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CIFA PART II SECTION 3

FINANCIAL STATEMENTS ANALYSIS

THURSDAY: 29 November 2018.

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) According to International Accounting Standard (IAS) 32, "Financial Instruments: Presentation", the issuer of a financial instrument must classify it as either a financial liability or equity instrument on initial recognition according to its substance.

**Required:**

With reference to the above statement, describe the accounting treatment of a compound instrument on initial recognition and on subsequent measurement. (8 marks)

- (b) Godin Limited is a public limited company with a portfolio of investments in many other entities. The extracts from its most recent financial statements are as set out below:

**Income statement for the year ended 31 October:**

|                                    | 2018          | 2017          |
|------------------------------------|---------------|---------------|
|                                    | Sh."000"      | Sh."000"      |
| Revenue                            | 126,000       | 175,000       |
| Cost of sales                      | (84,000)      | (105,000)     |
| Gross profit                       | 42,000        | 70,000        |
| Profit on disposal of a subsidiary | 3,500         | -             |
| Distribution costs                 | (12,250)      | (18,550)      |
| Administrative expenses            | (16,800)      | (10,150)      |
| Finance costs                      | (1,400)       | (2,800)       |
| Profit before tax                  | 15,050        | 38,500        |
| Income tax expense                 | (4,550)       | (11,550)      |
| Profit for the year                | <u>10,500</u> | <u>26,950</u> |

**Statement of financial position as at 31 October:**

|                                 | 2018          | 2017           |
|---------------------------------|---------------|----------------|
|                                 | Sh."000"      | Sh."000"       |
| <b>Non-Current assets:</b>      |               |                |
| Property, plant and equipment   | 57,050        | 66,500         |
| Intangible asset - goodwill     | -             | 7,000          |
|                                 | <u>57,050</u> | <u>73,500</u>  |
| <b>Current assets:</b>          |               |                |
| Inventories                     | 11,900        | 20,300         |
| Trade receivables               | 4,550         | 8,400          |
| Cash and cash equivalents       | 5,250         | -              |
|                                 | <u>21,700</u> | <u>28,700</u>  |
| Total assets                    | <u>78,750</u> | <u>102,200</u> |
| <b>Equity and liabilities:</b>  |               |                |
| <b>Equity:</b>                  |               |                |
| Ordinary shares of Sh.10 each   | 35,000        | 35,000         |
| Retained earnings               | 10,500        | 14,000         |
|                                 | <u>45,500</u> | <u>49,000</u>  |
| <b>Non-current liabilities:</b> |               |                |
| 10% debentures                  | 14,000        | 28,000         |
| <b>Current liabilities:</b>     |               |                |
| Bank overdraft                  | -             | 4,900          |
| Trade and other payables        | 15,050        | 10,850         |
| Current tax payable             | 4,200         | 9,450          |
|                                 | <u>19,250</u> | <u>25,200</u>  |
| Total equity and liabilities    | <u>78,750</u> | <u>102,200</u> |

**Additional information:**

1. On 1 November 2017, Godin Limited sold the net assets (including goodwill) of a 100% owned subsidiary for Sh.28 million cash on which it reported a gain of Sh.3.5 million. This disposal required approval by the shareholders of the parent entity. In order to achieve this, the directors of Godin Limited offered the shareholders a dividend of Sh.1.40 for each share in issue out of these disposal proceeds.

The trading results of the discontinued subsidiary indicated above, which are included in the income statement for the year ended 31 October 2017 were:

|                                | Sh. "000"     |
|--------------------------------|---------------|
| Revenue                        | 63,000        |
| Cost of sales                  | (35,000)      |
| Gross profit                   | 28,000        |
| Distribution costs             | (3,500)       |
| Administrative expenses        | (4,200)       |
| Profit before interest and tax | <u>20,300</u> |

2. The following selected ratios for Godin Limited have been calculated for the year ended 31 October 2017:

|                            |            |
|----------------------------|------------|
| Gross profit margin        | 40%        |
| Return on capital employed | 53.6%      |
| Operating profit margin    | 23.6%      |
| Net assets turnover        | 2.27 times |

