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CIFA PART II SECTION 3

FINANCIAL STATEMENTS ANALYSIS

THURSDAY: 23 May 2019. **Time Allowed: 3 hours.**

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings.

QUESTION ONE

(a) Describe the steps followed by financial analysts while undertaking a financial statements analysis assignment. (4 marks)

(b) (i) Explain the term "macro environment approach" to financial statements analysis. (1 mark)

(ii) Citing relevant examples, outline three factors that forms the basis of macro-economic environment of a firm. (3 marks)

(c) Pipel Limited, a public listed company carries out business in airline technology. It has made several investments, operating in diversified businesses. The following statements of comprehensive income relate to Pipel Limited and its investment companies for the year ended 30 April 2019:

	Pipel Limited Sh."million"	Sial Limited Sh."million"	Abbel Limited Sh."million"
Revenue	2,060	590	360
Cost of sales	(1,050)	(220)	(270)
Gross profit	1,010	370	90
Selling and distribution costs	(245)	(77)	(68)
Administrative expenses	(315)	(99)	(112)
Operating profits (or loss)	450	194	(90)
Finance costs	(140)	(44)	-
Profit (or loss) before tax	310	150	(90)
Income tax expense (credit)	(75)	(50)	10
Profit (or loss) for the year	235	100	(80)
Other comprehensive income – Revaluation gain	50	25	10
Total comprehensive income	285	125	(70)

Additional information:

1. Pipel Limited has owned 80% of the equity interest in Sial Limited for several years.
2. On 1 May 2014, Pipel Limited acquired 60% of the equity shares of Abbel Limited. The purchase consideration comprised cash of Sh.645 million and the fair value of the identifiable net assets acquired was Sh.775 million at that date.
3. Pipel Limited wishes to use the "partial goodwill" method for all acquisitions. There has been no impairment of goodwill in either Sial Limited or Abbel Limited since acquisition.
4. Pipel Limited disposed of a 20% equity interest in Abbel Limited on 31 October 2018 for Sh.280 million. At that date, Abbel Limited's identifiable net assets were Sh.955 million. The remaining equity interest in Abbel Limited was fair valued at Sh.560 million.
5. During the year ended 30 April 2019, Sial Limited sold goods worth Sh.60 million to Pipel Limited. Sial Limited makes all sales at a profit mark-up of $33^1/_3$% above the cost. Pipel Limited still had one third of these goods in its inventory on 30 April 2019.
6. Assume profit (or loss) and revaluation gain accrued evenly over the year.

Required:

(i) The profit or loss on disposal of shares in Abbel Limited to be presented on the group statement of comprehensive income. (4 marks)

(ii) Consolidated statement of comprehensive income for Pipel Group for the year ended 30 April 2019. (8 marks)

(Total: 20 marks)

QUESTION TWO

(a) Financial statements are highly aggregated which could make them of limited use for stakeholders who want to understand more about how an entity has arrived at its financial performance and position for a period.

In order to allow stakeholders to fully understand the development of the company's business, International Financial Reporting Standard (IFRS) 8 "operating segments", requires certain entities to provide segmental analysis of information which discloses revenues, profits and assets by major business area.

IFRS 8 is only compulsory for entities whose debt or equity instruments are traded in a public market or entities filing or in the process of preparing financial statements for the purpose of getting listed.

Required:
With reference to International Financial Reporting Standard (IFRS) 8 "operating segments", highlight six key disclosures required for the discrete financial information. (6 marks)

(b) Babito Limited, a public limited company has a called up and paid up capital comprising of 2 million ordinary shares of Sh.10 each and 400,000, 8% redeemable preference shares of Sh.15 each on 1 January 2018.

The company had also in issue Sh.5 million, 10% convertible bond, to be converted at any time at the holders' option into 15 ordinary shares of Sh.10 each for every Sh.100 of the bond.

The following transactions took place during the year ended 31 December 2018:

1. During the year, the group reported profit after tax of Sh.3,480,000 which included a loss after tax from discontinued operations of Sh.420,000.
2. On 1 April 2018, Babito Limited made a one for every four rights issue of ordinary shares to the existing shareholders at a concessionary price of Sh.36 per right. The market price of the company's share on the last day quotation on cumrights price basis was Sh.41.
3. On 1 August 2018, the company issued 1.2 million ordinary shares for a full market price as a consideration for the acquisition of an overseas property.
4. On 1 October 2018, holders of Sh.2 million, 10% convertible bond exercised their conversion option and were issued with ordinary shares at that date.

