UNIVERSITY OF COLOMBO, SRI LANKA

FACULTY OF MANAGEMENT AND FINANCE

Bachelor of Business Administration (Level II - Semester VII) Examination
July 2017

FIN 2201 – Financial Reporting and Analysis

Two (02) Hours

Instructions to candidates:

1. Answer **ALL** Questions.
2. The use of calculators is permitted.

1

i. Briefly explain any four main features of the financial statements.

(04 Marks)

ii. Gearing is one of the frequently used financial ratios to measure the long term financial stability of a company. Explain the weaknesses in this financial ratio and suggest possible solutions to overcome those weaknesses.

(08 Marks)

iii. The following information is extracted from the books of CCS (PLC).

Year	NP Margin ratio	Asset Turnover Ratio	Financial Leverage
2017	8.44%	1.88	1.58
2016	5.51%	1.73	1.55

a. Calculate the return on equity (ROE) of CCS (PLC) for the financial years 2016 and 2017.

(06 Marks)

b. The management of CCS (PLC) is expecting to increase the financial leverage of the company up to 1.8 in the next financial year (i.e. 2018). Further, it anticipates the net profit margin will increase by 6.7% and asset turnover ratio to increase up to 2 in the next financial year as a result of the change in the financial leverage of the company. Analyse the impact of above changes on ROE of the company and comment on your results.

(07 Marks)

(Total 25 marks)

2.

i. The corporate failure models such as A Score model attributed to Argenti (1976) are important to predict the bankruptcy risk of a company. Explain how Argenti's A Score model can be used in predicting the bankruptcy risk of a company

(12 Marks)

ii. Apex PLC leases a machine to Mount PLC. The lease is for six years at an annual cost of Rs. 400,000 payable in arrears. The fair value of the machinery is Rs. 1.8 million and the useful economic life of the machinery is estimated as 8 years. The implicit interest rate is 10.84%.

a. Briefly explain how Mount PLC should account for the above lease agreement.

(02 Marks)

b. Prepare the extracts from financial statements of Mount PLC for the first financial year.

(11 Marks)

(Total 25 marks)

3.

i. The following information is extracted from the financial statements of Amba PLC for the financial year 2016/2017.

Total sales (Rs,)	750,000
Net profit (Rs.)	25,000
Share capital (Rs. 1.00)	100,000
Debt (Rs.)	90,000
Dividend per share (Rs.)	0.10
Debt to Equity (debt/equity) ratio	45%

The Chief Executive Officer (CEO) of Amba PLC is expecting to achieve target sales revenue of Rs. 800,000 in the next financial year. However, he expects to maintain the existing operating, debt and dividend payout ratios while achieving this sales target in the next financial year.

Evaluate whether Amba PLC will be able to achieve the expected sales revenue target in the next financial year.

(10 Marks)

ii. The following information is reported as at 01 January, 2017 for Abba PLC .

	Rs.
Cash	80,000
Account receivable	200,000
Inventory	60,000
Accounts payable	130,000
Notes payable	30,000
Accrued tax liability	60,000

The following information is also reported for the year ended 31 December, 2016 for Abba PLC.

	Rs.
Sales	800,000
Cost of sales	500,000
Purchases	300,000
Depreciation	15,000
Net income	25,000

Abba PLC anticipates 10% growth in its sales while all expense items are expected to increase by 12%, except for depreciation, which remains the same for year 2017. All expenses are paid in cash as they are incurred, and closing inventory for year 2017 is projected to be Rs. 130,000. By the end of year 2017, Abba PLC expects to have notes payable of Rs. 40,000 and a zero balance in accrued taxes. Abba PLC is considering a change in credit policy where ending accounts receivable reflect 90 days of sales. All sales and purchases are done on credit basis. Assume 360 days per year.

a. Evaluate the impact of this policy change on the company's cash balance.

(12 Marks)

b. Identify whether the company needs to borrow any additional funds if the company expects to maintain a minimum cash balance of Rs. 50,000.

