KASNEB

CIFA PART II SECTION 3

FINANCIAL STATEMENTS ANALYSIS

THURSDAY: 26 May 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) (i) Differentiate between "top down investing" and "bottom up investing" as an approach to analysing financial statements of a firm. (4 marks)

(ii) Outline three limitations of financial analysis. (3 marks)

(b) On 1 January 2013, Dualmax Limited granted 100 cash share appreciation rights (SARs) to each of its 500 employees on condition that the employees remain in its employment for at least the next two years. The SARs vest on 31 December 2014 and could be exercised at any time up to 31 December 2015. The fair value of each SAR at the grant date is Sh.7.40. The following information has also been provided:

Year ended	Leavers	Number of employees exercising rights	Outstanding SARs	Estimated further leavers	Fair value of SARs Sh.	Intrinsic value (cash paid) Sh.
31 December 2013	50	-	450	60	8.00	-
31 December 2014	50	100	300	-	8.50	8.10
31 December 2015	-	300	-	-	-	9.00

Required:

The expense and liability which will appear in the financial statements in each of the three years. (6 marks)

(c) The directors of Zedmark Ltd. have been presented with the following abridged financial statements:

Zedmark Ltd.
Income statement for the year ended 30 September:

		2014		2015
	Sh."000"	Sh."000"	Sh."000"	Sh."000"
Sales revenue		3,600		3,840
Cost of sales:				
Opening inventories	320		400	
Purchases	2,240		2,350	
	2,560		2,750	
Closing inventories	(400)	(2,160)	(500)	(2,250)
Gross profit		1,440		1,590
Expenses		1,360		1,500
Profit		80		90

Zedmark Ltd.
Statement of financial position as at 30 September:

	2014	2015
	Sh."000"	Sh."000"
Non-current assets:		
Property, plant and equipment	1,900	1,860
Current assets:		
Inventories	400	500
Trade receivables	750	960
Cash at bank	8	4
	1,158	1,464
Total assets	3,058	3,324
Equity and liabilities:		
Equity		
Ordinary shares (Sh.1 each)	1,650	1,766
Reserves	1,018	1,108
	2,668	2,874
Current liabilities	390	450
Total equity and liabilities	3,058	3,324

Required:

(i) Calculate three profitability ratios and three efficiency ratios for the years ended 30 September 2014 and 30 September 2015. (6 marks)

(ii) Comment on the profitability and efficiency of the company using the ratios calculated in (c)(i) above. (1 mark)

(Total: 20 marks)

QUESTION TWO

(a) In a recent seminar on.the requirements of International Financial Reporting, many investments and financial analysts commented on a growing disillusionment with the usefulness and reliability of the information contained in some companies income statements.

With reference to the above statement, discuss the extent to which a company's statement of cash flow could be more useful and reliable than its income statement. (6 marks)

(b) The following are the comprehensive financial statements of Bozi Limited for the year ended 31 March 2015 and 31 March 2016:

Bozi Limited
Comprehensive income statement for the year ended 31 March 2016:

	Sh."000"
Revenue	5,106
Cost of sales	(3,628)
Gross profit	1,478
Distribution cost	(250)
Administrative expenses	(528)
Profit from operations	700
Interest received	50
Interest paid	(150)
Profit before tax	600
Income tax expense	(280)
Profit for the year	320
Dividend payable	200

Bozi Limited
Statement of financial position as at 31 March:

	2016 Sh."000"	2015 Sh."000"
Assets:		
Non-current assets:		
Tangible assets	760	610
Intangible assets	500	400
Investments	-	50
Current assets:		
Inventories	300	204
Trade receivables	780	630
Short-term investments	100	-
Cash in hand	4	2
Total assets	2,444	1,896
Equity and liabilities:		
Equity:		
Ordinary share capital (Sh.1 par value)	400	300
Share premium	320	300
Revaluation reserves	200	182
Retained earnings	320	200
Non-current liabilities:		
Long-term loan	340	100
Current liabilities:		
Trade payables	254	238
Bank overdraft	170	196
Taxation	240	220
Dividend payable	200	160
Total equity and liabilities	2,444	1,896

Additional information:

1. The proceeds of the sale of non-current assets investments amounted to Sh.60,000.
2. Fixtures and fittings with original cost of Sh.170,000 and a carrying value of Sh.90,000 were sold for Sh.64,000. During the year, new fixtures and fittings were purchased costing Sh.402,000.
3. The following information relates to tangible non-current assets as at 31 December:

	2014 Sh."000"	2015 Sh."000"
Cost/revaluation	1,440	1,190
Accumulated depreciation	680	580
Carrying value	760	610

4. 100,000 Sh.1 ordinary shares were issued during the year at a premium of Sh.0.20 per share.
5. The short-term investments are highly liquid and are close to maturity.

