



CIFA PART II SECTION 3
FINANCIAL STATEMENTS ANALYSIS

THURSDAY: 24 May 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) Distinguish between “top-down approach” from “bottom-up approach” techniques of analysing financial statements by outlining the salient steps followed in each approach. (6 marks)
- (b) Neptune Holdings is an entity that operates in the wholesale and retail clothing market sectors across several countries. The firm prepares its financial statements in accordance with the requirements of International Financial Reporting Standards (IFRSs). The directors are considering listing Neptune Holdings on a local securities exchange within the next twelve months. One of the directors has raised concerns about the costs associated with being a listed entity, in particular the additional expense of producing operating segment information.

Required:

- (i) Explain how the requirements of IFRS 8 “Operating Segments” assist entities in minimising the cost of producing the operating segment disclosures required by the standard. (2 marks)
- (ii) Discuss three benefits that could accrue to the investors from reviewing the operating segment disclosures of Neptune Holdings when making investment decisions. (6 marks)
- (iii) Describe two potential limitations that could be faced by investors using operating segment information when making investment decisions. (2 marks)
- (c) A motor vehicle manufacturing company commenced operations on 1 January 2017. The following information relates to the company for the financial year ended 31 December 2017:
1. Research and development costs related to software development for internal purposes amounted to Sh.750,000.
 2. Start-up costs amounted to Sh.1,200,000.
 3. Direct response advertising costs totalled to Sh.225,000.
 4. Research and development related to developing a new car model amounted to Sh.500,000.
 5. Testing of the prototype model is scheduled for June 2018.
 6. Start-up costs have an estimated period of benefits of two years, advertising three years while research and development is estimated at five years.

Required:

Calculate the amount that should be expensed in the company’s financial statements for the year ended 31 December 2017. (4 marks)

(Total: 20 marks)

QUESTION TWO

- (a) The following financial statements were extracted from the books of Melinda Limited:

Statement of comprehensive income for the year ended 31 March 2018

	Sh. “million”
Revenue	5,740
Cost of sales	(4,840)
Gross profit	900
Other income	60
Distribution cost	(120)
Administrative expenses	(350)
Finance cost	(50)
Profit before tax	440
Income tax expense	(160)
Profit for the year	280

Other comprehensive income:

Gain on property revaluation	100
Total comprehensive income	380

Statements of financial position as at 31 March:

	2018		2017	
	Sh. "million"	Sh. "million"	Sh. "million"	Sh. "million"
Non-current assets:				
Property, plant and equipment		2,880		1,860
Investment property		420		400
		3,300		2,260
Current assets:				
Inventory	1,210		810	
Accounts receivable	480		540	
Deferred tax asset	Nil		50	
Bank	10	1,700	Nil	1,400
		5,000		3,660
Equity and liabilities:				
Ordinary share capital		1,000		600
Share premium		600		Nil
Revaluation reserves		150		50
Retained earnings		1,440		1,310
		3,190		1,960
Non-current liabilities:				
6% Debentures	Nil		400	
Deferred tax	50	50	30	430
Current liabilities:				
Accounts payable	1,410		1,050	
Bank overdraft	Nil		120	
Warranty provision	200		100	
Current tax payable	150	1,760	Nil	1,270
		5,000		3,660

Additional information:

- An item of plant with a carrying value of Sh.240 million was sold at a loss of Sh.90 million during the year. Depreciation of Sh.280 million was charged to cost of sales for property, plant and equipment in the year ended 31 March 2018.
The company uses the fair value model as per International Accounting Standard (IAS) 40: Investment Property.
There was no acquisition or disposal of investment property during the year.
- The 6% debentures were redeemed early incurring a penalty payment of Sh.20 million which has been charged as an administrative expense in the income statement.
- Other incomes comprise:
 - Investment income of Sh.40 million.
 - Revaluation gain of investment property of Sh.20 million.
- Melinda Limited gives a 12 month warranty on some of the products it sells. The amount shown in current liabilities as warranty provision are an accurate assessment based on past experience of the amount of claims likely to be made in respect of warranties outstanding at each year end. Warranty costs are included in cost of sales.

