KASNEB

CIFA PART II SECTION 3

FINANCIAL STATEMENTS ANALYSIS

THURSDAY: 24 November 2016. **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) Analyse six steps that a financial analyst could follow when analysing financial statements of an entity. (6 marks)

(b) The following information was obtained from the records of Faridah Limited for the year ended 31 August 2016:

	Sh."000"
Prior-period adjustment - credit to retained earnings	10,000
Gain on sale of plant assets	42,000
Cost of goods sold	760,000
Income tax expense (savings):	
Continuing operations	64,000
Discontinued operations	16,000
Extraordinary gain	20,000
Preference shares, 8% Sh.100 par value	100,000
Dividends	32,000
Retained earnings, beginning as originally reported	206,000
Treasury stock, common (10,000 shares at cost)	50,000
Selling expenses	156,000
Ordinary shares (90,000 shares issued)	360,000
Sales revenue	1,240,000
Interest expense	60,000
Extraordinary gain	52,000
Income from discontinued operations	40,000
Loss due to lawsuit	22,000
General expenses	124,000

Assume a corporation tax rate of 40%.

Required:

(i) A single-step income statement (with all revenues and gains grouped together) for the year ended 31 August 2016.
Note: Include the earnings per share (EPS) presentation and show computations. Assume no changes in the share prices during the year. (8 marks)

(ii) Statement of retained earnings for the year ended 31 August 2016. (6 marks)

(Total: 20 marks)

QUESTION TWO

(a) Examine three warning signs that might indicate that the financial statements of a company are of a poor quality. (6 marks)

(b) The following financial information relates to Movida Limited for the year ended 30 September 2016:

		Sh."000"
Closing inventories:	Raw materials	150,000
	Work in Progress	60,000
	Finished goods	200,000
Purchases		500,000
Trade accounts receivable		230,000
Trade accounts payable		120,000
Sales		900,000
Cost of goods sold		750,000

Required:

The operating cycle of Movida Limited for the year ended 30 September 2016. (6 marks)

(c) The following balances were obtained from the books of Paloma Limited as at 31 March 2016:

	Debit Sh."000"	Credit Sh."000"
Building	500,000	
Provision for depreciation on building		75,000
Plant at cost	120,000	
Equity shares: (Sh.10 par value)		200,000
Retained earnings (1 April 2015)		375,000
Revaluation reserves		50,000
Interim dividends paid	5,000	
Bank	522,000	
Revenue		873,500
Cost of sales	243,500	
Operating expenses	183,000	
	1,573,500	1,573,500

Additional information:

1. Paloma Limited made a rights issue on 1 October 2015 of 1 share for every 5 shares held at a price of Sh.15 each. The market price per share being Sh.20.
2. A final dividend of 10% to be paid to equity shareholders.
3. A general reserve to be created and Sh.30,000,000 be transferred from retained earnings.

Required:

Statement of changes in equity for the year ended 31 March 2016. (4 marks)

(d) The following information relates to Eagle Limited defined benefit plan for the year ended 31 December 2015:

	Sh."000"
Fair value of plan assets	950
Present value of pension liability	800
Present value of future refunds and reductions in future contributions	70

Required:

The value of the plan assets to be recognised in the financial statements of Eagle Limited for the year ended 31 December 2015. (4 marks)

(Total: 20 marks)

QUESTION THREE

(a) Describe four categories of financial instruments as per the International Accounting Standard (IAS) 39 "Financial instruments". (4 marks)

(b) On 1 February 2016, Ndovu Limited acquired 80% of the ordinary share capital of Simba Limited at a cost of Sh.10.28 million. On the same date, Ndovu Limited also acquired 50% of Simba Limited's 10% loan notes at par. The market price of each of the Simba Limited's share at the date of acquisition was Sh.6.