Required:

Bozi Limited Statement of Cash Flows for the year ended 31 March 2016 in accordance with the requirements of International Accounting Standards (IAS) 7 ("Statement of Cash flows"). Use the indirect method. (14 marks)

(Total: 20 marks)

QUESTION THREE

(a) Examine three techniques that could be used in financial model building and forecasting. (3 marks)

(b) On 1 January 2014, Mobizon Limited, a manufacturing company, leased a cast iron making machine for four years. The lease calls for payment of Sh.12 million per year payable at the beginning of the year. At the end of the four years, Mobizon Limited will return the machine to the lessor who will sell it for scrap. The appropriate interest rate is 9%. Mobizon Limited depreciates its assets on a straight line basis.

Required:

Total expense under finance lease to be reported in the income statement for the year ended 31 December 2015. (4 marks)

(c) Apex Limited had 3,600,000 ordinary shares in issue on 1 January 2015. The profit after tax for the year ended 31 December 2015 was Sh.2,700,000.

Additional information:

1. On 1 July 2015, the company made a rights issue at a price of Sh.9.50 per share on the basis of one share for every five shares held. The share price immediately prior to the rights issue had been Sh.12.50 per share.
2. On 1 April 2015, Apex Limited issued Sh.5,000,000 7% convertible bonds at a discount rate of 5% to their par value. The terms of issue provided that the bond can be either redeemed for cash at par value or be converted into ordinary shares on 31 March 2018.
3. Each Sh.10 bond is convertible into two new ordinary shares. The proceeds of the convertible bonds issue have been credited to non-current liabilities.
4. The interest is payable annually in arrears commencing 31 March 2016. The effective rate of interest on an equivalent bond without the option to convert to ordinary shares would be 11% per annum.
5. The earnings per share (EPS) for the year ended 31 December 2014 was Sh.0.8.
6. Assume a corporate tax rate of 30%.

Required:

(i) The initial carrying amount of the convertible bond in both liability and equity component. (4 marks)

(ii) Basic earnings per share (EPS) for the year ended 31 December 2015. (4 marks)

(iii) Adjusted EPS for the year ended 31 December 2014 as it should be disclosed in the year 2015. (1 mark)

(iv) Diluted EPS for the year ended 31 December 2015. (4 marks)

(Total: 20 marks)

QUESTION FOUR

(a) (i) Explain the term "creative accounting" as used in the analysis of financial statements. (1 mark)

(ii) Propose five ways in which creative accounting could take place in an organisation. (5 marks)

(b) On 1 January 2011, A Ltd., a public limited company acquired 60% of B Ltd., a public limited company. On 30 July 2009, A Ltd. had acquired 10% of C Ltd. and on the same day B Ltd. had acquired 80% of C Ltd.

The following are the statements of financial position of the three companies as at 31 December 2015:

	A Ltd. Sh."million"	B Ltd. Sh."million"	C Ltd. Sh."million"
Non-current assets:			
Property, plant and equipment	2,458	1,410	870
Investment in B Ltd.	900		
Investment in C Ltd.	27	240	
	3,385	1,650	870
Current assets:			
Inventories	450	200	260
Trade receivables	610	365	139
Cash	240	95	116
	1,300	660	515
	4,685	2,310	1,385
Equity:			
Ordinary share capital	500	200	100
Share premium	250	120	50
Retained earnings	2,805	1,572	850
	3,555	1,892	1,000
Current liabilities:			
Trade payables	1,130	418	385
	4,685	2,310	1,385

Additional information:

1. During the year ended 31 December 2015, B Ltd. sold goods to C Ltd. for Sh.260 million including a mark up of 25%. All of these goods remained in the inventories at the year end.
2. The retained earnings of the three companies at the acquisition dates was as follows:

	30 July 2009 Sh."million"	1 January 2011 Sh."million"
A Ltd.	1,610	1,860
B Ltd.	700	950
C Ltd.	40	100

3. The book values of the identifiable net assets at the acquisition date are equivalent to their fair values.
4. On 1 January 2011, the fair value of A Ltd. was 10% holding and in C Ltd. was Sh.50 million.
5. A Ltd. and B Ltd. hold their investment in subsidiaries at cost in their separate financial statements. It is group policy to value the non controlling interests at fair value at acquisition. The directors valued the non controlling interests in B Ltd. at Sh.536 million and C Ltd. at Sh.210 million on 1 January 2011.
6. No impairment losses have been necessary in the consolidated financial statements to date.