**Required:**

Compute the equivalent ratios for Godin group for the year ended:

- (i) 31 October 2017 after excluding the consideration/contribution made by the disposal of the subsidiary. (4 marks)
- (ii) 31 October 2018, excluding the gain on disposal of the subsidiary. (4 marks)
- (iii) Based on the computed ratios in (b) (i) and (b) (ii) above, assess the comparative financial performance and financial position of Godin group as at 31 October 2018. (4 marks)

**(Total: 20 marks)**

**QUESTION TWO**

- (a) Differentiate between the "auditor's report" and the "management commentary". (4 marks)
- (b) ABC Company is evaluating a lease arrangement being offered by TKM Company for use of a computer system. The lease is non-cancellable and in no case will ABC Company receive title to the computer system during or at the end of the lease term. The lease starts on 1 January 2018, with the first rental payment due on 1 January 2018.

Additional information relating to the lease is as follows:

|  |  |
|--|--|
| Yearly rental payments                       | Sh.3,557.25 million.   |
| Lease term                                   | 3 years.   |
| Estimated economic life                      | 5 years.   |
| Purchase option                              | Sh.3,000 million at the end of 3 years, which approximates fair value.                 |
| Renewal option                               | 1 year at Sh.1,500 million, no penalty for non-renewal as per standard renewal clause. |
| Fair value at inception of lease             | Sh.10,000 million.   |
| Cost of asset to lessor                      | Sh.10,000 million.   |
| Residual value:                              |  |
| Guaranteed                                   | Nil.   |
| Unguaranteed                                 | Sh.3,000 million.  |
| Lessor's implicit rate (known by the lessee) | 12%.   |
| Executory costs paid by lessor               | Sh.500 million per year and is included in the yearly rental payments.                 |
| Estimated fair value at the end of lease     | Sh.3,000 million.  |

**Required:**

Analyse the lease capitalisation criteria for this lease for ABC Company.

(6 marks)

- (c) Omondi Enterprises Ltd., designs and manufactures locally made suits and the company's primary market is abroad. Sales have increased drastically in recent years. Such drastic growth has significant implications for cash flows. Provided below are the cash flow statements for the company for two recent years:

|  | Current year<br>Sh. | Prior year<br>Sh. |
|--|---------------------|-------------------|
| <b>Cash flows from operating activities:</b>   |                     |                   |
| Net income   | 17,523              | 838,955           |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |                     |                   |
| Deferred income taxes  | (69,524)            | (146,590)         |
| Depreciation and amortisation  | 316,416             | 181,348           |
| <b>Changes in assets and liabilities:</b>  |                     |                   |
| Accounts receivable  | (38,267)            | (25,947)          |
| Inventories  | (1,599,014)         | (1,289,293)       |
| Prepayments and other current assets   | (444,794)           | (113,205)         |
| Deposits and other assets  | (24,240)            | (83,044)          |
| Accounts payable   | 2,017,059           | (284,567)         |
| Accrued expenses   | 61,321              | 170,755           |
| Accrued interest payable (debentures)  | -                   | (67,179)          |
| Income taxes payable   | -                   | 117,810           |
| Net cash used for operating activities   | 236,480             | (700,957)         |
| Net cash used for investing activities   | (2,102,892)         | (4,422,953)       |
| Net cash used for financing activities   | (315,353)           | 9,685,435         |
| Net change in cash and cash equivalents  | (2,181,765)         | 4,561,525         |
| <b>Other information:</b>  |                     |                   |
| Current liabilities  | 4,055,465           | 1,995,600         |
| Total liabilities  | 4,620,085           | 2,384,386         |
| Net sales  | 20,560,566          | 17,025,856        |

**Required:**

- (i) Noting that net income in the current year was only Sh.17,523 compared to prior year net income of Sh.838,955, but net cash flow from operating activities was Sh.236,480 in the current year and a negative Sh.700,957 in the prior year;
- Explain the causes of this apparent paradox. (4 marks)
- (ii) Evaluate the firm's liquidity, solvency and profitability for the current year using cash flow based ratios. (6 marks)
- (Total: 20 marks)**

**QUESTION THREE**

- (a) Entities have a choice of the accounting policy they may wish to use in the preparation of financial statements. However, the financial results of an entity could be altered significantly by the choice of the accounting policy.

