CMA DECEMBER, 2019 EXAMINATION
MANAGEMENT LEVEL
SUBJECT: F2. FIM- FINANCIAL MANAGEMENT

MODEL SOLUTION

Solution of the Question No. 1

(c) Tk. 20,000 (Sales Tk. 60,000 – COGS Tk. 40,000)

(d) The £ value of the loan is recorded as £4m (€10/2.5). The UK company suffered an exchange loss of £1m.

(e) GRI- (Global Reporting Initiative) is an independent international organization that has pioneered sustainability reporting since 1997.

GRI helps businesses and governments worldwide understand and communicate their impact on critical sustainability issues such as climate change, human rights, governance and social well-being. This enables real action to create social, environmental and economic benefits for everyone. The GRI Sustainability Reporting Standards are developed with true multi-stakeholder contributions and rooted in the public interest.

Substance over form: The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

(f) Tk. 76,000 (Hot Ltd. Tk. 40,000 + Warm Ltd. Tk. 36,000)

(g) Value of liability as at 31 December 2018:

Opening balance Tk. 000	Finance cost at 8% Tk. 000	Interest paid 6% Tk. 000	Closing balance Tk. 000
9,206 (W1)	737	(600)	9,343

Working 1:

Liability element

PV of the principal (at 8% for 5 years) = (Tk. 10m x 0.681)	Tk. 6,810
PV of interest of 6% on Tk. 10m for 5 years = (Tk. 10m x 0.06 x 3.993)	Tk. 2,396
Total value of liability element	Tk. 9,206

(h)

89.1 pence

Weighted average number of shares:
TERP: 2 shares @ £2.00 = £4.00
1 share @ £1.40 = £1.40
3 £5.40 therefore £5.40/3 = £1.80

Adjustment factor: Market value of share=£2.00
TERP £1.80

1 Jan X7 – 31 March X7 2,400,000 x 2.00x 3/12 666,667
1.80

Rights issue 1,200,000
1 April X7 – 31 Dec X7 3,600,000 x 9/12 2,700,000
3,366,667

Basic EPS
= £3,000,000
3,366,667 shares

= 89.1p

Solution of the Question No. 2

(a)

(i) Under the *IFRS13 Fair Value Measurement* hierarchy a level 1 input will be a quoted price from an active market for an identical asset. In the case of an equity investment this will only be available where the entity in question is quoted on a stock exchange. The fair value will therefore be the share price of the entity.

(ii) A level 2 input is one which is observable directly or indirectly for the asset. In the case of an equity investment in an unquoted entity, this could be the quoted market share price of a similar entity or might come from market data on unquoted company valuations.

(b)

i. Journal entries for transactions: Finance director

The transactions are settled in cash and hence liabilities are created.

31 December 20X4

DR Expense £147

CR Liability £147

It is assumed that the current share price is the best estimate of the final share price.

(calculation note: 20 * 10 * £2.20 * 1/3)

31 December 20X5

DR Liability £147

CR Expense £147

Reverses entries for 20X4 as share price is less than minimum

31 December 20X6

DR Expense £480

CR Liability £480

DR Liability £480

CR Cash £480

(20 * 10 * £2.40 * 3/3)

ii. Journal entries for transactions: other individuals

31 December 20X4

DR Expense £1,467

CR Liability £1,467

(calculation note: 20 * 10 * 10 * £2.20 * 1/3)

31 December 20X5:

DR Liability	£1,467
CR Expense	£1,467

31 December 20X6

DR Expense	£3,840
CR Liability	£3,840

DR Liability	£3,840
CR Cash	£3,840

(calculation note: 20 * 10 * 8 * £2.40 * 3/3)

(c)

Financial statements are by their nature backward-looking, based primarily on historical information and are therefore limited in their usefulness for decision-making by investors. In addition, this entity is service-based and as the main resource is not included on the financial statements it is difficult for users to estimate future revenue streams. This has led to general pressure by the markets and investors for entities to provide additional information to that contained in the financial statements.

Investors in SR would benefit in this case from additional information on the resources available to the entity in order to generate future revenue. This information could be useful for users in estimating future profits and returns. It would also help users identify any key personnel or skills that the entity relies on and this helps users determine the risks that threaten the future income streams of SR. In addition, it would help show the hidden assets of the business without which traditional ratios like ROCE are meaningless, preventing comparison with other entities.

(d)

ii.

It should be	*Tk.*	*Tk.*
Cost	40,000	42,000
Accumulated depreciation	(8,000)	(18,000)
NBV	32,000	24,000

Adjustment required

Dr Stafford Ltd retained earnings (32,000-24,000)	8,000,
Cr Property, plant and equipment	8,000.