The corporation tax rate is at 30%.

Required:

(i) Basic earnings per share (BEPS) for the year ended 31 December 2018. (4 marks)

(ii) Diluted earnings per share (DEPS) for the year ended 31 December 2018. (4 marks)

(c) John Mundia, a financial analyst at Beta Capital has been provided with the following results for Panrama Limited for the year ended 31 December 2018:

Net profit margin ratio	0.04
Total asset turnover ratio	2.20
Total assets/equity ratio	2.40
Earnings per share (Sh.)	2.75
Dividends per share (Sh.)	1.25

Required:
The estimated growth rate for the company. (2 marks)

(d) Maria and Lynette are discussing accounting for income taxes. They are currently studying a schedule of taxable and deductible amounts that will arise in the future as a result of existing temporary differences. The schedule is as follows:

		Future years			
	2018	**2019**	**2020**	**2021**	**2022**
Taxable income (Sh.)	850,000				
Taxable amounts (Sh.)		375,000	375,000	375,000	375,000
Deductible amounts				(2,400,000)	
Enacted tax rate	30%	32%	33%	30%	25%

Required:
Explain the concept of future taxable amounts and future deductible amounts as illustrated in the above schedule. (4 marks)

(Total: 20 marks)

QUESTION THREE

(a) A company's financial statements are the most objective way to assess the health of an organisation. As the old adage says "numbers don't lie". Numbers can indicate prosperity or poverty, but they can also show the first signs of trouble within a company.

In relation the above statement, summarise six red flags that could indicate trouble for a business. (6 marks)

(b) The following are the extracts from the statements of financial position for Global Manufacturing Corporation for the years ended 31 December 2017 and 31 December 2018:

Statement of financial position as at 31 December:

	2018 Sh."000"	2017 Sh."000"
Assets:		
Current assets:		
Cash	73,000	22,000
Accounts receivable	82,000	66,000
Inventory	180,000	189,000
	335,000	277,000
Non-current assets:		
Land and buildings	71,000	110,000
Equipment	260,000	200,000
Accumulated depreciation - equipment	(69,000)	(42,000)
	262,000	268,000
Total assets	597,000	545,000
Liabilities and shareholder's equity:		
Accounts payable	34,000	47,000
Bonds payable	150,000	200,000
Ordinary shares (Sh.1 par value)	214,000	164,000
Retained earnings	199,000	134,000
Total liabilities and shareholders equity	597,000	545,000

Additional information:

1. Net income for 2018 was Sh.125,000,000. No gains and losses were recorded in the year 2018.
2. Cash dividends amounting to Sh.60,000,000 was declared and paid.
3. Bonds payable amounting to Sh.50,000,000 were retired through issuance of ordinary shares.

Required:

(i) Statement of cash flows in accordance with the requirements of the International Accounting Standard (IAS) 7, "Statements of Cash Flows". (7 marks)

(ii) Current cash debt coverage ratio. (2 marks)

(iii) Cash debt coverage ratio. (2 marks)

(iv) Free Cash Flow (FCF). (2 marks)

(v) Comment on the firm's liquidity and financial flexibility based on your results obtained in (b) (i) to (b) (iv) above. (1 mark)

(Total: 20 marks)

QUESTION FOUR

(a) A foreign subsidiary was created on 31 December 2017. The LC is the currency of the country in which the foreign subsidiary is located. The subsidiary's statement of financial position as at 31 December 2017 and 31 December 2018 and income statement for the year ended 31 December 2018 are shown below:

Statement of financial position as at 31 December:

	2017 (LC)	2018 (LC)
Cash	5,000	8,000
Inventory	25,000	25,000
Total assets	30,000	33,000

	2017 (LC)	2018 (LC)
Equity and liabilities:		
Accounts payable	20,000	20,000
Ordinary shares	10,000	10,000
Retained earnings	-	3,000
Total equity and liabilities	30,000	33,000

Income statement for the year ended 31 December 2018:

Revenue	15,000
Expenses	(12,000)
Net income	3,000

The following price indices are available:

31 December 2017	100
31 December 2018	150
Average for 2018	125

Required:
Prepare an inflation adjusted:

(i) Statement of financial position as at 31 December 2018. (4 marks)

(ii) Income statement for the year ended 31 December 2018. (3 marks)

(b) Sunny Limited issued a redeemable debt instrument on 1 July 2017 at its par value of Sh.6 million. The instrument carries a fixed coupon interest rate of 6% which is payable annually in arrears. The debt instrument will be redeemed for Sh.6.02 million on 30 June 2021. Transaction costs associated with the issue were Sh.200,000 and were paid at the time of issue. The effective interest rate applicable to this liability is approximately 7.06%.