**Required:**

With reference to the above statement, identify three key limitations of ratio analysis. (6 marks)

- (b) The following information was extracted from the financial records of Mickeyland Limited:

|                                | Sh. "000" |
|--------------------------------|-----------|
| Revenue                        | 1,857,000 |
| Profit before interest and tax | 298,500   |
| Interest on loan               | 16,500    |
| Income tax expense             | 69,000    |
| Total assets                   | 2,595,000 |
| Shareholders' equity           | 1,506,000 |
| Loan capital                   | 243,000   |

**Required:**

The company's return on equity (ROE) using the three-step DuPont analysis. (4 marks)

- (c) Wingstone Limited bought a drilling machine for Sh.7.2 million on 1 April 2016. The machine had an estimated economic useful life of six years on that date and a straight line depreciation to a nil residual value was provided.

On 1 April 2017, Wingstone Limited sold the machine to Whitesands Limited for Sh.8,880,000 at its fair value.

Wingstone Limited immediately leased the machine back from Whitesands Ltd. for five years (the remainder of its useful life) at a rental of Sh.1,920,000 per annum payable in arrears. The present value of the annual lease payments at the inception of the leaseback amounted to Sh.8.4 million at an implicit interest rate of 4.625%.

The transaction satisfies the International Financial Reporting Standard (IFRS) 15: Revenue from Contracts with Customers.

**Required:**

- (i) The amount of the gain that Wingstone Limited should recognise for the year ended 31 March 2018 in respect of the sale and leaseback. (4 marks)
- (ii) The extracts of financial statements of Wingstone Limited for the year ended 31 March 2018 to account for the right-of-use asset and lease liability. (6 marks)

**(Total: 20 marks)**

**QUESTION FOUR**

- (a) In relation to stock compensation plan, discuss three advantages of restricted stock plans. (6 marks)

- (b) On 1 June 2015, Juhudi Ltd. and Jamii Ltd. merged to form Jumii Ltd. A total of 800,000 shares were issued to complete the merger.

On 1 April 2017, the new corporation issued an additional 400,000 shares of stock and cash. All 1,200,000 shares were outstanding on 31 December 2017. Jumii Ltd. also issued Sh.600,000 of 20 year, 8% convertible bonds at par on 1 July 2017. Each Sh.1,000 bond converts to 40 ordinary shares at any interest date. None of the bonds have been converted to date. For the year ended 31 December 2017, the annual report indicated that the company had an after-tax net income of Sh.1,540,000. The tax rate is 30%.

**Required:**

The firm's diluted earnings per share (EPS). (8 marks)

- (c) The following are the comparative income and retained earnings statements, for Pingu Ltd. for the years 2016 and 2017:

|                                 | 2017<br>Sh.    | 2016<br>Sh.    |
|---------------------------------|----------------|----------------|
| Sales                           | 340,000        | 270,000        |
| Cost of sales                   | (200,000)      | (142,000)      |
| Gross profit                    | 140,000        | 128,000        |
| Expenses                        | (88,000)       | (50,000)       |
|                                 | <u>52,000</u>  | <u>78,000</u>  |
| Retained earnings (1 January)   | 125,000        | 72,000         |
| Net income                      | 52,000         | 78,000         |
| Dividends                       | (30,000)       | (25,000)       |
| Retained earnings (31 December) | <u>147,000</u> | <u>125,000</u> |

**Additional information:**

1. In the year 2017, Pingu Ltd. decided to switch its depreciation method from sum-of-the years' digits to the straight-line method.

The assets were purchased at the beginning of year 2016 for Sh.100,000 with an estimated useful life of 4 years and no salvage value. The year 2017 income statement contains depreciation expense of Sh.30,000 on the assets purchased at the beginning of year 2016.