Property, plant and equipment in consolidated balance sheet of Rugby Ltd

= Tk.(260,000 + 80,000 – 8,000)

= Tk.332,000

(e)

(i) Investment	Dr.	Tk. 3,420,000
Bank	Cr.	Tk. 3,420,000

(Being initial recording of the purchase including transaction fees (34,00000+20,000)

Investment	Dr	Tk. 180,000
Other reserves	Cr.	Tk. 180,000

(Being the increase in fair value being recorded within equity/OCI) (36,00,000-34,20,000)

(ii) The functional currency of a foreign enterprise is the currency of the primary economic environment in which the entity operates. The key considerations would be:

- The currency which principally influences selling prices for goods and services;
- The country that most influences the selling prices of the entity's goods and services through its competitive forces and regulation;
- The currency that mainly influences labor, material and other costs.

If it is still unclear which currency should be the functional currency then consider the currency in which funding is primarily raised and in which operating receipts are retained. Where the subsidiary operates relatively autonomously, rather than as an extension of the parent, this provides evidence that the functional currency of this subsidiary should be the local currency in which it operates.

It is likely that AB would adopt the Yip as its functional currency. Its results would be impacted by the local currency as it would be sourcing goods locally and recruiting local workforce. In addition, it is subject to local tax regulations. AB sales are both domestic and overseas, however it raised finance locally and has continued to operate autonomously, so the Yip is likely to be its functional currency. AB will prepare its financial statements using the Yip.

Solution of the Question No. 3

Consolidated Balance Sheet		
	£	**£**
Fixed assets		
Intangible assets (101,300+110,580(W2))		211,880
Tangible assets (660,700+635,300+24,000-1000(W1)-3,000(W7))		1,316,000
Investment in joint venture (W6)	-	90,100
		1,617,980
Current assets		
Stock (235,400+195,900-2400)(W5)	428,900	
Trade and other debtors (174,900+78,800-50,000)	203,700	
Cash at bank and in hand (23,700+11,900+10,000)	45,600	
	678,200	
Creditors: amounts falling due within one year		
Trade and other creditors (151,200+101,800-40,000)	(213,000)	
Taxation (85,000+80,000)	(165,000)	
Deferred consideration	(441,000)	
	(819,000)	
Net current liabilities		(140800)
Net Asset		14,77,180
Capital and reserves		
Equity attributable to owners of Tong well Ltd		
Called up share capital (£1 shares)		100,000
Revaluation reserve		125,000
Profit and loss account (W4)		10,62,155
		12,87,155
Non-controlling interest (W3)		1,90,025
		14,77,180

Workings

W- 1 Net assets – Watling Ltd

	Year end	Acquisition date	Post acquisition period
	£	£	£
Called up share capital	500,000	500,000	-
Profit and loss account reserve			
Per Q	312,100	206,700	
Less intangible ((72,000 + 18,000)	(72,000)	(90,000)	
Fair value adj. of tangible fixed asset (120,000 – (92,000 × 48/46))	24,000	24,000	
Dep. thereon (24,000 × 2/48)	1,000	-	
Tangible fixed asset PURP (W7)	(3,000)		
	760,100	640,700	119400

W- 2: Goodwill – Watling Ltd

Cost of investment (250,000 + (441,000 – 41,000 (W4)))	650,000
Less: share of net assets at acquisition (640,700 (W1) ×75%)	(480,525)
Goodwill at acquisition date	**169,475**
Impairment to date	(25,000)
Amortization to date (169,475 * 2/10years)	(33,895)
Goodwill at reporting date	**110,580**

W- 3: Non-controlling interest – Watling Ltd

Non-controlling interest at acquisition (640,700 × 25%)	160,175
Share of post-acquisition reserves (119,400 (W1) × 25%)	29,850
	190,025

W-4:Profit and loss account reserve

Tong well Ltd	1,084,800
Unwinding of discount on deferred consideration:	
Two years (441,000 – (441,000/1.05^2))	(41,000)
Less PURP (Watling Ltd) (W5)	(2,400)
Watling Ltd (119,400 (W1) × 75%)	89,550
Groveway Ltd(W6)	3,600
Less impairments to date (25,000 + 10,000)	(35,000)
Less goodwill amortisation to date(33,895 (W2) + 3,500 (W6))	(37,395)
	1,062,155

W- 5: Stock PURPs	%	Groveway Ltd	Watling Ltd
SP	100	15,000	12,000
Cost	(80)	(12,000)	(9,600)
GP	20	3,000	2400

W- 6: Investment in joint venture – Groveway Ltd		
Cost		100,000
Add post acquisition profits	12,000	
Less PURP (W5)	(3,000)	
	9,000	
	x40%	3,600
		103,600
Less impairment to date		(10,000)
Less amortization to date ((100,000 – (40% * 200,000-Net asset at acq. date)) * 21/120months)		(3,500)
		90,100

W- 7: Tangible fixed asset PURP – Walting Ltd	
Asset now in TongwellLtd's books at 15,000 × 1/3	5,000
Asset would have been in Watling Ltd's books at 10,000 × 1/5	(2000)
	3,000

i.

