KASNEB

CIFA PART II SECTION 3

FINANCIAL STATEMENTS ANALYSIS

THURSDAY: 25 May 2017. **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) Nancy Naliaka, a financial analyst at ABC Capital Investment firm is analysing the financial statements of some companies in the manufacturing sector in her country.

Required:
In relation to the above statement, highlight three different types of information that she could obtain from each of the following sources:

(i) Press release. (3 marks)

(ii) Proxy statements. (3 marks)

(b) Noor Kiptoon, a finance director at Equid Limited is evaluating whether the company should purchase a production plant in cash or through a finance lease.

Additional information:
1. The plant will cost Sh.280 million.
2. The interest rate implicit in the lease is 10% per annum.
3. The finance lease would be repaid in four equal instalments of Sh.80 million each, payable annually in advance commencing 1 January 2017.

Required:
The amount to be included in both the statement of comprehensive income and the statement of financial position for the years ended 31 December 2017 and 31 December 2018. (6 marks)

(c) (i) Distinguish between "taxable temporary differences" and "deductable temporary differences" as used in the computation of income taxes. (2 marks)

(ii) Bitech Ltd. had a deferred tax assets of Sh.20 million as at 1 April 2016.
During the year ended 31 March 2017, the following information was available for computation of deferred tax:

1. Property, plant and equipment had a carrying amount of Sh.600 million and a tax base of Sh.500 million.
2. Trade receivables had been reported at Sh.250 million before making an allowance for doubtful debts of Sh.5 million and exchange gain (unrealised) of Sh.20 million. Both the allowance and exchange gain are not allowed for tax purposes.
3. Trade and other payables stood at Sh.550 million which included accrual of Sh.60 million allowable for tax purposes.
4. Inventory is carried at Sh.150 million before making a provision of 5% on obsolete stock.
5. Intangible assets comprise of patents being amortised over 5 years which had a carrying value of Sh.60 million. This had been allowed for tax purposes when the cost was incurred.

Assume a tax rate of 30%.

Required:
The deferred tax provision for the year ended 31 March 2017. (6 marks)

(Total: 20 marks)

QUESTION TWO

(a) (i) Explain four purposes of financial ratios. (4 marks)

(ii) James Oduor, a financial analyst is examining the performance of Betam Airways and wishes to understand the factors driving the trend in its return on equity (ROE) over a three year period. James obtains the following data from a leading news provider and ascertains that the news provider has included non-operating income in the interest burden factor:

Factor	2016	Year 2015	2014
Return on equity (ROE)	20.62%	14.42%	10.17%
Tax burden	64.88%	62.52%	60.67%
Interest burden	130.54%	112.60%	130.50%
Earnings before interest and tax (EBIT) margin	6.51%	6.40%	4.84%
Asset turnover	1.55	1.38	1.19
Leverage	2.42	2.32	2.24

Required:

Analyse each of the factors driving the trend in return on equity (ROE) over the three year period. (6 marks)

(b) The following are extracts of the financial statements of Aquila Ltd., Leo Ltd. and Orion Ltd. for the year ended 31 December 2016:

Summarised income statements and other income for the year ended 31 December 2016:

	Aquila Ltd. Sh."million"	Leo Ltd. Sh."million"	Orion Ltd. Sh."million"
Profit from operations	580	280	140
Finance costs	(90)	(16)	(20)
Profit before tax	490	264	120
Income tax expense	(160)	(64)	(30)
Profit for the year	330	200	90
Other comprehensive income:			
Items that will not be classified to the income statement:			
Revaluation of property (net of tax)	120	40	20
Other comprehensive income for the year	120	40	20
Total comprehensive income	450	240	110

Additional information:

1. Aquila Ltd. acquired 80% of the equity share capital of Leo Ltd. for Sh.405 million in the year 2013 when the fair value of the net assets was Sh.465 million. The non-controlling interest in Leo Ltd. was measured as its fair value of Sh.100 million at the date of acquisition. Aquila Ltd. conducted an annual impairment review and concluded that the goodwill on the acquisition of Leo Ltd. was impaired by 20% as at 31 December 2016. No previous impairment of goodwill had occurred.
2. Aquila Ltd. established a joint venture entity, Orion Ltd., with one other party on 1 January 2016. Aquila Ltd. is accounting for its 50% share in this joint venture in accordance with the International Accounting Standard (IAS) 28: "Investment in Associates and Joint Ventures".

Required:

(i) The summarised consolidated income statement and other comprehensive income for Aquila Ltd. for the year ended 31 December 2016. (6 marks)

(ii) Aquila Ltd. is planning to acquire 100% of the equity of Delta Ltd., an entity that operates overseas and which currently prepares its financial statements in E Shillings. The directors of Aquila Ltd. intend to require that Delta Ltd. adopts the currency of Aquila Ltd.'s country as its functional currency.

Required:

Explain how the functional currency of Delta Ltd. should be determined under International Accounting Standard (IAS) 21: "The effects of changes in Foreign exchange rates" framework. (4 marks)

(Total: 20 marks)

QUESTION THREE

(a) (i) Summarise four conditions that must be satisfied before the revenue from the sale of goods could be recognised as per the International Accounting Standard (IAS) 18: "Revenue". (4 marks)

(ii) Fairmall Technology Limited was awarded a contract to develop a computer software program for a client for a total sales price of Sh.100 million.
The project was to take three years to develop with a total development cost estimated at Sh.60 million.