Required:

- A statement of cash flows for the year ended 31 March 2018 in accordance with the requirements of the International Accounting Standard (IAS) 7, Statement of Cash Flows. (14 marks)
 - Comment on the cash flow management of Melinda Limited as revealed by the statement of cash flows in (a) above and the information provided by the above financial statements. (6 marks)
- (Total: 20 marks)**

QUESTION THREE

- Pauline Nangila and Johnson Mugecha are discussing the recent fraud that occurred at AKIP Limited. The fraud involved the improper reporting of revenue to ensure that the company would have income in excess of Sh.1 billion.

Required:

- Explain the term "fraudulent financial reporting". (2 marks)
- Evaluate five ways in which fraudulent financial reporting differs from an embezzlement of company's funds. (5 marks)

- (b) (i) Examine two reasons why the components of income tax expense should be disclosed and a reconciliation between the effective tax rate and the statutory tax rate be provided. (2 marks)
- (ii) Baobab Cement Limited reported a pre-tax income of Sh.70 million for the year 2017. The following items caused taxable income to be different from pre-tax financial income reported:
1. Depreciation on the tax return was greater than depreciation on the income statement by Sh.16 million.
 2. Rent collected on the tax return was greater than rent recognised on the income statement by Sh.22 million.
 3. Fines for pollution appear as an expense of Sh.11 million on the income statement.

Baobab Cement Limited's tax rate is 30% for all years and the company expects to report taxable income in all future years. There are no deferred taxes at the beginning of the year 2017.

Required:

Compute the effective income tax rate for the year 2017. (6 marks)

- (c) Shadrack Magu, a financial analyst at Beta Capital has gathered the following information about ABC Limited for the year ended 31 December 2017:

1. Net income for the year was Sh.130 million.
2. Outstanding number of ordinary shares for the entire year was 3 million.
3. The company had 1.2 million, 9%, Sh.100 par value preference shares for the entire year with each preferred share being convertible into 5 ordinary shares.
4. The corporate tax rate is 30%.

Required:

(i) Basic earnings per share (EPS). (2 marks)

(ii) Diluted earnings per share (EPS). (3 marks)

(Total: 20 marks)

QUESTION FOUR

Western Corporation was formed 5 years ago through a public subscription of ordinary shares. Douglas Wekesa who owns 15% of the ordinary shares is the current chairman of Western Corporation. The company has been successful, but is currently experiencing a shortage of funds. On 10 June 2017, Wekesa approached Salama Bank requesting for a 24-month extension on two Sh. 35 million notes, which were due on 30 June 2017 and 30 September 2017. Another note of Sh.6 million was due on 31 March 2018, but he expects no difficulty in paying this note on its due date. Wekesa explained that Western Corporation's cash flow problems were due primarily to the company's desire to finance a Sh.300 million plant expansion over the next two financial years through internally generated funds.

The commercial loan officer of Salama Bank obtained the following financial reports of the company for the last two financial years:

Western Corporation		
Statement of financial position as at 31 March:		
Assets:	2017	2016
	Sh."000"	Sh."000"
Cash	18,200	12,500
Notes receivable	148,000	132,000
Accounts receivable (net)	131,800	125,500
Inventories (at cost)	105,000	50,000
Plant and equipment	1,449,000	1,420,500
Total assets	1,852,000	1,740,500
Liabilities and stockholders' equity:		
Accounts payable	79,000	91,000
Notes payable	76,000	61,500
Accrued liabilities	9,000	6,000
Ordinary shares (130 million shares, Sh.10 par)	1,300,000	1,300,000
Retained earnings	388,000	282,000
	<u>1,852,000</u>	<u>1,740,500</u>

Western Corporation
Income statement
For the financial year ended 31 March

	2017	2016
	Sh. "000"	Sh. "000"
Sales revenue	3,000,000	2,700,000
Cost of goods sold	(1,530,000)	(1,425,000)
Gross profit margin	1,470,000	1,275,000
Operating expenses	(860,000)	(780,000)
Income before income taxes	610,000	495,000
Income taxes	(244,000)	(198,000)
Net income	366,000	297,000

Additional information:

1. Cash dividends were paid at the rate of Sh.1 per share in the financial year 2016 and Sh.2 per share in the financial year 2017.
2. Depreciation charges on the plant and equipment of Sh.100 million and Sh.102.5 million for the financial years ended 31 March 2016 and 31 March 2017 respectively are included in the cost of goods sold.

