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CIFA PART II SECTION 3

FINANCIAL STATEMENTS ANALYSIS

THURSDAY: 30 November 2017. **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) The role of financial statements analysis is to use financial reports prepared by companies, combined with other information, to evaluate the past, current and potential performance and financial position of a company for the purpose of making investment, credit and other economic decisions.

In relation to the above statement, analyse four types of economic decisions that a financial analyst could make from the financial statements of a company. (4 marks)

(b) (i) Explain the term "earnings management". (2 marks)

(ii) John Kitili, a financial analyst at Rich Investment Firm has been presented with the following data from the statement of financial position of Mwenja Dairy Limited for analysis:

Mwenja Dairy Limited statement of financial position as at 31 October:

	2017 Sh. "000"	2016 Sh. "000"
Assets:		
Cash	4,400	4,000
Accounts receivable	7,000	6,000
Inventory	8,400	8,000
Non-current assets	27,600	26,000
Total assets	47,400	44,000
Liabilities and equity:		
Accounts payable	3,520	3,200
Short-term notes payable	5,288	4,800
Long-term debt	30,000	30,000
Total liabilities	38,808	38,000
Equity:		
Ordinary shares	4,600	4,000
Retained earnings	3,992	2,000
Total liabilities and equity	47,400	44,000

Required:

The accrual ratio for the year 2017. (4 marks)

(c) The following information relates to Zalip Limited and Avela Limited which operates wholesale stores as at 30 June 2017:

Statement of financial position as at 30 June 2017

	Zalip Limited Sh. "million"	Avela Limited Sh. "million"
Non-current assets:		
Land and buildings	360.0	510.0
Fixtures and fittings	87.0	91.2
	447.0	601.0
Current assets:		
Inventories	592.0	403.0
Trade receivables	176.4	321.9
Cash at bank	84.6	91.6
	853.0	816.5
Total assets	1,300.0	1,417.7

	Sh. "million"	Sh. "million"
Equity and liabilities:		
Equity		
Ordinary shares (Sh.1 each)	320.0	250.0
Retained earnings	367.6	624.6
Total equity	687.6	874.6
Non-current liabilities:		
Borrowings – loan notes	190.0	250.0
Current liabilities:		
Trade payables	406.4	275.7
Taxation	16.0	17.4
	422.4	293.1
Total equity and liabilities	1,300.0	1,417.7

Income statement for the year ended 30 June 2017

	Zalip Limited Sh. "million"	Avela Limited Sh. "million"
Revenue	1,478.1	1,790.4
Cost of sales	(1,018.3)	(1,214.9)
Gross profit	459.8	575.5
Operating expenses	(308.5)	(408.6)
Operating profit	151.3	166.9
Interest payable	(19.4)	(27.5)
Profit before taxation	131.9	139.4
Taxation	(32.0)	(34.8)
Profit for the year	99.9	104.6

Additional information:

1. All purchases and sales were on credit.
2. Zalip Limited and Avela Limited had announced their intention to pay dividends of Sh.135 million and Sh.95 million respectively in respect of the year 2017.
3. The market value of a share in Zalip Limited and Avela Limited at the end of the year were Sh.6.50 and Sh.8.20 respectively.

Required:
For each business, calculate two ratios that are concerned with each of the following aspects:

(i) Profitability. (2 marks)

(ii) Efficiency. (2 marks)

(iii) Liquidity. (2 marks)

(iv) Gearing. (2 marks)

(d) Interpret the ratios computed in (c) (i) to (c) (iv) above. (2 marks)

(Total: 20 marks)

QUESTION TWO

(a) Evaluate four factors that could contribute to the reliability of financial statements. (4 marks)

(b) Benson Kilonzo, a financial analyst at ABC Capital has been presented with the following financial statements of Venus Limited for analysis:

Venus Limited
Income statement for the year ended 31 October 2017

	Sh.
Revenue	3,257,489
Cost of sales	(840,204)
Gross profit	2,417,285
Less expenses:	
Salaries and wages	1,036,005
Rent and lighting	123,467
General administrative expenses	783,969
Total operating expenses	(1,943,441)
Earnings before interest, tax, depreciation and amortisation (EBIDA)	473,844

	Sh.
Depreciation and amortisation	(156,368)
Earnings before interest and tax (EBIT)	317,476
Interest and other expenses	(31,089)
Pre-tax income	286,387
Income taxes	(85,642)
Net income	200,745

Venus Limited
Statement of financial position as at 31 October:

	2016	2017
Non-current assets:	**Sh.**	**Sh.**
Land and buildings	1,694,720	1,774,550
Plant and equipment	618,084	663,472
Motor vehicles	15,001	23,965
	2,327,805	2,461,987
Accumulated depreciation	(1,295,761)	(1,418,835)
Non-current assets	1,032,044	1,043,152
Goodwill	216,605	252,790
	1,248,649	1,295,942
Current assets:		
Cash	73,633	62,271
Inventory	67,023	70,559
Accounts receivable	46,588	43,944
Total current assets	187,244	176,774
Total assets	1,435,893	1,472,716
Financed by:		
Equity and liabilities:		
Equity:		
Ordinary share capital	507,736	512,735
Retained earnings	(586,196)	(725,834)
Total shareholders' equity	(78,460)	(213,099)
Long-term liabilities:		
Loan notes	970,825	1,113,949
Current liabilities:		
Trade payables	412,112	427,160
Accrued expenses	131,416	144,706
Total liabilities and equity	1,435,893	1,472,716

