KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2017/2018

FIRST SEMESTER EXAMINATION FOR THE DEGREE OF

BACHELOR OF COMMERCE

<u>BAC 407: FINANCIAL STATEMENT ANALYSIS</u>

DATE: Friday, 24th November 2017 **TIME:** 4.30 p.m. - 6.30 p.m.

<u>INSTRUCTIONS</u>:

Answer all questions.

QUESTION ONE

The Altman formula for prediction of bankruptcy is given as follows:

Z score = $1.2X_1 + 1.4X_2 + 3.3X_3 + 1X_4 + 0.6X_5$

X_1, X_2, X_3, X_4 and X_5 are ratios as indicated below

Where: X_1 = Working capital/total assets

X_2 = Retained earnings/Total assets

X_3 = Earnings before interest and tax/Total assets

X_4 = Sales/Total assets

X_5 = Market value of Equity/Liabilities

You are provided with the following information in respect of four listed companies.

	Working Capital	Retained Earnings	Earnings before interest and tax	Market value of equity	Total Assets	Liabilities	Sales
	Sh. '000'	Sh. '000'	Sh. '000'	Sh. '000'	Sh. '000'	Sh. '000'	Sh. '000'
A Ltd.	4,000	60,000	10,000	20,000	200,000	120,000	200,000
B Ltd.	2,000	20,000	0	5,000	100,000	80,000	120,000
C Ltd.	6,000	20,000	-30,000	48,000	800,000	740,000	900,000
D Ltd.	40,000	200,000	30,000	100,000	1,800,000	1,000,000	2,000,000

Required:

(a) The Z-Score for each of the companies. Comment on the results obtained. (8 marks)

(b) It has been suggested that other ratios ought to be incorporated into Altman's bankruptcy prediction model. What is your opinion on this? (3 marks)

(c) Outline the indictors of possible business failure. (4 marks)

[Total - 15 marks]

QUESTION TWO

(a) Distinguish between operating and financial lease. (2 marks)

(b) Explain the limitations of percentage of sales method as used in projecting the financial requirements of an entity. (2 marks)

(c) Rahisi Pegra Company Limited sells hardware items on terms of 2/10 net 30. Its financial statements for the last three years are as follows:

	2013	2014	2015
	Sh. '000'	Sh. '000'	Sh. '000'
Cash	30,000	20,000	5,000
Accounts receivable	200,000	260,000	290,000
Inventory	400,000	480,000	600,000
Net fixed assets	800,000	800,000	800,000
	1,430,000	1,560,000	1,695,000
Accounts payable	230,000	300,000	380,000
Accruals	200,000	210,000	225,000
Bank loan, short term	100,000	100,000	140,000
Long term debt	300,000	300,000	300,000
Common stock	100,000	100,000	100,000
Retained earnings	500,000	550,000	550,000
	1,430,000	1,560,000	1,695,000
Additional information:			
Sales	4,000,000	4,300,000	3,800,000
Cost of goods sold	3,200,000	3,600,000	3,300,000
Net profit	300,000	200,000	100,000

Required:

(a) For each of the three years, calculate the following ratios:

(i) Acid test ratio (2 marks)

(ii) Average collection period (2 marks)

(iii) Inventory turnover (2 marks)

(iv) Total debt/equity (2 marks)

(v) Net profit margin (2 marks)

(vi) return on asset (2 marks)

(b) From the ratios calculated above, comment on the liquidity, profitability and gearing positions of the company. (2 marks)

(c) Identify and describe limitations of ratio analysis. (2 marks)

[Total: 20 marks]

QUESTION 3

Using the following information prepare a common size income statement and comment on the analysis results. (15 marks)

Particulars	2014	2015
Manufacturing expenses	70,000	160,000
Opening stock	60,000	60% of closing stock
Sales	1,920,000	900,000
Return outwards	8,000 (out of credit purchase)	12,000 (out of credit purchase)
Closing stock	150% of opening stock	200,000
Credit purchase	300,000	150% of cash purchase
Cash purchase	80% of credit purchase	80,000
Carriage outwards	20,000	60,000
Buildings	200,000	400,000
Depreciation on building	20%	10%
Interest on bank overdraft	10,000	-------------
10% debenture	400,000	4,000,000
Profit on sale of copyright	20,000	40,000
Loss on sale of personal car	20,000	40,000
Other operating expenses	40,000	20,000
Tax rate	50%	40%

QUESTION 4

(a) Explain functions of a cash budget in a business organization. (5 marks)

(b) Lake View Ltd is a small company that operates an electronics equipment business along Moi Avenue in Kisumu city. The firm sales its equipment on credit and its suppliers also extend the same to the firm. The company's account expects the 1st January 2017 opening cash balance to be shs 60,000. The company's projected sales budget for sales and purchases are given below:

Month	Projected Sales	Projected Purchases
November 2016	160,000	-
December 2016	180,000	120,000
January 2017	150,000	110,000
February 2017	150,000	90,000
March 2017	80,000	110,000

The company's debt policy stipulates that 65% of the sales are collected within the actual month of the sale, 25% of the sales are collected a month after the actual sale while 10% of the sales are collected the second month after the sale.

All purchases are made on credit and past experience shows that 90% of the purchases are paid in the actual month when the purchase occurs while the 10% is paid the month after the purchase.

The firm has employed three support staff who earns an equal monthly salary of shs 10,000 each (*ignore income tax and other deductions*). The firm also incurs factory overheads of shs 40,000 on a monthly basis inclusive of depreciation of shs 10,000 per month.

Taxation of shs 16,000 will be settled in the month of February 2017. The company expects to be paid insurance settlement of shs 50,000 in the month of March 2017.

Required:

(i) Prepare the firm's cash collections schedule for January to March 2017. (4 marks)

(ii) Prepare the firm's cash payments schedule for January to March 2017. (4 marks)

(iii) Prepare the firm's cash budget for January to March 2017. (7 marks)

[Total - 20 Marks]