Additional information:

1. At the end of year 1, the company had spent Sh.30 million, total costs to completion being estimated at Sh.30 million.
2. At the end of year 2, the company had spent an additional Sh.24 million, total costs to completion being estimated at Sh.6 million.
3. At the end of year 3, the contract was complete. The company spent an accumulated total cost of Sh.60 million.
4. The company recognises long-term contract revenue using the percentage of completion method and estimates the percentage complete based on expenditure incurred as a percentage of total estimated expenditures.

Required:
The amount of revenue that Fairmall Technology Limited should recognise in year 1, year 2 and year 3. (6 marks)

(b) The following comprehensive income statement relates to the performance of Beste Ltd. for the year ended 31 March 2017 and 31 March 2016 respectively:

	31 March 2017 Sh."000"	31 March 2016 Sh."000"
Revenue	141,088	122,516
Cost of sales	(71,956)	(67,400)
Gross profit	69,132	55,116
Distribution costs	(11,054)	(9,830)
Administrative expenses	(29,702)	(22,278)
Total operating profit	28,376	23,008
Profit/(loss) on sale of non-current assets	(1,418)	1,240
Profit before interest and taxation	26,958	24,248
Net interest payable	(5,508)	(6,438)
Profit before taxation	21,450	17,810
Taxation	(6,244)	(4,470)
Profit for the period	15,206	13,340

Required:

(i) Common size percentage income statement for the year ended 31 March 2017 and 31 March 2016. (8 marks)

(ii) Comment on your results in (b)(i) above. (2 marks)

(Total: 20 marks)

QUESTION FOUR

(a) Examine two limitations of cash flow reporting. (2 marks)

(b) The following information relates to Maji Ltd.:

	Sh."000"
Cash and cash equivalents (31 December 2016)	1,500
Cash and cash equivalents (31 December 2017)	1,850
Interest expense	480
Net borrowings	250
Cash dividends	1,250

The corporation tax rate is 30%.

Required:
The free cash flow to the firm (FCFF) at the end of year 2017. (3 marks)

(c) The following are the financial statements for Halzina Limited for the year ended 30 April 2017:

Halzina Limited
Income statement for the year ended 30 April 2017:

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

Halzina Limited
Statement of financial position as at 30 April:

	2017 Sh."000"	2016 Sh."000"
Assets:		
Non-current assets:		
Tangible assets	760	610
Intangible assets	500	400
Investment	-	50
	1,260	1,060
Current assets:		
Inventories	300	204
Trade receivables	780	630
Short-term investments	100	-
Cash	4	2
	1,184	836
Total assets	2,444	1,896
Equity and liabilities:		
Equity:		
Ordinary share capital of Sh. 1 each	400	300
Share premium account	320	300
Revaluation reserve	200	182
Retained earnings	320	200
	1,240	982
Non-current liabilities:		
Long-term loan	340	100
Current liabilities:		
Trade payables	254	238
Bank overdraft	170	196
Taxation	240	220
Dividends payable	200	160
	864	814
Total equity and liabilities	2,444	1,896

Additional information:

1. The proceeds of the sale of non-current asset investments amount to Sh.60,000.
2. Fixtures and fittings with an original cost of Sh.170,000 and a carrying value of Sh.90,000 were sold for Sh.64,000 during the year.
3. New fixtures and fittings were purchased at a cost of Sh.402,000.

4. The following information relates to tangible non-current assets:

	30 April 2017 Sh."000"	30 April 2016 Sh."000"
Cost/revaluations	1,440	1,190
Accumulated depreciation	680	580
Carrying value	760	610

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

Required:

Statement of cash flows for the year ended 30 April 2017 in accordance with the requirements of International Accounting Standard (IAS) 7: "Statement of cash flows". (15 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Evaluate five mechanisms that could be put in place to prevent strategic manipulation of financial statements. (5 marks)

(b) During the year 2016, OLB Ltd. reported a net income of Sh.115,600 and had 200,000 ordinary shares outstanding for the entire year. The company also had 1,000, 10% Sh.100 par value convertible preferred shares, convertible into 40 ordinary shares each, outstanding for the entire year.
OLB Ltd. also had 600, 7% Sh.1,000 par value convertible bonds, convertible into 100 shares each, outstanding for the entire year. The company also had 10,000 stock options outstanding during the year. Each option is convertible into one share of stock at Sh.15 per share. The average market price of the stock for the year was Sh.20.

The corporate tax rate is 30%.

Required:

The diluted earnings per share (EPS) for OLB Ltd. for the year 2016. (5 marks)

(c) Fahari Ltd. operates a defined benefit pension plan for its employees. On 1 April 2016, the fair value of the pension plan assets was at Sh.8,200,000 and the present value of pension plan liabilities was Sh.8,500,000.
The actuary estimated that the service cost for the year to 31 March 2017 was Sh.2,100,000. The pension plan paid Sh.500,000 to retired members and Fahari Ltd. paid Sh.1,900,000 in contributions to the pension plan in the year to 31 March 2017. The actuary estimated that the relevant discount rate for the year to 31 March 2017 was 6%.

On 31 March 2017, Fahari Ltd. announced improvements to the benefits offered by the pension plan to all of its members. The actuary estimated that the past service cost associated with these improvements was Sh.2 million.
At 31 March 2017, the fair value of the pension plan assets was Sh.10,200,000 and the present value of the pension plan liabilities including the past service cost was Sh.12,500,000.

Required:

In accordance with International Accounting Standard (IAS) 19: "Employee Benefits":

(i) Calculate the net actuarial gain or loss that will be included in Fahari Ltd.'s other comprehensive income for the year ended 31 March 2017. (8 marks)

(ii) Calculate the net pension asset or liability that will be included in Fahari Ltd.'s statement of financial position as at 31 March 2017. (2 marks)

(Total: 20 marks)

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