(03 Marks)

(Total 25 marks)

4.

i. Development of a sustainability balance score card is one of the ways to assess the corporate contribution towards the sustainable development. Construct a sustainability balance score card using appropriate performance measurement indicators under different perspectives.

(10 Marks)

ii. Delta PLC is a listed apparel manufacturing company which has several operations across the globe while headquartered in Colombo which is the commercial hub of Sri Lanka. At the last board meeting, the Chief Executive Officer (CEO) of Delta PLC has proposed to acquire another rival apparel manufacturing company, Gamma PLC, in order to expand the existing production capacity of the company.

The following information is extracted from the recently published financial statements of Delta PLC and Gamma PLC.

	Gamma PLC	Delta PLC
Sales (Rs. 000)	35,000	64,000
Gross profit margin	28%	40%
Depreciation (Rs. 000)	500	750
Other expenses (Rs. 000)	7,500	20,500
Share capital (Rs.1.00)	800, 000	1,200,000

Estimated annual synergies of Rs. 5.5 million are expected to achieve as a direct consequence of this acquisition proposal. Further, the earning yield of the combined company is expected to be 0.125 while the current market prices of Delta PLC and Gamma PLC are 16 and 12 times higher than their earnings per share respectively. Both companies are liable to pay 20% corporate tax.

Advise the CEO of Delta PLC, showing all relevant calculations, the ideal price range that Delta PLC should consider in the process of acquiring Gamma PLC.

(15 Marks)

(Total 25 marks)

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Present Value Table

Present value of 1 i.e. $(1 + r)^{-n}$

Where r = discount rate
n = number of periods until payment

Discount rate (r)

Periods (n)	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	1
2	0·980	0·961	0·943	0·925	0·907	0·890	0·873	0·857	0·842	0·826	2
3	0·971	0·942	0·915	0·889	0·864	0·840	0·816	0·794	0·772	0·751	3
4	0·961	0·924	0·888	0·855	0·823	0·792	0·763	0·735	0·708	0·683	4
5	0·951	0·906	0·863	0·822	0·784	0·747	0·713	0·681	0·650	0·621	5
6	0·942	0·888	0·837	0·790	0·746	0·705	0·666	0·630	0·596	0·564	6
7	0·933	0·871	0·813	0·760	0·711	0·665	0·623	0·583	0·547	0·513	7
8	0·923	0·853	0·789	0·731	0·677	0·627	0·582	0·540	0·502	0·467	8
9	0·914	0·837	0·766	0·703	0·645	0·592	0·544	0·500	0·460	0·424	9
10	0·905	0·820	0·744	0·676	0·614	0·558	0·508	0·463	0·422	0·386	10
11	0·896	0·804	0·722	0·650	0·585	0·527	0·475	0·429	0·388	0·350	11
12	0·887	0·788	0·701	0·625	0·557	0·497	0·444	0·397	0·356	0·319	12
13	0·879	0·773	0·681	0·601	0·530	0·469	0·415	0·368	0·326	0·290	13
14	0·870	0·758	0·661	0·577	0·505	0·442	0·388	0·340	0·299	0·263	14
15	0·861	0·743	0·642	0·555	0·481	0·417	0·362	0·315	0·275	0·239	15

(n)	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	1
2	0·812	0·797	0·783	0·769	0·756	0·743	0·731	0·718	0·706	0·694	2
3	0·731	0·712	0·693	0·675	0·658	0·641	0·624	0·609	0·593	0·579	3
4	0·659	0·636	0·613	0·592	0·572	0·552	0·534	0·516	0·499	0·482	4
5	0·593	0·567	0·543	0·519	0·497	0·476	0·456	0·437	0·419	0·402	5
6	0·535	0·507	0·480	0·456	0·432	0·410	0·390	0·370	0·352	0·335	6
7	0·482	0·452	0·425	0·400	0·376	0·354	0·333	0·314	0·296	0·279	7
8	0·434	0·404	0·376	0·351	0·327	0·305	0·285	0·266	0·249	0·233	8
9	0·391	0·361	0·333	0·308	0·284	0·263	0·243	0·225	0·209	0·194	9
10	0·352	0·322	0·295	0·270	0·247	0·227	0·208	0·191	0·176	0·162	10
11	0·317	0·287	0·261	0·237	0·215	0·195	0·178	0·162	0·148	0·135	11
12	0·286	0·257	0·231	0·208	0·187	0·168	0·152	0·137	0·124	0·112	12
13	0·258	0·229	0·204	0·182	0·163	0·145	0·130	0·116	0·104	0·093	13
14	0·232	0·205	0·181	0·160	0·141	0·125	0·111	0·099	0·088	0·078	14
15	0·209	0·183	0·160	0·140	0·123	0·108	0·095	0·084	0·074	0·065	15

