UNIVERSITY OF COLOMBO, SRI LANKA

FACULTY OF MANAGEMENT AND FINANCE

Bachelor of Business Administration (Level II- Semester VII) Examination
July 2016

FIN 2201 - Financial Reporting and Analysis

Two (02) Hours

Instructions to candidates:

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

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1. "The economic analysis, strategy analysis and quality of financial statements are considered to be the three building blocks of the financial statement analysis."

   i. Explain the main components of strategy analysis.

   (08 marks)

   Cotton Plc., a listed textile company, manufactures high quality garment products to international markets. The senior management of the company is currently considering the possibility of upgrading its manufacturing base in order to cope with the high demand for its products from the international markets. Hence, the management has decided to set up new machinery which will enable the company to optimize its operating capacity. The chief financial manager of the company proposed to lease the required machinery as current cash resources should be reserved for other future investment requirements. Thus, Cotton Plc. leases the machinery from MachineShop for a period of 04 years. The fair value of the machine is Rs.1,400,000 while the present value of minimum lease payment is Rs.1,366,650. The annual lease installments should be paid in arrears where the implicit interest rate is 12%.

   ii. Briefly explain how Cotton Plc. should categorize this lease arrangement.

   (02 marks)

   iii. Prepare the lease amortization table for the period of four years.

   (08 marks)

By upgrading the current manufacturing base company is expecting to improve its current year's earnings from Rs.550,000 to Rs.750,000 in the next year. Further, the CEO of Cotton Plc. proposed to make a bonus issue of one new share for every five shares hold by existing shareholders on 1st of April next year (assume the financial year ends at 31st December). Currently company has an issued share capital of Rs. 1,000,000 (Rs.1 each).

iv. Calculate current year's EPS as it would appear in next year and comment on the CEO's proposal to make a bonus issue.

(07 marks)

(Total 25 Marks)

2. Bricks Plc. is a listed construction company operated with modern advanced technology in the industry. Due to some unfavourable macroeconomic conditions in the country the construction industry was highly affected in the recent past. Extracts from latest financial statements of Bricks Plc. is given below.

Extracts from financial statements of Bricks Plc.

	Rs. '000'
Revenue	200,000
Operating profit	9,000
Interest cost	800
Tax (30%)	2,460
Net profit	5,740
Property plant and equipment	45,000
Marketable securities	20,000
Current assets	15,000
Share capital (Rs.1)	35,000
Retained earnings	15,000
Non-current liabilities	20,000
Current liabilities	10,000
Current market capitalization	87,500

i. Capital Fund, an institutional investor of Bricks Plc., conveyed its doubt regarding the sustainable going concern of the company at the last shareholders' meeting. The management of Bricks Plc. seeking your advice in this regard in order to recommend a response to Capital Fund's assertion on company's future going concern.

(08 marks)

ii. The CEO of Bricks Plc. drafted a proposal to increase the current profitability of the company. In there he suggests Bricks Plc. to borrow additional long term loan of Rs.1 million. He further reported that as a direct consequence of this borrowing, the net borrowing rate of the company would be increased to 4.5%. Additionally the current operating profit will increase by 5%. Thus, the CEO expects to achieve a required rate of return on capital employed of 15%. Current level of retained profits is expected to prevail in next year. Evaluate the feasibility of CEO's proposal to increase the current profitability of Bricks Plc. to 15%. Unless or otherwise mentioned, assume all other figures will remain constant as shown in the given extracts from financial statements,

(10 marks)

iii. Recently Bricks Plc. won a bid to put up a new chemical factory for Chemist Inc., a chemical manufacturer, in northern part of the country. The factory will exist for another 40 years and it is estimated once the factory is closed down that area will turn into a barren land. The laws stipulated that the company has to incur decommissioning cost in order to restate the area into its previous condition. Also Chemist Inc. included an environment protection clause into its mission statement. The estimated present value of the decommissioning cost calculated by the operations manager of Chemist Inc. is Rs.15 million. However, the chief accountant of Chemist Inc. is considering whether she should create a provision for this Rs.15 million. Advise the chief account whether she should recognize a provision in the books of Chemist Inc.

(07 marks)

(Total 25 Marks)

3. Lego Inc. manufactures toys for small children where it has a significant market share in the industry. Assume today is 30th June. The sales manager of Lego Inc. projected the company's next 6 months sales revenue as follows.

	July	August	September	October	November	December
Sales Rs.'000'	200	220	240	260	250	240

The sales manager forecasted that 80% of each month's sales would be taken place on credit terms while with the past experience he further predicts that, 60% of the receivables can be collected one month from the date of sale and remainder are to be collected from two months from the date of sale.