Required:

(i) Vertical analysis on the income statement for the year ended 31 October 2017. (4 marks)

(ii) Horizontal analysis on the statement of financial position. (4 marks)

(iii) Inventory turnover ratio. (2 marks)

(iv) Cash conversion cycle. (4 marks)

(v) Return on equity (ROE). (2 marks)

(Total: 20 marks)

QUESTION THREE

(a) Highlight three conditions to be satisfied before provision is recognised as per the International Accounting Standard (IAS) 37 "provision, contingent liabilities and contingent assets". (3 marks)

(b) Medichem Limited, a public limited company operating in the pharmaceuticals sector intends to achieve economies of scale by entering into a business combination with compatible partner companies. To achieve this objective, Medichem Limited acquired all of the ordinary share capital of Diapharm Limited by way of a share exchange on 1 April 2017. Medichem Limited issued 5 of its own shares for every 4 shares in Diapharm Limited. The market value of Medichem Limited's share on 1 April 2017 was Sh.6 each. The share issue has not been recorded in Medichem Limited's books.

The summarised financial statements of both companies for the year to 30 September 2017 were as follows:

Income statement for the year ended 30 September 2017:

	Medichem Limited Sh. "000"	Diapharm Limited Sh. "000"
Sales revenue	48,000	40,000
Cost of sales	(33,200)	(23,600)
Gross profit	14,800	16,400
Operating expenses	(3,200)	(2,000)
Profit before tax	11,600	14,400
Taxation	(4,000)	(6,000)
Profit for the year	7,600	8,400

Statement of financial position as at 30 September 2017:

	Medichem Limited		Diapharm Limited	
Non-current assets:	Sh. "000"	Sh. "000"	Sh. "000"	Sh. "000"
Property, plant and equipment		128,000		70,000
Investments		-		25,600
		128,000		95,600
Current assets:				
Inventory	45,600		47,200	
Trade receivables	32,800		48,400	
Bank	1,000	79,400	400	96,000
Total assets		207,400		191,600
Equity and liabilities:				
Ordinary shares (Sh.1 each)		40,000		24,000
Share premium	8,000		4,800	
Retained earnings	114,400	122,400	85,400	90,200
		162,400		114,200
Non-current liabilities:				
8% loan note		10,000		36,000
Current liabilities:				
Trade payables	30,600		35,400	
Taxation	4,400	35,000	6,000	41,400
		207,400		191,600

Additional information:

1. The fair value of Diapharm Limited investment was Sh.10 million in excess of its book value at the date of acquisition.
2. The fair value of Diaphram Limited's other net assets was equal to the book value.
3. Goodwill was reviewed on 30 September 2017. Sh.6 million loss is to be recognised.
4. No dividends have been paid or proposed by either companies.

Required:

(i) Consolidated income statement for the year ended 30 September 2017. (5 marks)

(ii) Consolidated statement of changes in equity for the year ended 30 September 2017. (4 marks)

(iii) Consolidated statement of financial position as at 30 September 2017. (8 marks)

(Total: 20 marks)

QUESTION FOUR

(a) In relation to the International Accounting Standard (IAS) 38 "Intangible Assets":

(i) Define the term "intangible asset". (2 marks)

(ii) Outline three examples of intangible assets. (3 marks)

(b) The following information relates to Golden Cake Limited pension scheme for the year ended 31 October 2017:

Beginning projected benefit obligation (PBO)	Sh.24 million
Fair market value of plan assets	Sh.16 million
Discount rate	9%
Expected return on plan assets	Sh.1.96 million

Anticipated compensation growth rate	4%
End of period actual return on assets	14%
End of period plan assets	Sh.18 million
Service cost for the year	Sh.1.8 million

Note: Ignore amortisation of unrecognised prior service costs and deferred gains and losses.

Required:
Pension expenses for the year ended 31 October 2017. (3 marks)

(c) Milliam Akinyi is a financial analyst at Vinball Limited which operates a defined-benefit retirement plan for its employees. The firm has a relatively young workforce with a low percentage of retirees. She is tasked to analyse the effects of changing assumptions on different variables used to calculate certain pension amounts.

