CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

THIRD YEAR EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 334: FINANCIAL STATEMENT ANALYSIS

STREAMS: BCOM Y3S1 **TIME: 2 HOURS**

DAY/DATE: MONDAY 10/12/2018 **11.30 AM – 1.30 PM**

INSTRUCTIONS:

Answer Question One and any other Two Questions

QUESTION ONE

(a) A financial analyst came across the following section in the 2001 annual report of Mwangaza Kodak Company. The Company is headquartered in Kenya and has branches in East African countries. The company's key operations are in health imaging and consumer digital camera business.

The company expects 2018 to be another difficult economy year, with full year revenues level with 2017 and some earnings improvements in the second half of 2018. We do not expect to see any real upturn in the economy until 2019 with a very gradual return to consumer spending habits and behavior that will positively affect our business growth. The company will continue to take actions to minimize the financial impact of this slowdown. These actions include efforts to better manage production and inventory levels and reduce capital spending to further hold down costs. The company will also complete the implementation of the restructuring programs announced in 2017 to make its operations more cost competitive and improve margins, particularly in its health imaging and consumer digital camera businesses.

During 2016, the company completed an ongoing program of real estate divestitures and portfolio rationalization that contributed to other income (charges) reaching an annual average of ksh. 100 million over the past three years. Now that this program is largely complete, the other income (charges) category is expected to run in the negative ksh. 50 million to negative ksh. 100 million range annually.

The company expects its effective tax rate to approximate 29% in 2018. The lower rate is attributable to favorable tax benefits from the elimination of goodwill amortization and expected increased earnings from operations in lower taxed jurisdictions outside Kenya. From liquidity and capital perspective, the company expects to generate Ksh. 6 billion in cashflow after dividends during the next six years, with approximately ksh. 400 million of this being achieved in 2018. This will enable the company to maintain its dividend, pay down debt and make acquisitions that promote profitable growth.

Required:

What kind of report does this extract represent in the annual financial report? Highlight the key aspects addressed in the report. [10 marks]

(b) Briefly explain the parties interested in analysis of financial statements and why they are interested in the analysis. [10 marks]

(c) The management of East -End Company provides you with comparative income statements for the years ended December 31, 2017 and 2016.

East-End Company
Income Statement
For the year ended 31st December (sh.000)

	2017	**2016**
Sales revenue	3074	2567
Less cost of sales	2088	1711
Gross profit	986	856
Less: Operating expenses	568	553
Operating profit	**418**	**303**
Less: interest expense	93	91
Net profit before taxes	325	212
Less: taxes (29%	94	64
Net profit after tax	231	148
Less: dividends	10	10
Earnings available to ordinary shareholders	**221**	**138**

East End Company
Statement of Financial Performance
For the year ended 31st December (sh.000)

	2017	2016
Current Assets	1223	1004
Net Non-current Assets	2374	2266
Total Assets	**3597**	**3270**
Liabilities & Stockholders' Equity		
Total current liabilities	620	483

Long term Debt	1023	967
Total liabilities	**1643**	**1450**
Shareholders' Equity:		
5% preferred stock (sh. 100 par)	200	200
Ordinary shares (sh. 2.50 par)	191	190
Share Premium	428	418
Retained Earnings	1135	1012
Total Liabilities & stockholders' Equity	**3597**	**3270**

The end of year market price per ordinary share of East-End company was sh. 25.25 and sh. 32.25 in 2016 and 2017 respectively

Required:

(i) Current ratio [2 marks]
(ii) Earnings Per Share (EPS) [2 marks]
(iii) Price/Earnings ratio [2 marks]
(iv) Debt ratio [2 marks]
(v) Average collection period [2 marks]

QUESTION TWO

(a) Explain the following components of business analysis

(i) Business environment and strategy analysis [3 marks]
(ii) Credit analysis [3 marks]

(b) The following are ratio information for EABL Ltd, and the manufacturing industry averages for the year ending 31.12.2015 and 31.12.2016

		2015	2016
Financial Leverage Multiplier	EABL	1.75	1.75
	Industry	1.67	1.69
Net Profit Margin	EABL	5.9%	5.8%
	Industry	5.4%	4.7%
Total Assets Turn-over	EABL	2.11	2.18
	Industry	2.05	2.13

Construct the DuPont system of analysis for both EABL and the industry. Comment on how effective has EABL Ltd has utilized other people's money to earn income for shareholders. [6 marks]

(c) Robert Brown recently inherited as tock portfolio form his uncle. Wishing to learn more about the companies that he is now invested in, Robert performs ratio analysis on each one and decides to compare them to each other. Some of the ratios are listed below

Ratio	A	B	C	D
Current ratio	1.1	1.3	6.8	4.5
Quick Ratio	0.9	0.82	5.2	3.7
Debt ratio	0.68	0.46	0	0.35
ROA	6.2%	14.3%	28.5%	8.4%

Assuming that his uncle was a wise investor who assembled the portfolio with care, Robert finds the wide differences in the ratios confusing. Help him out

(i) What might be the probable reason for low current and quick ratios for company A and B? [3 marks]

(ii) Why would investors consider company A to have high financial risk. [2 marks]

(iii) Suppose company D has current assets valued at sh. 450,000, calculate its balance sheet inventory value. [3 marks]

QUESTION THREE

(a) Financial statements, though valuable, suffer from certain limitations. Discuss. [10 marks]

(b) Selected comparative income statement of Daima Company is given below:

Year	**2016**	**2015**
Net sales	990,000	810,000
Cost of goods sold	574,000	461,700
Gross Profit	416,000	348,300
Operating Expenses		
Selling expenses	130,000	132,000
General expenses	122,500	125,500
Total Operating Expenses	252,500	257,500
Income from operations	**163,500**	**90,800**
Interest expense	21,000	24,000
Income before tax	139,000	66,800
Income tax expense	36,360	17,368
Net Income	**103,140**	**49,432**

Required: Horizontal analysis of income statement showing changes in shilling amount and percentage changes, taking 2015 as the base year. [10 marks]

QUESTION FOUR

(a) Financial ratio analysis divided into liquidity, activity, debt, profitability and market ratios. Differentiate each of these areas of analysis from the others. [10 marks]

(b) XYZ company provides the following statement of cash flows:

XYZ Company
Statement of Cash Flows
For the year ended 31st December 2014

Operating Activities		
Net income		134,000
Adjustments:		
Depreciation	21,000	
Changes in operating assets and liabilities		
Decrease in accounts receivable	10,000	
Increase in prepaid items	(6,000)	
Increase in accounts payable	35,000	60,000
Cash provided by operating activities		194,000
Cash flows from investing activities:		
Purchase of land	(70,000)	
Purchase of building	(200,000)	
Purchase of equipment	(68,0000)	
Cash used by investing activities		(338,000)
Cash flows from financing activities:		
Issuance of bonds	150,000	
Payment of cash dividends	(18,000)	
Cash provided by financing activities		132,000
Net decrease in cash		(12,000)

Provide an analysis of the statement of cash flows for the company paying attention to:

(i) Ability to generate cash internally
(ii) Capital expansion
(iii) Dividend payout
(iv) Changes in accounts receivable and payables
(v) Interest free financing
(vi) Financing risk to investors [10 marks]
