MACHAKOS UNIVERSITY

University Examinations for 2020/2021 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF BUSINESS ADMINISTRATION

SECOND YEAR FIRST SEMESTER EXAMINATION FOR

MASTER OF BUSINESS ADMINISTRATION

BAC 819: FINANCIAL ANALYSIS

DATE: 3/3/2021 **TIME: 9.00-12.00 PM**

INSTRUCTIONS:

- **Answer any FOUR Questions // All Questions have equal Marks**

QUESTION ONE (25 MARKS)

A Telkom company reports sales of 100 million shillings and net income of Kshs. 1 million. Included in the net income figure is 5% of sales in Research and development costs, and 1 percent of sales in operating lease expense. In the past years, however, the company's research and development costs relative to sales was 8%. Similar companies are showing 8% this year as well. Competing companies have classified the same lease as finance lease because all the risks and rewards of legal ownership are transferred to the lease. The effect of the misclassification of the lease on Telcom total expenses is only Kshs. 500,000.

REQUIRED:

a) As an analyst whose intention is to compare Telcom company with its competitors, what adjustments are necessary on the earnings as reported and why? (4 marks)

b) Prepare industry comparable Income statement for Telcom Company reflecting realistic earnings. (10 marks)

c) The Telcom company is an example of how accountants can distort accounts or misstate accounts and hence quality of earnings of a company. Distinguish between accounting misstatement and accounting distortion. Do you judge Telcom was a case of misstatement or accounting distortion? (6 marks)

d) Discuss which of the two accounting systems (Historical or Fair value accounting) produces numbers relevant for decision making. (5 marks)

QUESTION TWO (25 MARKS)

a) Write short notes on following concepts:

   i. Management discussions & analysis (MD&A) (6 marks)

   ii. Faithful representation of accounts (6 marks)

   iii. Vertical analysis (4 marks)

b) As an investor, you are considering buying Equity shares. As part of your preliminary review of Equity, you examine its financial statements. What information are you attempting to obtain from each of these statements to aid in your decision? (9 marks)

QUESTION THREE (25 MARKS)

a) Orange company is listed in the NSE. Recently, an analyst carried out financial ratios analysis for 5 years and extracted the following:

Ratio	**2013**	**2014**	**2015**	**2016**	**2017**	**Industry Average**
Current ratio	1.9	2.10	2.35	2:22	2:1	2.30
Quick ratio	1.3	1.1	1.4	1.45	1.5	1.06
Asset turnover	1.06	1.1	1.13	1.2	1.15	1.40
ROI	13.2%	12.09	12.0	12.5	13.2	15.2%
ROA	12.5%	13.0	13.1	13.5	14.1	12.3%
ROE	13%	12	13.0	12	13	13%
Debt ratio	0.49	0.45	0.43	0.40	0.41	0.45
EPS	1.60	3.16	2.77	3.10	3.50	2.50
DPS	1.1	1.3	1.2	1.2	1.2	1.5
P/E ratio	8.5	8.3	10.2	9.7	8.9	7.2

REQUIRED:

i. Explain the types of ratio analysis used in the illustration from the extract ratios. (2 marks)

ii. As a broker what's your recommendation for this company to a potential investor who recently won the Safaricom's 'Tetemesha" lottery and is contemplating investing in a good company. (5 marks)

iii. At a recent finance conference, one of the papers presented cautioned on relying wholly on results based on ratios. Do you agree? Give reason for this caution. (3 marks)

b) The following Balance sheet belongs to ABC Ltd.

Balance sheet	2011	2012	2013	2014	2015
Current Assets	16,320	18,058	18,593	19,807	25,491
Non-current Assets	33,392	36,526	39,962	43,058	41,449
Current Liabilities	15,509	22,484	26,606	27,400	24,930
Non-Current Liabilities	7,315	23,384	23,515	26,304	28,656
Total Equity	26,888	24,833	25,592	27,311	31,982
Short term Borrowings	1,229	4,857	4,951	12,545	4,894
Long term Borrowings	3,918	19,982	19,841	22,294	24,469

REQUIRED:

i. Prepare a common size percentage Balance Sheet (9 marks)

ii. Make comments on key highlights (6 marks)

QUESTION FOUR (25 MARKS)

Over the Counter Ltd. Summary Profit statements 2014 – 2016

	Kshs. '000		
	2014	**2015**	**2016**
Sales	250	280	300
Less: Cost of sales	170	180	210
Gross profit	80	100	90
Less: Operating Expenses and depreciation	40	45	50
Net profit before tax	40	55	40
Less: Taxation	15	20	17
Net Profit after tax	25	35	23
Less: dividends	10	10	7
Retained profit	15	25	16
Industry average (Turnover)	**250**	**300**	**350**
Current ratio	**1.5**	**1.8**	**1.1**
Debt Ratio (%)	**38**	**40**	**45**

REQUIRED

a) Prepare a common-size inter-period analysis (Horizontal & Vertical) of these statements and evaluate significant changes in the company's performance through each analysis. (10 marks)

b) Which analysis lends itself to easy interpretation, discuss (5 marks)

c) Assume OTC company wants a revolving credit of Kshs. 10 million. Should this loan be made? Undertake a credit risk analysis. (10 marks)

QUESTION FIVE (25 MARKS)

a) "Assume you are a transport analyst, and you have been asked to write a research report on the on-going Kenyan standard gauge rail (SGR) project. The railroad industry is capital intensive where most assets are long-lived. In November 2013 the Jubilee government hired a new management team that took over the rail operations in Kenya. In reviewing the 2014 semi-annual report you are concerned about some of the accounting choices the SGR management team has made. The choices differ from common industry practice, as well as from previous Kenyan railway accounting reports. You have highlighted the following statements from the explanatory notes to the 2014 Semi-annual accounts report.

Statement #1: "In 2014 SGR sent significant amounts on track replacement and similar improvements. SGR expensed rather than capitalize a significant proportion of the expenditures".

Statement #2: "SGR uses the straight line method of depreciation for both financial and tax reporting purposes to account for plant and equipment".

REQUIRED:

i. With respect to statement #1, analyze the effect of management's decision to expense rather than capitalize the expenditures. (6 marks)

ii. With respect to statement #2, analyze the likely effect in 2015 if SGR were to switch to an accelerated depreciation method for financial and tax reporting. (6 marks)

b) Why are companies audited? Explain whether analysts rely on audited report and for what purpose. (8 marks)

c) Give reasons why disclosure requirements in accounting are important to financial analysts. (5 marks)