KASNEB

CIFA PART II SECTION 3

FINANCIAL STATEMENTS ANALYSIS

THURSDAY: 26 November 2015. **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) Explain three components of management commentary in a company's annual report to shareholders. (6 marks)

(b) The auditors of Global Meridian Investment Limited discovered that certain items had been included in the inventory of the company as at 31 October 2015. These items which were valued at Sh.4.2 million had in fact been sold before the end of the year.

The following are the extracts of the income statements of Global Meridian Investment Limited for the year ended 31 October 2014 and 31 October 2015:

Statement of comprehensive income for the year ended 31 October:

	2014	**2015**
	Sh. "000"	**Sh. "000"**
Revenue	47,400	67,200
Cost of goods sold	(34,570)	(55,800)
Profit before tax	12,830	11,400
Income tax expense	(3,880)	(3,400)
Net profit	8,950	8,000

Additional information:

1. The retained profits as at 1 November 2013 amounted to Sh.13 million.
2. The cost of goods sold for the year ended 31 October 2015 includes an error of Sh.4.2 million in the opening inventory.
3. The corporation income tax rate for 2014 and 2015 was 30%.

Required:

(i) Comparative income statement for the year ended 31 October 2015. (6 marks)

(ii) Retained earnings for the year ended 31 October 2015. (4 marks)

(c) During the financial year ended 31 October 2010, Walnut Ltd. issued the following two financial instruments:

1. Redeemable preference shares with a coupon rate of 8%. The shares are redeemable on 31 October 2016 at a premium of 10%.
2. A grant of share options to senior executives. The options may be exercised from 31 October 2015.

Required:

For each of the instruments, identify whether it should be classified as debt or equity. Justify your choice citing the relevant provision of International Accounting Standards or International Financial Reporting Standards. (4 marks)

(Total: 20 marks)

QUESTION TWO

One of your clients, Best Limited, invested in 50% of the ordinary share capital of Fist Limited several years ago. The management has presented you with the following financial statements of the two companies for the year ended 31 May 2015:

Income statement for year ended 31 May 2015:

	Best Limited	**Fist Limited**
	Sh. "million"	**Sh. "million"**
Revenue	10,500	8,600
Cost of sales	(4,200)	(3,100)
Gross profit	6,300	5,500

	Sh. "million"	Sh. "million"
Expenses:		
Distribution costs	(1,400)	(2,000)
Administrative expenses	(1,050)	(2,980)
Finance cost	(200)	(100)
Profit before tax	3,650	420
Income tax expense	(1,050)	(120)
Profit for the period	2,600	300
Dividends paid	(500)	-
Profit for the year	2,100	300
Retained profits brought forward	1,400	1,000
Retained profits carried forward	3,500	1,300

Statement of financial position as at 31 May 2015:

	Best Limited Sh. "million"	Fist Limited Sh. "million"
Non-current assets		
Property, plant and equipment	5,000	2,100
Investment in Fist Limited	450	-
Other investments	300	200
	5,750	2,300
Current assets		
Inventory	2,650	350
Trade receivables	1,200	650
Cash at bank	600	200
	4,450	1,200
Total assets	10,200	3,500
Equity and liabilities		
Equity		
Ordinary share capital	4,000	500
Retained profits	3,500	1,300
Shareholders' funds	7,500	1,800
Non-current liabilities		
10% loan stock	2,000	1,000
Current liabilities		
Trade payables	650	600
Current tax	50	100
	700	700
Total equity and liabilities	10,200	3,500

Additional information:

1. Best Limited acquired Fist Limited when the retained profits of Fist Limited amounted to Sh.300 million. There was no fair value adjustments.
2. During the year, the inter-company sales between Best Limited and Fist Limited amounted to Sh.200 million. None of these goods were remaining in the inventory.
3. As at 31 May 2015, Best Limited owed Fist Limited Sh.40 million.
4. Goodwill arising on the acquisition of Fist Limited has not been impaired in the past but in the current year, the management of Best Limited feels there should be a 20% impairment.

Required:

(a) Prepare in columnar form, the financial statements of Best Limited assuming that the investment in Fist Limited should be accounted for using:

(i) Proportional consolidation method. (6 marks)

(ii) Equity method. (6 marks)

(b) Compute the following ratios for each of the methods identified in (a) (i) and (ii) above:

(i) Net profit margin. (2 marks)

(ii) Return on equity. (2 marks)

(iii) Gearing ratio. (2 marks)

(c) Comment on the results obtained in (b) (i) to (iii) above. (2 marks)

(Total: 20 marks)

QUESTION THREE

(a) Outline four applications of financial statements forecasting. (4 marks)

(b) The following financial statements relate to Alpha Limited and Omega Limited for the year ended 31 October 2015:

	Alpha Limited		**Omega Limited**	
	Sh. "million"	**Sh. "million"**	**Sh. "million"**	**Sh. "million"**
Sales		4,000		6,000
Cost of sales				
Opening inventory	200		800	
Purchases	3,200		4,800	
	3,400		5,600	
Closing inventory	(400)	(3,000)	(800)	(4,800)
Gross profit		1,000		1,200
Expenses				
Distribution Costs	200		150	
Administrative expenses	290		250	
Finance cost	10	(500)	400	(800)
Profit before tax		500		400
Income tax expense		(120)		(90)
Profit after tax		380		310
Dividends paid		(150)		(100)
Retained profit for the year		230		210
Retained profit brought forward		220		2,480
Retained profit carried forward		450		2,690

Statement of financial position as at 31 October 2015:

	Alpha Limited		**Omega Limited**	
	Sh. "million"	**Sh. "million"**	**Sh. "million"**	**Sh. "million"**
Non-current assets				
Land and Buildings	1,200		5,000	
Furniture and motor vehicle	600	1,800	1,000	6,000
Current assets				
Inventory	400		800	
Trade receivables	850		750	
Financial assets	100		230	
Cash at bank	-	1,350	100	1,880
Total assets		3,150		7,880
Equity and liabilities				
Equity				
Ordinary shares		1,000		1,600
Retained profits		450		2,690
		1,450		4,290
Non-current liabilities				
Bank loans		500		3,000
Current liabilities				
Trade payables	1,080		590	
Bank overdraft	120	1,200	-	590
		3,150		7,880

Required:

(i) Common size percentage income statement for the year ended 31 October 2015. (7 marks)

(ii) Common size percentage statement of financial position as at 31 October 2015. (7 marks)

(iii) Comment on the profitability and gearing of the two companies based on the results obtained in (b) (i) and (ii) above. (2 marks)

(Total: 20 marks)

QUESTION FOUR

(a) Outline four factors that could be considered in determining an entity's functional currency as per International Accounting Standard, IAS 21 - The effects of changes in foreign exchange rates. (4 marks)

(b) ABC Ltd. formed a subsidiary in a foreign country on 1 January 2014 through a combination of debt and equity financing. The foreign subsidiary acquired land on 1 January 2014 which it rents to a local farmer. The foreign subsidiary's financial statements for its first year of operations, in foreign currency units (FC), are as follows:

Foreign subsidiary statement of comprehensive income:

	2014 FC (million)
Rent revenue	1,000
Interest expense	(250)
Net income	750

Foreign subsidiary statement of financial position:

	1 January 2014 FC (million)	**31 December 2014 FC (million)**
Cash	1,000	1,750
Land	9,000	9,000
Total assets	10,000	10,750
5% notes payable	5,000	5,000
Ordinary share capital	5,000	5,000
Retained earnings	-	750
Total equity and liabilities	10,000	10,750

Additional information:

1. The foreign country experienced significant inflation in 2014, especially in the second half of the year. The general price index during 2014 was as follows:

1 January 2014	100
Average 2014	125
31 December 2014	200

2. The rate of inflation in 2014 was 100% and the foreign country clearly meets the definition of a highly inflationary economy under International Financial Reporting Standards, IFRSs.
3. As a result of the high rate of inflation in the foreign country, the FC weakened substantially during the year relative to other currencies. Relevant exchange rates between ABC Ltd's presentation currency, Kenya Shilling (KES) and the FC during 2014 were as follows:

	KES per FC
1 January 2014	1.00
Average 2014	0.80
31 December 2014	0.50

Required:

The amounts that ABC Ltd. will include in its consolidated financial statements for the year ended 31 December 2014 related to the foreign subsidiary. (8 marks)

(c) The following financial data was extracted from the books of Signtex Limited for the year ended 31 December 2014:

	Sh. "000"
Current tax liability brought forward from the year 2013	102,300
Liability agreed during the year 2014	107,340
Estimated tax liability for year 2014	123,675
Deferred tax liability brought forward from the year 2013	82,254
Tax written down value of non-current assets	2,420,580
Carrying value of non-current assets	2,742,840

The corporation tax rate is 30%

Required:

(i) The taxation charge to be included in the income statement for the year ended 31 December 2014. (6 marks)

(ii) The amounts to be reported on the statement of financial position at the end of the year 2014, indicating how these amounts should be reported. (2 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Identity five warnings signs that might alert financial analysts and investors of low quality revenue reporting. (5 marks)

(b) The following information relates to Athi Limited:

1. The company contributes Sh.42 million per annum to a pension scheme and treats the amount as current service cost pension expense.
2. On 1 July 2015, the actuarial valuation of the scheme showed a deficit of Sh.840 million.
3. The actuary recommended that the deficit be cleared within 4 years by paying Sh.210 million per annum in addition to the annual service costs.
4. The average remaining service years of the employees in the scheme on 1 July 2015 was 8 years.

Required:

For each of the remaining 8 years, calculate the pension expense and the pension liability or assets. (5 marks)

(c) The following summarised information is available in relation to Flamingo Ltd., a publicly listed company:

Income statement extract for the years ended 31 March:

	2015		2014	
	Continuing Operations Sh. "000"	**Discontinued Operations Sh. "000"**	**Continuing Operations Sh. "000"**	**Discontinued Operations Sh. "000"**
Profit after tax:				
• Existing operations	2,000	(750)	1,750	600
• Operations acquired on 1 August 2013	450		nil	

Additional information:

1. Analysts expects profits from the market sector in which Flamingo Ltd. existing operations are based to increase by 6% in the year to 31 March 2016 and by 8% in the sector of its newly acquired operations.
2. On 1 April 2013, Flamingo Ltd. had the following financial instruments:
   - Sh.6 million Sh.0.5 equity shares in issue.
   - Sh.5 million 8% convertible loan stock redeemable in the year 2020: the terms of conversion are 40 equity shares in exchange for each Sh.100 of loan stock.
3. On 1 October 2014, the directors of Flamingo Ltd. were granted option to buy 2 million shares in the company for Sh.15 each. The average market price of Flamingo Ltd. shares for the year ending 31 March 2015 was Sh.30 each.
4. Assume a corporation tax rate of 30%.

Required:

(i) Estimated profit after tax for the year ending 31 March 2016. Assuming the analysts expectations prove correct. (2 marks)

(ii) Basic and diluted earnings per shares (EPS) on the continuing operations of Flamingo Ltd. for the year ended 31 March 2015 and the comparatives for the year 2014. (8 marks)

(Total: 20 marks)

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