The purchasing manager has projected the following details with respect to purchase of raw materials required for the production process for the next 6 months. Further, she expects that the company will be able to settle 50% of its bills on the same month of purchase and remainder during the following month.

	July	August	September	October	November	December
Purchases Rs.'000'	100	120	120	140	120	120

The operations manager of Lego Inc. recently informed the management that one of the company's machinery should be disposed at the end of December. He further stated that it can be sold at its net cost of Rs.60,000. The finance manager proposed the board that company should make a new share issue to raise Rs.0.5 million. As a consequence of this share issue the existing number shares in issue will be doubled. The board expects this share issue can be completed by December. Lego Inc. has borrowed Rs.0.8 million two years ago and bank imposed a loan covenant that the company should maintain more than Rs.100,000 as cash at the end of each month and company expects to comply with this covenant throughout the next year,

Additional Information

- Closing stock at the end of December is expected to be Rs.50,000
- Net profit for the next six months is expected to be Rs.60,000
- Depreciation for the six month period is expected to be 20% of the opening net cost of non-current assets
- 50% of the bank loan will be repaid in November

Lego Inc.
Balance Sheet as at 30th June

	Rs.	Rs.
Non-current assets		1,191,250
Current assets		
Inventory	25,000	
Receivables	50,000	
Cash	105,750	180,750
		1,372,000
Equity		
Share capital (Rs. 1)		250,000
Retained earnings	50,000	
Other components of equity	15,000	65,000
Total equity		315,000
Non-current liabilities		
Bank loan		800,000
Current liabilities		
Payables		257,000
		1,372,000

i. Prepare the projected balance sheet for Lego Inc. as at 31st December.

(16 marks)

ii. Calculate the following forecasted ratios for next six months period (round off the answers to two decimal places);
    a. Gearing ratio
    b. Net profit margin
    c. Asset turn-over ratio

(03 marks)

Based on the above projections made by the senior management of the company, CEO of Lego Inc. is keen to achieve a sales target of Rs.1.5 million at the end of last six months of the next financial year (financial year of Lego Inc. starts on 1st July) as it would enable the company to secure a significant market share. Further, he intends to continue with a target dividend payout ratio of 40% in the last six months of the next financial year in order to satisfy the shareholders of the company. However, he expects other performance and gearing ratios to be remained constant as forecasted in the first six months of the next financial year

iii. Evaluate whether Lego Inc. could achieve the target sales revenue at the end of last six months of the next financial year.

(06 marks)

(Total 25 Marks)

4. Cell Co. is a listed engineering company, manufactures large scale machinery for industrial companies. The company is well reputed among the investors as it distributes attractive amount of dividends to its shareholders. Recently, the Board of Directors (BoD) decides to pay a constant dividend of Rs.2.60 per share for the next three years and to increase the growth rate of dividends by 5% thereafter into perpetuity. The expected return of the market is 11.4% and the market premium is 7.4%. The beta value of the company's share is 1.5.

i. Calculate the current market value per share of Cell Co. (Round off your answer to the nearest rupee).

(05 marks)

Cell Co. is now expecting to diversify its business operations and intends to expand its operations into car manufacturing sector. The BoD of Cell Co. is expecting to acquire full equity stake of Automobile Co., one of the best performing car manufacturers in the industry. The extracts from recently published financial statements for the financial year 2014/2015 of both the companies are shown below.

	Cell Co.	Automobile Co.
	Rs. 000	**Rs. 000**
Operating profit	18,000	10,000
Depreciation	500	100
Pre-tax profit	15,000	8,000
Share capital (Rs.1.00)	2,000	500
Retained earnings	20,000	10,000

The BoD of Cell Co. estimated that the acquisition will generate annual synergies of Rs.7.6 million. Further, the BoD has estimated the earnings yield of the combined company will be 0.25 after the acquisition. The current market price per share of Automobile Co. is Rs.32. Both companies are liable to pay 20% corporate tax. However, the BoD of Cell Co. is still unsure of the correct price that it should offer to acquire Automobile Co.

ii. Advise the BoD of Cell Co, showing all relevant calculations, the maximum premium that it should pay to acquire Automobile Co.

(10 marks)

Namal is naturally a risk averse investor who is looking to secure his investments. Recently he observed two investment opportunities where one is to invest in Company A which offers a dividend of Rs.2 per share with an expected growth of 5% in dividends to perpetuity at a required rate of return on equity of 10% while Company B also offers a dividend of Rs.2 per share with an expected growth of 7% in dividend to perpetuity at a required rate of return on equity of 10%.

iii. Recommend the ideal investment opportunity that suits with Namal's risk characteristic.

(10 marks)

(Total 25 Marks)

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