Annuity Table

Present value of an annuity of 1 i.e. $\frac{1-(1+r)^{-n}}{r}$

Where r = discount rate
n = number of periods

Discount rate (r)

Periods (n)	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	1
2	1·970	1·942	1·913	1·886	1·859	1·833	1·808	1·783	1·759	1·736	2
3	2·941	2·884	2·829	2·775	2·723	2·673	2·624	2·577	2·531	2·487	3
4	3·902	3·808	3·717	3·630	3·546	3·465	3·387	3·312	3·240	3·170	4
5	4·853	4·713	4·580	4·452	4·329	4·212	4·100	3·993	3·890	3·791	5
6	5·795	5·601	5·417	5·242	5·076	4·917	4·767	4·623	4·486	4·355	6
7	6·728	6·472	6·230	6·002	5·786	5·582	5·389	5·206	5·033	4·868	7
8	7·652	7·325	7·020	6·733	6·463	6·210	5·971	5·747	5·535	5·335	8
9	8·566	8·162	7·786	7·435	7·108	6·802	6·515	6·247	5·995	5·759	9
10	9·471	8·983	8·530	8·111	7·722	7·360	7·024	6·710	6·418	6·145	10
11	10·368	9·787	9·253	8·760	8·306	7·887	7·499	7·139	6·805	6·495	11
12	11·255	10·575	9·954	9·385	8·863	8·384	7·943	7·536	7·161	6·814	12
13	12·134	11·348	10·635	9·986	9·394	8·853	8·358	7·904	7·487	7·103	13
14	13·004	12·106	11·296	10·563	9·899	9·295	8·745	8·244	7·786	7·367	14
15	13·865	12·849	11·938	11·118	10·380	9·712	9·108	8·559	8·061	7·606	15

(n)	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	1
2	1·713	1·690	1·668	1·647	1·626	1·605	1·585	1·566	1·547	1·528	2
3	2·444	2·402	2·361	2·322	2·283	2·246	2·210	2·174	2·140	2·106	3
4	3·102	3·037	2·974	2·914	2·855	2·798	2·743	2·690	2·639	2·589	4
5	3·696	3·605	3·517	3·433	3·352	3·274	3·199	3·127	3·058	2·991	5
6	4·231	4·111	3·998	3·889	3·784	3·685	3·589	3·498	3·410	3·326	6
7	4·712	4·564	4·423	4·288	4·160	4·039	3·922	3·812	3·706	3·605	7
8	5·146	4·968	4·799	4·639	4·487	4·344	4·207	4·078	3·954	3·837	8
9	5·537	5·328	5·132	4·946	4·772	4·607	4·451	4·303	4·163	4·031	9
10	5·889	5·650	5·426	5·216	5·019	4·833	4·659	4·494	4·339	4·192	10
11	6·207	5·938	5·687	5·453	5·234	5·029	4·836	4·656	4·486	4·327	11
12	6·492	6·194	5·918	5·660	5·421	5·197	4·988	4·793	4·611	4·439	12
13	6·750	6·424	6·122	5·842	5·583	5·342	5·118	4·910	4·715	4·533	13
14	6·982	6·628	6·302	6·002	5·724	5·468	5·229	5·008	4·802	4·611	14
15	7·191	6·811	6·462	6·142	5·847	5·575	5·324	5·092	4·876	4·675	15