Goodwill journal entries

Dr: Intangible assets – Goodwill	39,160
Dr: Called up share capital	320,000
Dr: Profit and loss account reserve	112,300
Cr: Investments	385,000
Cr: Non-controlling interest [(320,000 + 112,300) × 20%]	86,460

Solution of the Question No. 4

(i) Analysis of financial performance and position of LW

Revenue has increased by almost 15% from 2012 to Tk. 470 million in this year. The increase in revenue together with an increase in gross margin from 36.6% to 39.4% indicates that the sales of the new mobile phone technology have had a positive impact on the performance of LW. The change in sales mix may have contributed to the increase in the gross margin. Given that LW manufactures in Asia and South America it is also possible that the gross margin has been benefited by favorable exchange rates and/or economic conditions in these regions.

Unfortunately LW has not managed to maintain these margins to operating profit. The operating profit has fallen in the year from 13.4% to 12.6%. This may be due to the labor dispute that occurred in the year and the related legal fees that were incurred and also to the Tk. 8 million charge for the potential lawsuit. The distribution costs appear to be consistently

high as a result of the manufacturing and sales channels being a significant distance apart. Without the staff dispute and lawsuit, we would expect this ratio to improve in the next financial period.

The profit margin for the year has dropped from 10.0% to 8.3%. This is mainly as a result of the increase in operating expenses but is also affected by the increase in finance costs. LW has taken on short term borrowings and this has increased finance costs. The average rate of lending has also increased from 5% to 12.8%. This is likely to be the result of short term borrowings being more costly than the convertible debt or it could be that the short term borrowings were significantly higher during the year, which is potentially more concerning. Either way, the entity has low gearing and should look to secure more long term funding rather than relying on a short term facility.

The return on capital employed has fallen from 16.2% to 15.1% due to falling returns and the revaluation and investment in PPE. The investment in PPE may not yet have generated returns, however the revaluation has improved total comprehensive income which otherwise would have been significantly lower than 2012. It may be that the policy of revaluation has been adopted to ensure PPE can offer the maximum available security for long term finance sought. It is unlikely to be a deliberate attempt to manipulate the figures as the gearing and interest cover are likely to be more than satisfactory for any lender.

Financial position

The main issue for LW is the immediate management of working capital. Inventories days have increased from 112 to 141 days. It may be that with the new technology introduced during the year, the entity has been left with unsold items and may require to sell-off or write-off out-of date inventories. It could be with increasing sales volume the year end inventories have been deliberately increased to meet expected future demand, although given that the new product launch was in April this cannot be the whole reason. An alternative explanation could be that inventory management at the two factories has declined. Given the labor dispute in South America there is a risk that local management are not completely in control of operations leading to an increase in inventory levels. Clearly this is of concern.

LW is clearly using trade payables as a means of funding working capital and this situation is not sustainable. Payables days have increased from 98 days to 154 days. Funding should be secured and payables settled to avoid any legal action from suppliers. It maybe, however that a purchase of inventories occurred immediately prior to the year end and the related invoices have not yet been settled. This together with the shortage of cash and existence of short term borrowings does indicate that this is more likely to be an issue with working capital management.

The current ratio, although reduced from 2012 is at 1.4, however the removal of the inventories highlights the cash crisis that LW is facing. The quick ratio has fallen to 0.5 and LW must seek additional funding immediately.

The gearing of LW indicates a relatively low risk entity with gearing of just 11%, and there is more than adequate interest cover with very low finance costs. LW is potentially paying more for the short-term borrowings with the average lending having increased from 5% to 12.8% and there is the added risk that these amounts are likely to be repayable on demand. It would be essential for the entity to secure long-term finance to ensure it can trade for the foreseeable future.

In addition to the working capital issues, the lawsuit when concluded looks likely that it will result in a cash outflow and LW will require additional cash resources to settle this. It may then subsequently need additional resource to negotiate a license deal to ensure the entity can continue to use the related technology.

One last comment is that LW appears to have paid a dividend of Tk. 67 million to its shareholders in the year. Depending on the timing of this payment this could have resulted in the short term borrowings at the year-end (although the increase in finance costs suggests

that this is not likely to be the case). In any event, the level of dividend might be a factor in your investment decision, although it should be borne in mind that the dividend could decline in the future if there is increasing pressure on liquidity or if LW's management decides to invest in further technology.

(ii) Segmental information

LW operates over a number of different geographical areas and will be subject therefore to different risks and economic influences. It would be useful to have segmental information for LW to fully appreciate the inherent risks within the business that may affect revenues and costs in the future.

The manufacturing resources are operating in Asia and South America and yet the majority of the sales revenues are generated in North America and Europe. The economic factors of these areas may be significantly different and therefore appreciating the different dynamics may be important for users who are attempting to predict the future profitability of LW. In addition, having operations in different locations in the world can mean that the entity must consider adherence to local labor laws, local safety and environmental guidelines and again this changes the dynamics of the different segments of the business.

In addition to the geographical split, it is likely that the segmental information will give a clearer indication of the segments that are expanding and those that are in decline, especially since LW is operating in the technology sector. The segmental information is prepared by the management based on the information that is presented to them as a basis for decision making and so provides an insight into the information that the entity is utilizing internally.

= THE END =