

# KASNEB

## CIFA PART II SECTION 3

### FINANCIAL STATEMENTS ANALYSIS

#### PILOT PAPER

September 2015.

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) Financial statements analysis is important for various reasons.

Describe four such reasons.

(8 marks)

- (b) The following is the income statement and statement of financial position of Incubator Limited for the ended 31 December 2014:

Income statement	Sh. "000"	Sh. "000"
Revenue		42,000
Cost of goods sold		(28,000)
Gross profit		14,000
<b>Operating expenses</b>		
Selling and administrative cost	7,100	
Depreciation	1,700	
Total operating costs		(8,800)
Income before income taxes		5,200
Income tax expense		(1,560)
Net income		<u>3,640</u>

#### Statement of financial position as at 31 December:

	2014	2013
Assets:	Sh. "000"	Sh. "000"
Cash	6,000	4,400
Accounts receivable (Net)	4,540	4,800
Inventory	3,200	2,400
Property, plant and equipment	19,200	16,000
Less accumulated depreciation	(8,100)	(6,400)
Total assets	<u>24,840</u>	<u>21,200</u>
<b>Liabilities and shareholders equity:</b>		
Accounts payable	2,900	2,600
Income taxes payable	2,940	3,400
Other payables	1,900	1,000
Long-term debt	0	2,000
Common stock	9,260	8,000
Retained earnings	<u>7,840</u>	<u>4,200</u>
Total liabilities and shareholders equity	<u>24,840</u>	<u>21,200</u>

#### Required:

- (i) Statement of cash flow for the year ended 31 December 2014 using the direct method. (6 marks)
- (ii) Show the cash flows from activities for Incubators Limited for the year ended 31 December 2014 using the indirect method. (6 marks)

(Total: 20 marks)

#### QUESTION TWO

- (a) In the context of IAS 10: Events after the reporting period, differentiate between "adjusting" and "non-adjusting" events giving two examples in each case. (6 marks)
- (b) Explain any two adjustments that might be necessary to make financial statements comparable. (4 marks)

- (c) Buxton Limited reported a net income after tax of Sh.154,000,000 in the year ended 31 December 2014. It had Sh.60,000,000 ordinary shares outstanding on 1 January 2014. On 1 March 2014, 12 million new ordinary shares were issued. The company distributed 10% dividend on 1 July 2014 and decided to reacquire 8 million shares as treasury stock on 1 October 2014. The company had in its capital structure during the year 5 million 8% Sh.10 par value non-convertible preference stock.

In 2012, the company granted executive stock options exercisable for 15 million ordinary shares at an exercise price of Sh.20 per share. The average price of ordinary shares during year 2014 was Sh.25 per share.

**Required:**

- (i) Determine basic earnings per share as at 31 December 2014. (5 marks)
- (ii) Determine dilute earnings per share as at 31 December 2014. (5 marks)
- (Total: 20 marks)**

**QUESTION THREE**

- (a) Pluto Limited issues 1 million convertible bonds of Sh.100 each carrying nominal interest of 10%. Bondholders are entitled to convert their bonds into Sh.100 ordinary shares of the company on the date of their maturity in three years time instead of receiving principal repayment. Interest rate of a similar bond without the conversion option is 15%.

**Required:**

Analyse how Pluto Limited should account for the convertible bonds during the following instances assuming all bonds are convertible after three years.

- (i) Upon initial recognition. (3 marks)
- (ii) Subsequent measurement. (3 marks)
- (iii) At maturity. (2 marks)
- (b) Pemba Limited acquired 50% of the share capital of Kando Limited at the beginning of year 2014, when the net assets of Kando Limited were Sh.125,000,000. Pemba Limited paid initial cash consideration of Sh.75,000,000. Additionally, Pemba Limited issued 200,000 shares with nominal value of Sh.5 per share and a current market value of Sh.8 per share. It was further agreed that Pemba Limited will pay Sh.60,000,000 at the end of the third year.

On the date of acquisition, the fair value of Kando Limited's assets exceeded their book value by Sh.5,000,000. They had a remaining useful life of five years at this date. The implicit interest rate in the market is 10%. The market value of non controlling interest at the date of acquisition was Sh.30,000,000. Pemba Limited values non-controlling interest using full goodwill method. At the end of one year since acquisition goodwill has been impaired by 20%. The statement of financial position of Kando Limited indicated net assets of Sh.135,000,000 before fair value adjustment on net assets.

**Required:**

- (i) The value of goodwill at the time of acquisition. (6 marks)
- (ii) The value of non-controlling interest at the end of year 2014. (6 marks)
- (Total: 20 marks)**

**QUESTION FOUR**

- (a) Outline four advantages of operating leases over finance leases. (4 marks)
- (b) Kisan Distributors was in need of cash. To obtain the cash, the firm sold its three warehouses for Sh.27,000,000, then leased back the warehouses. The warehouses had a carrying value of Sh.18,000,000 (original cost Sh. 28,500,000).

**Additional information:**

1. The sale date was 31 December 2013.
2. Non-cancellable lease term is 10 years and require annual payments of Sh.3,994,662, beginning 31 December 2013. The estimated useful life of the warehouses is 10 years.
3. Annual rental payments provide the lessor with a 10% rate of return on the financing arrangement.
4. Kisan Distributors depreciated its warehouses on a straight line basis.

**Required:**

- (i) Deferred gain on sale-leaseback at the point of lease contract. (3 marks)
  - (ii) Lease payable (current liability) on 31 December 2014. (3 marks)
  - (iii) Interest expense for the year 2014. (2 marks)
  - (iv) Accumulated depreciation as at 31 December 2014. (2 marks)
- (c) In light of IAS 26: Pensions, define the following terms:
- (i) Vested benefit obligation. (2 marks)
  - (ii) Accumulated benefit obligation. (2 marks)
  - (iii) Projected benefit obligation. (2 marks)
- (Total: 20 marks)**

**QUESTION FIVE**

- (a) (i) In the context of organisation performance; define the term "operating cash cycle". (2 marks)
- (ii) Explain three ways in which a company could improve its operating cash cycle. (6 marks)
- (b) The income statement of Metro Ltd. for year 2014 reported net sales of Sh.48,000,000 and net income of Sh.8,000,000. The following table shows the company's comparative statements of financial position for years 2013 and 2014.

	2013 Sh."000"	2014 Sh."000"
<b>Assets:</b>		
Cash	3,000	3,800
Accounts receivable	7,000	5,000
Inventory	9,000	7,000
Property, plant and equipment	<u>24,000</u>	<u>21,200</u>
Total assets	<u>43,000</u>	<u>37,000</u>
<b>Liabilities and equity:</b>		
Current liabilities	9,600	8,300
Bonds payable	12,000	12,000
Paid up share capital	10,000	10,000
Retained earnings	<u>11,400</u>	<u>6,700</u>
Total liabilities and shareholders equity	<u>43,000</u>	<u>37,000</u>

**Some industry averages for Metro Ltd.'s line of business:**

Inventory turnover	5 times
Average collection period	25 days
Assets turnover	1.8 times
Day sales in inventory	70 days

**Required:**

- Assess Metro Ltd.'s assets management relative to its industry (Hint: use efficiency ratios). (12 marks)
- (Total: 20 marks)**
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