2. In the year 2017, Pingu Ltd. discovered that the ending inventory for the year 2016 was overstated by Sh.24,000.
3. The ending inventory for the year 2017 was correctly stated.

**Required:**

The revised earnings statement for the years 2016 and 2017. (Ignore income taxes). (6 marks)

**(Total: 20 marks)**

**QUESTION FIVE**

- (a) Explain the term “earnings quality” in relation to accrual component of earnings and earnings management. (2 marks)
- (b) On 1 October 2016, HM Ltd. acquired 2,000,000 ordinary shares of SJ Ltd. by paying Sh.4.50 per share. As at the date of acquisition, the retained earnings of SJ Ltd. were Sh.4,200,000.

The draft statements of financial position of the two companies as at 30 September 2018 were as follows:

|                                 | HM Ltd.<br>Sh. “000” | SJ Ltd.<br>Sh. “000” |
|---------------------------------|----------------------|----------------------|
| <b>Assets:</b>                  |                      |                      |
| <b>Non-current assets:</b>      |                      |                      |
| Land                            | 11,000               | 6,000                |
| Plant and equipment             | 10,225               | 5,110                |
| Investment in SJ Ltd.           | <u>9,000</u>         | <u>-</u>             |
|                                 | <u>30,225</u>        | <u>11,110</u>        |
| <b>Current assets:</b>          |                      |                      |
| Inventories                     | 4,925                | 3,295                |
| Trade receivables               | 5,710                | 1,915                |
| Cash                            | <u>495</u>           | <u>-</u>             |
|                                 | <u>11,130</u>        | <u>5,210</u>         |
| Total assets                    | <u>41,355</u>        | <u>16,320</u>        |
| <b>Equity and liabilities:</b>  |                      |                      |
| <b>Equity:</b>                  |                      |                      |
| Ordinary shares of Sh.1 each    | 5,000                | 2,500                |
| Retained earnings               | <u>25,920</u>        | <u>8,290</u>         |
|                                 | <u>30,920</u>        | <u>10,790</u>        |
| <b>Non-current liabilities:</b> |                      |                      |
| 10% loans                       | <u>6,000</u>         | <u>2,000</u>         |
| <b>Current liabilities:</b>     |                      |                      |
| Trade payables                  | 3,200                | 2,225                |
| Bank overdraft                  | -                    | 285                  |
| Corporation tax                 | <u>1,235</u>         | <u>990</u>           |
|                                 | <u>4,435</u>         | <u>3,530</u>         |
| Total equity and liabilities    | <u>41,355</u>        | <u>16,320</u>        |

**Additional information:**

1. Extracts from the income statement of SJ Ltd. before inter-group adjustments for the year ended 30 September 2018 are as follows:

|                   | Sh. “000”    |
|-------------------|--------------|
| Profit before tax | 2,700        |
| Corporation tax   | <u>(800)</u> |
| Profit after tax  | <u>1,900</u> |

2. During the year, SJ Ltd. sold goods to HM Ltd. for Sh.900,000. SJ Ltd. adds a 20% mark-up on cost to all its sales. Goods with a transfer price of Sh.240,000 were included in HM Ltd.’s inventories as at 30 September 2018.
3. The fair value of SJ Ltd.’s land, plant and equipment at the date of acquisition was Sh.1,000,000 and Sh.2,000,000 respectively in excess of the carrying values. SJ Ltd.’s statement of financial position has not taken account of these fair values. The group depreciation policy is that land should not be depreciated while plant and equipment should be depreciated at the rate of 10% per annum on fair value.
4. During the year, an impairment review was carried out on the consolidated goodwill and it was found that the goodwill had been impaired by Sh.400,000 as at 30 September 2018.

**Required:**

- (i) Determine the value of goodwill arising on acquisition of SJ Ltd. (5 marks)
- (ii) HM Ltd. group consolidated statement of financial position as at 30 September 2018. (13 marks)
- (Total: 20 marks)**

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