The summarised draft financial statements of both companies are as follows:

Statement of comprehensive income as at 31 October 2016:

	Ndovu Limited Sh."000"	Simba Limited Sh."000"
Revenue	60,000	24,000
Cost of sales	(42,000)	(20,000)
Gross profit	18,000	4,000
Operating expenses	(6,000)	(200)
Loan interest received/(paid)	75	(200)
Profit before tax	12,075	3,600
Taxation	(3,000)	(600)
Profit for the year	9,075	3,000

Statement of financial position as at 31 October 2016:

	Ndovu Limited Sh."000"	Simba Limited Sh."000"
Tangible non-current assets	19,320	8,000
Investment	11,280	-
	30,600	8,000
Current assets	15,000	8,000
Total assets	45,600	16,000
Equity and liabilities:		
Equity:		
Ordinary shares (Sh.1 par value)	10,000	2,000
Retained earnings	25,600	8,400
	35,600	10,400
Non-current liabilities:		
10% loan notes	-	2,000
Current liabilities	10,000	3,600
Total equity and liabilities	45,600	16,000

Additional information:

1. The fair values of Simba Limited's assets were equal to their book values with the exception of its plant which had a fair value of Sh.3,200,000 in excess of its book value at the date of acquisition. The remaining useful life of all Simba Limited's plant at the date of acquisition was four years and this period has not changed as a result of the acquisition.
2. Depreciation of plant is on a straight line basis and is charged to cost of sales. Simba Limited has not adjusted the value of its plant as a result of the fair value exercise.
3. In the past acquisition period, Ndovu Limited sold goods to Simba Limited at a price of Sh.12 million. These goods had cost Ndovu Limited Sh.9 million. During the year, Simba Limited had sold Sh.10 million (at cost to Simba Limited) of these goods for Sh.15 million.
4. Ndovu Limited bears almost all of the administration costs incurred on behalf of the group such as invoicing and credit control. It does not charge Simba Limited for this service as to do so would not have a material effect on the group profit.
5. Revenue and profits should be deemed to accrue evenly throughout the year.
6. The current accounts of the two companies were reconciled at the year end with Simba Limited owing Ndovu Limited Sh.750,000.
7. Ndovu Limited has a policy of valuing non-controlling interest at fair value at the date of acquisition. For this purpose, the share price of Simba Limited should be used.
8. An impairment test on 31 October 2016 showed that consolidated goodwill should be written down by Sh.400,000.

Required:

(i) Consolidated statement of comprehensive income for the year ended 31 October 2016. (8 marks)

(ii) Consolidated statement of financial position as at 31 October 2016. (8 marks)

(Total: 20 marks)

QUESTION FOUR

(a) Discuss four limitations of segment reporting requirements. (4 marks)

(b) For the year ended 31 December 2015, GreatDreams Company Limited reported cash flow from operating activities of Sh.163 million, income from continuing operations of Sh.146 million and total revenue of Sh.852 million. Review of GreatDreams' footnotes revealed the following:

1. In the year 2015, GreatDreams' pension contribution was Sh.35 million higher than in previous year. This typical contribution is not expected to continue in the foreseeable future.
2. Included in the income from continuing operations was Sh.17 million one time non-cash charge. The charge is not deductible for income tax purposes.
3. The corporation tax rate is 30%.

Required:

GreatDreams Company Limited excess cash margin. (4 marks)

(c) Explain three ways in which operating leases could impact on the financial statements. (3 marks)

(d) The following information was obtained from the financial statement notes of Kisumu United Ltd. and Tigania Products Ltd. for the year ended 31 December 2015:

	Item	Kisumu United Ltd.	Tigania Products Ltd
1.	Goodwill	The company amortises goodwill over 20 years.	The company amortises goodwill over 5 years.
2.	Property, plant and equipment	The company uses a straight line depreciation method over the economic lives of the assets which range from 5 to 20 years for buildings.	The company uses an accelerated depreciation method over the economic lives of the assets which range from 5 to 20 years for buildings.
3.	Accounts receivable	The company uses a bad debt allowance of 2% of accounts receivable.	The company uses a bad debt allowance of 5% of accounts receivable.