Required:
Group consolidated statement of financial position as at 31 December 2015. (14 marks)
(Total: 20 marks)

QUESTION FIVE

(a) On 1 July 2013, Quorondom Limited issued a redeemable debt instrument at a par value of Sh.6 million. The instrument carries a fixed coupon interest at a rate of 6% payable annually in arrears. The debt instrument will be redeemable for Sh.6.02 million on 30 June 2017. Transaction costs associated with the issue were Sh.200,000 and were paid at the time of the issue. The approximate interest rate applicable to this liability is 7.06%.

Required:
The carrying value of the liability to be included in Quorondom Limited in the statement of financial position as at 30 June 2015.

Note: (Round all workings to the nearest Sh."000"). (3 marks)

(b) Kesty Ltd. made taxable trading profits of Sh.1,200,000 for the year ended 30 April 2016 on which corporation tax is payable at a rate of 30%. A transfer of Sh.20,000 will be made to the deferred taxation account. The balance on this account was Sh.100,000 before making any adjustments for the following items:

1. The estimated tax on profits for the year ended 30 April 2015 was Sh.80,000 but tax has been agreed at Sh.84,000 and fully paid.

2. Tax on profits for the year to 30 April 2016 is payable in arrears.

3. In the year to 30 April 2016, the company made a capital gain of Sh.60,000 on the sale of some property.

The capital gain is taxable at a rate of 30%.

Required:

(i) The tax charge for the year to 30 April 2016. (4 marks)

(ii) The tax liabilities in the statement of financial position. (4 marks)

(c) (i) Explain the three components of DuPont equation. (6 marks)

(ii) An investment and financial analyst gathered the following information about Farasi Holdings Limited for the year ended 31 December 2015:

	Sh."000"
Revenue	1,000
Net income	400
Total assets	500
Shareholders' equity	10,000

Required:

The company's return on equity (ROE) using DuPont analysis. (3 marks)

(Total: 20 marks)

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Present Value of 1 Received at the End of n Periods:

