksh)

	2016	**2017**
Assets	'000'	'000'
Cash and Cash Equivalents	6,000	4,000
Receivables	15,000	12,000
Merchandise Inventories	28,000	20,000
Total Current Assets	49,000	36,000
Property, Plant, and Equipment, Net	75,000	64,000
Total Assets	124,000	100,000
Liabilities and Shareholders' Equity		
Accounts Payable.	31,000	24,800
Accrued Wages and Other	19,000	16,000
Total Current Liabilities	50,000	40,800
Long-Term Debt	18,000	12,000
Shareholders' Equity:		

Common Stock	1,500	1,000
Additional Paid-in Capital	24,500	18,000
Retained Earnings	30,000	28,200
Total Shareholders' Equity	56,000	47,200
Total Liabilities and Shareholders' Equity	124,000	100,000

Markup Corporation

Income Statements

For Years 2016 and 2017(Ksh)

	2016	**2017**
Revenue	92,000	85,000
Cost of Goods Sold	67,000	70,000
Gross Profit	25,000	15,000
Selling, General, and Administrative Expenses.	8,000	6,000
Research and Development Expenses	7,000	5,000
Operating Income	10,000	4,000
Interest Expense	2,000	1,000
Income Before Income Tax Expense	8,000	3,000
Income Tax Expense	3,200	1,200
Net Income	4,800	1,800

Tax Rate 40.0% 40.0%

Required:

a) Prepare Comparative Statements of Financial position and income statements for markup Corporation. (14 marks)

b) Based on your Analysis, would advise a potential investor of Markup Corporation to proceed or review his investment decision in this Corporation. (6 marks)

QUESTION FOUR (20 MARKS)

The following information was taken from the annual reports of a firm that wishes to remain anonymous.

FINANCIAL SUMMARY

For a Number of years, the Corporation has used the Last in First Out Method of Accounting for its Inventories. In periods of extended inflation, coupled with uncertain supplies of raw materials from diverse suppliers, and rapid increases and fluctuations in prices of raw materials, earnings can be affected unrealistically for any given year.

Due to these factors, the Corporation will apply to the Internal Revenue Service to discontinue using the LIFO method of accounting for valuing those inventories for which this method has been used. If such application is granted, the LIFO reserve at December 31 2017 of Shs.12, 300,000 would be eliminated, which would require a provision for income taxes over 10-year period. If the corporation had used LIFO method of accounting during 2016, net earnings for the year would have increased by approximatelyShs.1, 500,000.

The 2017 Report disclosed the following:

	2017	2016
Sales and Revenues	Shs. 536,467,000	487,886,000
Earnings per share	Sh.3.40	Shs. 3.60

Required:

a) The Corporation indicates that earnings can be affected unrealisticaclly by rapid increases and Fluctuations in Prices when using LIFO. Comment. (6 marks)

b) How will a Switch from LIFO affect 2017 Profits (7 marks)

c) How will a Switch from LIFO affect future profits (7 marks)