Required:
By comparing the performance of each company in relation to items 1, 2 and 3 above, identify which company has the higher quality of earnings. (9 marks)

(Total: 20 marks)

QUESTION FIVE

(a) The following are the financial statements of Quittet Limited for the year ended 31 October 2015 and 31 October 2016:

Quittet Limited
Cash flow statement for the year ended 31 October:

	2015 Sh."000"	2016 Sh."000"
Cash flow from operating activities:		
Profit before interest and tax	2,293	162
Adjustment for:		
• Investment income	-	(55)
• Finance cost	165	102
• Depreciation	262	369
• Loss on disposal of investments	101	-
• Profit on disposal of plant	(2,502)	(2)
	319	576
Working capital changes:		
Increase in inventories	(709)	(201)
Decrease in receivables	532	256
Increase in payables	727	251
Cash flow from operating activities	869	882
Less: Interest paid	(165)	(102)
Tax paid	(13)	(49)
Net cash flow from operating activities	691	731

	2016 Sh."000"	2015 Sh."000"
Cash flow from investing activities:		
Dividends received	-	55
Proceeds from sale of investments	32	-
Proceeds from sale of plant	1,609	12
Net cash flow from investing activities	1,641	67

	Sh."000"	Sh."000"
Cash flow from financing activities:		
Dividend paid	-	(110)
Borrowings	500	100
Net cash flow from financing activities	500	(10)
Net change in cash and cash equivalent2,832	788	
Cash and cash equivalent at the beginning	910	122
Cash and cash equivalent at the end	3,742	910

The extracts from the income statement and statement of financial position for the same period were as follows:

	2016 Sh."000"	2015 Sh."000"
Revenue	2,201	3,102
Equity and liabilities:		
Ordinary share capital (Sh.1 par value)	100	100
Retained earnings	7,052	4,772
	7,152	4,872
Long term liabilities:		
Borrowings	1,500	1,000
Current liabilities:		
Trade and other payables	1,056	329
	9,708	6,201

Required:
Calculate the following cash flow items:

(i) Cash return. (2 marks)

(ii) Cash return on capital employed ratio. (2 marks)

(iii) Cash flow to operating profit ratio. (2 marks)

(iv) Cash interest cover ratio. (2 marks)

(v) Cash flow per share. (2 marks)

(b) The financial controller of Quittet Limited has been under pressure from his operational director to improve the figures in (a)(i) to (v) above in readiness for the upcoming Annual General Meeting (AGM).

Discuss how this pressure might have influenced the financial statements and the reporting in general. (2 marks)

(c) Ivy Maritim, an investment and financial analyst at Faida Capital Investment Services has prepared the following proforma income statement for PinBall Limited for the year ended 30 September 2016:

	Sh."million"
Net sales	6,000
Cost of goods sold	(2,850)
Gross profit	3,150
Selling, general and administration expenses	(1,780)
Depreciation	(280)
Goodwill amortisation	(25)
Operating income	1,065
Interest expense	(170)
Income before taxes	895
Income tax	(300)
Net income	595
Diluted Earnings per Share (EPS) (Sh.)	2.29
Average shares outstanding (millions)	260
Dividends per Share (DPS) (Sh.)	0.64

Ivy Maritim is interested in forecasting the earnings per share (EPS) for the year 2017 and has made the following assumptions for the year 2017, compared with the year 2016:

1. Unit sales will rise by 7% but prices will remain the same.
2. Synergies from acquisitions will add an additional Sh.200 million to net sales.
3. Gross margin as a percentage of net sales will improve by 1.5%.
4. Selling, general and administration expenses as a percentage of sales will improve by 0.7%.
5. Depreciation expense will rise by 5%.
6. Goodwill amortisation will rise by Sh.10 million.
7. Long-term debt will remain the same.
8. Interest rates will decrease, reducing interest expense by Sh.10 million.
9. The income tax rate will rise by 0.5%.
10. Average shares outstanding will remain the same.
11. Dividends per share (DPS) will rise by 10%.

Required:
Projected income statement for PinBall Limited for the year ended 30 September 2017. (8 marks)
(Total: 20 marks)

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