$$PVIF_{r,n} = 1/(1+r)^n = (1+r)^{-n}$$

Period	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	12%	14%	15%	16%	18%	20%	24%	28%	32%	36%
1	.9901	.9804	.9709	9615	.9524	.9434	.9346	.9259	.9174	.9091	.8929	8772	.8696	.8621	.8475	.8333	.8065	.7813	.7576	.7353
2	.9803	.9612	.9426	9246	.9070	.8900	.8734	.8573	.8417	.8264	.7972	.7695	.7561	.7432	.7182	.6944	.6504	.6104	5739	.5407
3	.9706	.9423	.9151	8890	.8638	.8396	.8163	.7938	7722	.7513	.7118	.6750	.6575	.6407	.6086	.5787	.5245	.4768	.4348	.3975
4	.9610	.9238	.8885	.8548	.8227	.7921	.7629	.7350	7084	.6830	.6355	.5921	.5718	.5523	.5158	.4823	.4230	.3725	.3294	.2923
5	.9515	.9057	.8626	.8219	.7835	.7473	.7130	.6806	.6499	.6209	.5674	5194	.4972	.4761	.4371	.4019	.3411	.2910	.2495	.2149
6	.9420	.8880	.8375	.7903	.7462	.7050	.6663	.6302	.5963	.5645	.5066	.4556	.4323	.4104	.3704	.3349	.2751	.2274	.1890	.1580
7	.9327	.8706	.8131	.7599	.7107	.6651	.6227	.5835	.5470	.5132	.4523	.3996	.3759	.3538	.3139	.2791	.2218	:1776	.1432	.1162
8	.9235	.8535	.7894	.7307	.6768	.6274	.5820	.5403	.5019	.4665	.4039	.3506	.3269	.3050	.2660	.2326	.1789	.1388	.1085	.0854
9	.9143	.8368	.7664	.7026	.6446	.5919	.5439	.5002	.4604	.4241	.3606	3075	.2843	.2630	.2255	.1938	.1443	.1084	.0822	.0628
10	.9053	.8203	.7441	.6756	.6139	.5584	.5083	.4632	.4224	.3855	.3220	.2697	.2472	.2267	.1911	.1615	.1164	.0847	.0623	.0462
11	.8963	.8043	.7224	.6496	.5847	.5268	.4751	.4289	.3875	.3505	.2875	.2366	.2149	.1954	.1619	.1346	.0938	.0662	.0472	.0340
12	.8874	.7885	.7014	.6246	.5568	.4970	.4440	.3971	.3555	.3186	.2567	.2076	.1869	1685	.1372	.1122	.0757	.0517	.0357	.0250
13	.8787	.7730	.6810	.6006	.5303	.4688	.4150	.3677	.3262	.2897	.2292	.1821	.1625	.1452	.1163	.0935	.0610	.0404	.0271	.0184
14	.8700	.7579	.6611	.5775	.5051	.4423	.3878	.3405	.2992	.2633	.2046	.1597	.1413	.1252	.0985	.0779	.0492	.0316	.0205	.0135
15	.8613	.7430	.6419	.5553	.4810	.4173	.3624	3152	.2745	.2394	.1827	.1401	.1229	.1079	.0835	.0649	.0397	.0247	.0155	.0099
16	.8528	.7284	.6232	.5339	.4581	.3936	.3387	.2919	.2519	.2176	.1631	.1229	1069	.0930	.0708	.0541	.0320	.0193	.0118	.0073
17	.8444	.7142	.6050	.5134	.4363	.3714	.3166	.2703	.2311	.1978	.1456	.1078	.0929	.0802	.0600	.0451	.0258	.0150	.0089	.0054
18	.8360	.7002	.5874	.4936	.4155	.3503	.2959	.2502	.2120	.1799	.1300	.0946	.0808	.0691	.0508	.0376	.0208	.0118	.0068	.0039
19	.8277	.6864	.5703	.4746	.3957	.3305	.2765	.2317	.1945	.1635	.1161	.0829	.0703	.0596	.0431	.0313	.0168	.0092	.0051	.0029
20	.8195	.6730	.5537	.4564	.3769	.3118	.2584	.2145	.1784	.1486	1037	.0728	.0611	.0514	.0365	.0261	.0135	.0072	.0039	.0021
25	.7798	.6095	.4776	.3751	.2953	.2330	.1842	.1460	.1160	.0923	.0588	.0378	.0304	.0245	.0160	.0105	.0046	.0021	.0010	.0005
30	.7419	.5521	.4120	.3083	.2314	.1741	.1314	.0994	.0754	.0573	.0334	.0196	.0151	.0116	.0070	.0042	.0016	.0006	.0002	.0001
40	.6717	.4529	3066	.2083	.1420	.0972	.0668	0460	.0318	.0221	.0107	.0053	.0037	.0026	.0013	.0007	.0002	.0001	*	*
50	.6080	.3715	.2281	.1407	.0872	.0543	.0339	.0213	.0134	.0085	.0035	.0014	.0009	.0006	.0003	.0001	*	*	*	*
60	.5504	.3048	.1697	.0951	.0535	.0303	.0173	.0099	.0057	.0033	.0011	.0004	.0002	.0001	*	*	*	*	*	*

* The factor is zero to four decimal places

Present Value of an Annuity of 1 Per Period for n Periods:

$$PVIF_{r,t} = \sum_{t=1}^{n} \frac{1}{(1+r)^t} = \frac{1 - \frac{1}{(1+r)^n}}{r}$$