Required:

(i) Explain how this instrument will be initially measured and subsequently measured. (2 marks)

(ii) Calculate the carrying value of this liability to be included in Sunny Limited's statement of financial position as at 30 June 2019. (Round all workings to the nearest thousand). (4 marks)

(c) Triple D Limited operates a defined benefit pension plan for its employees. At 1 July 2017, the fair value of the pension plan assets was Sh.1,200,000 and the present value of the plan liabilities was Sh.1,400,000. The interest cost on the plan liabilities was estimated at 7% and the expected return on plan assets was estimated at 4%.

The actuary estimates that the current service cost for the year ended 30 June 2018 shall be Sh.300,000. Triple D Limited made contributions into the pension plan of Sh.400,000 in the year ended 30 June 2018. The pension plan paid Sh.220,000 to retired members in the year to 30 June 2018. At 30 June 2018, the fair value of the pension plan assets was Sh.1,400,000 and the present value of the plan liabilities was Sh.1,600,000.

In accordance with International Accounting Standard (IAS) 19, "Employee Benefits", Triple D Limited recognises actuarial gain and losses in other comprehensive income in the period in which they occur.

Required:

(i) The net expense that will be included in Triple D Limited's income statement for the year ended 30 June 2018. (2 marks)

(ii) The amounts that would be included in other comprehensive income in respect of actuarial gains or losses for the year ended 30 June 2018. (5 marks)

(Total: 20 marks)

QUESTION FIVE

(a) The following information was extracted from the financial records of TBT Limited, a business which provides technical support services to customers worldwide:

Extracts of income statement for the years ended 31 March:

	2019 Sh."million"	2018 Sh."million"
Sales revenue	3,627	3,908
Cost of sales	(2,765)	(2,886)
Gross profit	862	1,022

Extracts of statement of financial position as at 31 March:

	2019 Sh."million"	2018 Sh."million"
Current assets:		
Inventories	271	330
Trade receivables	632	719
Short-term deposits and cash	342	242
	1,245	1,291
Current liabilities:		
Loans and overdrafts	54	135
Tax payable	113	128
Accruals	20	29
Trade payables	512	479
	699	771

Required:

(i) Horizontal analysis for income statement for the year ended 31 March 2019. (2 marks)

(ii) Horizontal analysis for the statements of financial position as at 31 March 2019. (4 marks)

(iii) Current ratios for the financial years 2018 and 2019. (2 marks)

(iv) Quick ratio for the financial years 2018 and 2019. (2 marks)

(b) The following is a draft statement of financial position of Mawingu Limited as at 31 December 2018:

Statement of financial position as at 31 December 2018:

	Sh."000"
Assets:	
Non-Current assets:	
Property, plant and equipment (net)	20,000
Intangible assets	4,000
	24,000
Current assets:	
Cash	1,000
Marketable securities	500
Accounts receivable	5,000
Inventories	3,500
	10,000
Total assets	34,000
Equity and liabilities:	
Current liabilities:	
Accounts payable	3,000
Notes payable	2,000
Total current liabilities	5,000
Non-current liabilities:	
Long-term debt	10,000
Ordinary shares (1,000,000 shares)	7,000
Retained earnings	12,000
	29,000
Total equity and liabilities	34,000

Additional information:

1. Inventories are valued at cost as determined using Last in first out (LIFO) method. The LIFO reserve is Sh.500,000.
2. Additional operating facilities and equipment are financed with operating leases that have a present value of Sh.5,000,000.
3. Intangible assets represent Sh.4,000,000 of goodwill from previous acquisitions.
4. Due to an increase in interest rates, Mawingu Limited's long-term debt has a current market value of Sh.9,500,000.

Required:

(i) Adjusted statement of financial position as at 31 December 2018. (6 marks)

(ii) Book value per share before and after adjustment. (2 marks)

(iii) Ratio of long-term debt to equity before and after adjustment. (2 marks)

(Total: 20 marks)

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