Required:

- (a) Compute the following items for Western Corporation:
- (i) Current ratio for financial year 2016 and 2017. (2 marks)
 - (ii) Acid-test (quick) ratio for the financial year 2016 and 2017. (2 marks)
 - (iii) Inventory turnover for financial year 2017. (2 marks)
 - (iv) Return on asset (ROA) for financial year 2016 and 2017 (Assume total assets were Sh.1,688,500,000 as at 31 March 2015). (2 marks)
 - (v) Percentage change in sales, cost of goods sold, gross profit margin and net income after taxes from financial year 2016 to 2017. (4 marks)
- (b) Propose two financial reports and or financial analysis that might be helpful to the commercial loan officer of Salama Bank in evaluating Wekesa's request for a time extension on Western Corporation's notes. (2 marks)
- (c) Assume that the percentage change experienced in the financial year 2017 as compared with financial year 2016 for sales and cost of goods sold will be repeated in each of the next 2 years.
- Determine whether Western Corporation's desire to finance plant expansion from internally generated funds is realistic. (5 marks)
- (d) Determine whether Salama Bank should grant the extension on Western Corporation's notes considering Wekesa's statement about financing the plant expansion through internally generated funds. (1 mark)
- (Total: 20 marks)**

QUESTION FIVE

- (a) Complex Machineries Limited leased a new model of a machine under the following terms:
1. Four year lease with annual end of year payments of Sh.10,000.
 2. At the end of the lease, the lessor regains possession, and the asset is expected to be sold at scrap value.
 3. The discount rate on the lease is 6%.
 4. The company's incremental borrowing rate is 7%.
 5. The company depreciates all its assets on a straight-line basis.
 6. Useful life of the machine is 5 years.

Required:

Illustrate how the above lease would be reported in the company's statement of financial position and income statement for each of the next four years. (4 marks)

(b) In relation to the International Financial Reporting Standard (IFRS) 5, "Non-current Assets Held for Sale and Discontinued Operations":

- (i) Highlight three conditions that must be met for an asset to be classified as held for sale. (3 marks)
- (ii) Allied group operates hotel chain within East Africa. After a period of declining profitability, the directors made the following decisions during the year ended 30 April 2018:
1. To dispose of all of its hotels in Rwanda.
 2. To refurbish all of its hotels in Kenya in order to target the business clients market. The previous target market in Kenya had been aimed at the holiday and tourism market.

Required:

Treating the two decisions separately, explain whether they meet the criteria for being classified as discontinued operations in the financial statements for the year ended 30 April 2018. (3 marks)

(c) The following are the extracts from the financial statements of Zoo Limited and Niqe Limited for the year ended 31 December 2017:

Summarised income statement and statement of other comprehensive income for the year ended 31 December 2017:

	Zoo Limited Sh."million"	Niqe Limited Sh."million"
Profit from operations	290	140
Finance costs	(45)	(8)
Profit before tax	245	132
Income tax expense	(80)	(32)
Profit for the year	165	100
Other comprehensive income:		
Items that may be reclassified to profit or loss:		
Gains on sale of investment	2	
Items that will not be reclassified to profit or loss:		
Revaluation of property, net of tax	60	20
Other comprehensive income for the year	62	20
Total comprehensive income	227	120

Additional information:

1. Zoo Limited acquired 40% of the equity share capital of Niqe Limited for Sh.270 million in the year 2014 when the fair value of the net assets of Niqe Limited was Sh.600 million. Zoo Limited acquired a further 30% of the equity share capital of Niqe Limited for Sh.260 million on 1 October 2017 when the fair value of the net assets was Sh.800 million. The fair value of the initial 40% investment in Niqe Limited was Sh.390 million as at 1 October 2017. There has been no impairment of the investments in Niqe Limited.
2. Assume that profits, gains and losses accrue evenly throughout the year.
3. It is the group's policy to measure the non-controlling interest at its proportionate share of the fair value of the net assets acquired.

Required:

Group consolidated income statement and other comprehensive income for the year ended 31 December 2017.

(10 marks)

(Total: 20 marks)

.....

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	.0316	.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:

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

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

www.kasnebnotes.co.ke