Number of payments	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	12%	14%	15%	16%	18%	20%	24%	28%	32%
1	0.9901	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091	0.8929	0.8772	0.8696	0.8621	0.8475	0.8333	0.8065	0.7813	0.7576
2	1.9704	1.9416	1.9135	1.8861	1.8594	1.8334	1.8080	1.7833	1.7591	1.7355	1.6901	1.6467	1.6257	1.6052	1.5656	1.5278	1.4568	1.3916	1.3315
3	2.9410	2.8839	2.8286	2.7751	2.7232	2.6730	2.6243	2.5771	2.5313	2.4869	2.4018	2.3216	2.2832	2.2459	2.1743	2.1065	1.9813	1.8684	1.7663
4	3.9020	3.8077	3.7171	3.6299	3.5460	3.4651	3.3872	3.3121	3.2397	3.1699	3.0373	2.9137	2.8550	2.7982	2.6901	2.5887	2.4043	2.2410	2.0957
5	4.8534	4.7135	4.5797	4.4518	4.3295	4.2124	4.1002	3.9927	3.8897	3.7908	3.6048	3.4331	3.3522	3.2743	3.1272	2.9906	2.7454	2.5320	2.3452
6	5.7955	5.6014	5.4172	5.2421	5.0757	4.9173	4.7665	4.6229	4.4859	4.3553	4.1114	3.8887	3.7845	3.6847	3.4976	3.3255	3.0205	2.7594	2.5342
7	6.7282	6.4720	6.2303	6.0021	5.7864	5.5824	5.3893	5.2064	5.0330	4.8684	4.5638	4.2883	4.1604	4.0386	3.8115	3.6046	3.2423	2.9370	2.6775
8	7.6517	7.3255	7.0197	6.7327	6.4632	6.2098	5.9713	5.7466	5.5348	5.3349	4.9676	4.6389	4.4873	4.3436	4.0776	3.8372	3.4212	3.0758	2.7860
9	8.5660	8.1622	7.7861	7.4353	7.1078	6.8017	6.5152	6.2469	5.9952	5.7590	5.3282	4.9464	4.7716	4.6065	4.3030	4.0310	3.5655	3.1842	2.8681
10	9.4713	8.9826	8.5302	8.1109	7.7217	7.3601	7.0236	6.7101	6.4177	6.1446	5.6502	5.2161	5.0188	4.8332	4.4941	4.1925	3.6819	3.2689	2.9304
11	10.3676	9.7868	9.2526	8.7605	8.3064	7.8869	7.4987	7.1390	6.8052	6.4951	5.9377	5.4527	5.2337	5.0286	4.6560	4.3271	3.7757	3.3351	2.9776
12	11.2551	10.5753	9.9540	9.3851	8.8633	8.3838	7.9427	7.5361	7.1607	6.8137	6.1944	5.6603	5.4206	5.1971	4.7932	4.4392	3.8514	3.3868	3.0133
13	12.1337	11.3484	10.6350	9.9856	9.3936	8.8527	8.3577	7.9038	7.4869	7.1034	6.4235	5.8424	5.5831	5.3423	4.9095	4.5327	3.9124	3.4272	3.0404
14	13.0037	12.1062	11.2961	10.5631	9.8986	9.2950	8.7455	8.2442	7.7862	7.3667	6.6282	6.0021	5.7245	5.4675	5.0081	4.6106	3.9616	3.4587	3.0609
15	13.8651	12.8493	11.9379	11.1184	10.3797	9.7122	9.1079	8.5595	8.0607	7.6061	6.8109	6.1422	5.8474	5.5755	5.0916	4.6755	4.0013	3.4834	3.0764
16	14.7179	13.5777	12.5611	11.6523	10.8378	10.1059	9.4466	8.8514	8.3126	7.8237	6.9740	6.2651	5.9542	5.6685	5.1624	4.7296	4.0333	3.5026	3.0882
17	15.5623	14.2919	13.1661	12.1657	11.2741	10.4773	9.7632	9.1216	8.5436	8.0216	7.1196	6.3729	6.0472	5.7487	5.2223	4.7746	4.0591	3.5177	3.0971
18	16.3983	14.9920	13.7535	12.6593	11.6896	10.8276	10.0591	9.3719	8.7556	8.2014	7.2497	6.4674	6.1280	5.8178	5.2732	4.8122	4.0799	3.5294	3.1039
19	17.2260	15.6785	14.3238	13.1339	12.0853	11.1581	10.3356	9.6036	8.9501	8.3649	7.3658	6.5504	6.1982	5.8775	5.3162	4.8435	4.0967	3.5386	3.1090
20	18.0456	16.3514	14.8775	13.5903	12.4622	11.4699	10.5940	9.8181	9.1285	8.5136	7.4694	6.6231	6.2593	5.9288	5.3527	4.8696	4.1103	3.5458	3.1129
25	22.0232	19.5235	17.4131	15.6221	14.0939	12.7834	11.6536	10.6748	9.8226	9.0770	7.8431	6.8729	6.4641	6.0971	5.4669	4.9476	4.1474	3.5640	3.1220
30	25.8077	22.3965	19.6004	17.2920	15.3725	13.7648	12.4090	11.2578	10.2737	9.4269	8.0552	7.0027	6.5660	6.1772	5.5168	4.9789	4.1601	3.5693	3.1242
40	32.8347	27.3555	23.1148	19.7928	17.1591	15.0463	13.3317	11.9246	10.7574	9.7791	8.2438	7.1050	6.6418	6.2335	5.5482	4.9966	4.1659	3.5712	3.1250
50	39.1961	31.4236	25.7298	21.4822	18.2559	15.7619	13.8007	12.2335	10.9617	9.9148	8.3045	7.1327	6.6605	6.2463	5.5541	4.9995	4.1666	3.5714	3.1250
60	44.9550	34.7609	27.6756	22.6235	18.9293	16.1614	14.0392	12.3766	11.0480	9.9672	8.3240	7.1401	6.6651	6.2402	5.5553	4.9999	4.1667	3.5714	3.1250