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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 Sh."000"	2017 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	10,500	26,950

Statement of financial position as at 31 October:

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

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	20,300

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 Sh.	Prior year Sh.
Cash flows from operating activities:		
Net income	17,523	838,955
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	(69,524)	(146,590)
Depreciation and amortisation	316,416	181,348
Changes in assets and liabilities:		
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
Other information:		
Current liabilities	4,055,465	1,995,600
Total liabilities	4,620,085	2,184,386
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	2016
	Sh.	Sh.
Sales	340,000	270,000
Cost of sales	(200,000)	(142,000)
Gross profit	140,000	128,000
Expenses	(88,000)	(50,000)
	52,000	78,000
Retained earnings (1 January)	125,000	72,000
Net income	52,000	78,000
Dividends	(30,000)	(25,000)
Retained earnings (31 December)	147,000	125,000

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. Sh."000"	SJ Ltd. Sh."000"
Assets:		
Non-current assets:		
Land	11,000	6,000
Plant and equipment	10,225	5,110
Investment in SJ Ltd.	9,000	-
	30,225	11,110
Current assets:		
Inventories	4,925	3,295
Trade receivables	5,710	1,915
Cash	495	-
	11,130	5,210
Total assets	41,355	16,320
Equity and liabilities:		
Equity:		
Ordinary shares of Sh.1 each	5,000	2,500
Retained earnings	25,920	8,290
	30,920	10,790
Non-current liabilities:		
10% loans	6,000	2,000
Current liabilities:		
Trade payables	3,200	2,255
Bank overdraft	-	285
Corporation tax	1,235	990
	4,435	3,530
Total equity and liabilities	41,355	16,320

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	(800)
Profit after tax	1,900

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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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