Required:
(i) Describe the impact of an increase in the compensation growth. (2 marks)

(ii) Examine the impact of the funded status in case of a decrease in the discount rate. (1 mark)

(d) Stella Maris, a Certified Financial and Investment Analyst (CIFA) has calculated the following ratios for ABC Limited:

Operating profit margin	17.5%
Net profit margin	11.7%
Total asset turnover	0.89 times
Return on assets	10.4%
Financial leverage	1.46
Debt to equity ratio	0.46

Required:
The company's return on equity (ROE) using DuPont analysis. (2 marks)

(e) In relation to International Accounting Standard (IAS) 10 "Events after the reporting period":

(i) Distinguish between "adjusting event" and "non-adjusting event". (4 marks)

(ii) The current financial year for Damiano Limited ends on 31 March 2017. The company's financial statements were authorised by its directors on 6 May 2017 and the annual general meeting (AGM) was held on 3 June 2017. The following events have been brought to your attention:

On 12 April 2017, a fire completely destroyed the company's largest warehouse and the inventory inside. The carrying amount of the warehouse and the inventory were Sh.20 million and Sh.12 million respectively. It appears that the company had not updated the value of its insurance cover and only expects to be able to recover a maximum of Sh.18 million from its insurers. Damiano Limited trading operations had been severely disrupted since the fire outbreak and it expects large trading losses in the foreseeable future.

Required:
Explain the required treatment of the above item by Damiano Limited in its financial statements for the year ended 31 March 2017. (3 marks)

(Total: 20 marks)

QUESTION FIVE

(a) (i) Explain the term "shenanigan strategies" as used in financial statements analysis. (2 marks)

(ii) Describe two basic strategies underlying accounting shenanigans. (2 marks)

(b) In March 2017, Nebulax Limited acquired 40,000 shares in Jedidah Limited for Sh.2.68 per share. The investment was classified as available for sale on initial recognition. The shares were trading at Sh.2.96 per share on 31 July 2017. The directors of Nebulax Limited are concerned about the value of the company's investment in Jedidah Limited and in an attempt to hedge against the risk of a fall in its value, they are considering acquiring a derivative contract. The directors wish to use hedge accounting in accordance with International Accounting Standard (IAS) 39: "Financial Instruments".

Required:
Explain how both the available for sale investment and any associated derivative contract would be subsequently accounted for, assuming that the criteria for hedge accounting was met, in accordance with IAS 39. (3 marks)

(c) ABK Ltd. a subsidiary of MNC Ltd., prepares its financial statements in AHS currency. The following financial information relates to the two entities for the year ended 30 September 2017:

Statement of financial position as at 30 September 2017:

	MNC Ltd.		ABK Ltd.	
	SHS "million"	SHS "million"	AHS "million"	AHS "million"
Non-current assets:				
Property, plant and equipment	107		164	
Investments (Note 1)	60	167	-	164
Current assets:				
Inventory (Note 2)	70		50	
Accounts receivable	65		60	
Cash and bank balances	25	160	12	122
		327		286
Equity and liabilities:				
Ordinary share capital (1SHS/1 AHS shares)	100		60	
Retained profits	127	227	89	149
Non-current liabilities		65		72
Current liabilities		35		65
		327		286

Statement of comprehensive income for the year ended 30 September 2017

	MNC Ltd.	ABK Ltd.
	SHS "million"	AHS "million"
Revenue	200	240
Cost of sales	(120)	(145)
Gross profit	80	95
Operating expenses	(35)	(40)
Operating income	45	55
Intergroup investment income	4.5	
Finance cost	(7.5)	(10)
Profit before tax	42	45
Income tax expense	(10)	(15)
	32	30

Notes to the financial statements:

Note 1: On 1 October 2014, when the retained earnings of ABK Ltd. showed a credit balance of AHS 38 million, MNC Ltd. purchased 45 million shares of ABK Ltd. for AHS 4 each. At this date, a non-current asset in the books of ABK Ltd. with a carrying value of AHS 50 million was deemed to have a fair value of AHS 80 million. This asset had a remaining useful life of 10 years at this time and depreciation is charged to cost of sales.

Note 2: On 1 September 2017, MNC Ltd. sold computer components to ABK Ltd. for SHS 12 million. These components had a cost of SHS 10 million to manufacture. All of these components were included in the inventory of ABK Ltd. as at 30 September 2017. ABK Ltd. had paid for half of the consignment before the year end and the balance of the liabilities was included in its payables.

Exchange rate on relevant dates were as follows:

Date	Exchange rate: (AHS/SHS)
1 October 2014	3.00
30 September 2016	2.70
1 September 2017	2.45
30 September 2017	2.40

The weighted average exchange rate for the year ended 30 September 2017 was AHS 2.50 = 1 SHS

Required:
MNC Ltd. consolidated statement of comprehensive income for the year ended 30 September 2017. (8 marks)

(d) Radian Limited had 10 million ordinary shares in issue on both 1 January 2016 and 31 December 2016. On 1 January 2016, Radian Limited issued 1.2 million, 1 unit of 5% convertible loan stock. Each unit of stock is convertible into 4 ordinary shares on 1 January 2019 at the option of the holder.

The following is an extract from Radian Limited income statement for the year ended 31 December 2016:

	Sh. "000"
Profit before interest and tax	1,960
Interest payable on 5% convertible stock	(60)
Profit before tax	1,900
Income tax expenses at 30%	(570)
Profit for the year	1,330

Required:

(i) The basic earnings per share (EPS) for the year ended 31 December 2016. (2 marks)

(ii) The diluted earning per share (EPS) for the year ended 31 December 2016. (3 marks)

(Total: 20 marks)

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