CMA DECEMBER, 2016 EXAMINATION
MANAGEMENT LEVEL
SUBJECT: F2. FINANCIAL MANAGEMENT

Model Solution

Solution to the Question No: 2.1

The defined benefit pension plan is treated in accordance with IAS 19 *Employee Benefits*.
The pension plan has a deficit of liabilities over assets.

Statement of Financial Position

	Tk. (in million)
PV of defined benefit obligation	4.540
FV of plant assets	4.115
	0.425
Actuarial loss of the year	(0.353)
Unrecognized actuarial loss	0.072

Statement of Comprehensive Income

	Tk. (in million)
Current service cost	0.275
Return on assets	(0.295)
Surplus for the year	0.020

Reconciliation of Scheme Movements

	Tk. (in million)
Opening net liability [4.3-3.6]	0.700
Surplus	(0.020)
Contribution	(0.550)
Redundant employee	(0.058)
Actuarial loss	0.353
Closing net liability	0.425

Working:

	FV of assets (amount in million Tk.)	PV of liabilities (amount in million Tk.)
Opening Balance	3.600	4.300
Contribution paid in	0.550	-
Paid to retired members	(0.330)	(0.330)
Actual return on assets	0.295	-
Benefits of redundant employee	-	(0.058)
Service cost	-	0.275
Actuarial loss on plant liabilities (bal.)	-	0.353
Closing Balance	4.115	4.540

Solution to the Question No: 2.2

(a) **Basic earnings per share**

Profit after tax ($1,040,000 - $270,000)	$770,000
Weighted average number of shares:	
At 1 January 2009	3,000,000
Bonus issue	1,000,000
Full market price issue (2,000,000 x 4/12)	666,667
4,666,667	
Basic eps for 2009 $770,000/4,666,667	16.5 cents per share
Basic eps for 2008 restated 15.4 cents x bonus fraction of 3/4	11.6 cents per share

(b) **Fully diluted earnings per share**

Reported profit after tax (as in part (a))	$770,000
Plus post-tax saving of finance costs (70% x 7% x $4m)	$196,000
	$966,000

Weighted average number of shares:	
As reported in part (a)	4,666,667
Dilution from potential share issue	2,400,000
7,066,667	
Fully diluted eps $966,000/7,066,667	13.7 cents per share

(c) A bonus issue does not raise any new finance and therefore the profit for the year will have been generated with the same level of resources throughout the year. As the issue results in no additional resources it is treated as if it had always been in existence. Comparative figures also need to be restated as if the bonus issue was made at the earliest reported period. The issue at full market price brings additional resources, which will impact on profits from the date of issue. Therefore a weighted average number of shares is used to calculate eps.

Solution to the Question No: 2.3

SARs are an example of a cash-settled share-based transaction and, in accordance with IFRS2 Share-based Payments, are initially measured at their fair value at grant date and subsequently remeasured to fair value at each year end. The liability is remeasured, and any difference is charged to the income statement as an expense.

In the year to 2008:

Eligible employees (120 – 12 – 15) = 93
Equivalent cost of SARs = 93 employees x 1,000 rights x FV$15 = $1,395,000
Allocate over 3-year vesting period $1,395,000/3 = $465,000 equivalent charge to the income statement in the first year.

In the year to 2009:

Eligible employees (120 – 12 – 8 – 10) = 90
Equivalent cost of SARs = 90 employees x 1,000 rights x FV$17 = $1,530,000
Cumulative amount to be recognised as a liability = $1,530,000 x 2/3 years = $1,020,000
Less amount previously recognised = $1,020,000 - $465,000 = $555,000
The expense will be recorded as:
Dr Income statement $555,000
Cr SOFP - liability $555,000

Solution to the Question No: 3.1

Assessments

Profitability

The company's gross profit margin is strengthening due to the South Korean phone, which can be purchased at very competitive prices and still be sold at half the price of competitive products. This can be further illustrated by comparing the 207% increase in revenue with a 285% increase in gross profit.

Similarly, overheads have only increased by 1 99%, even including one-off relocation expenses. Therefore, costs are being controlled despite the expansion, and the net margin is also strengthening. However, the overheads do not include all charges for advertising (see below). If these were included net profit would clearly fall. In addition, the company's warranty provisions do not appear to be calculated correctly and the expense is probably understated.

Return on capital employed has improved on the previous year, as the company has turned from a loss-making position to a profit. However, ROCE may be misleading as there is some doubt as to the suitability of capitalizing advertising expenditure and/or the cost of distribution rights. If these were charged as expenses, the company would continue to be in a loss-making position.

The improving profitability of the company is very reliant on the continued success of the South Korean phone, and in a rapidly changing industry, this cannot be guaranteed.

Liquidity

Liquidity has deteriorated in the period, as evidenced by both the current and quick ratios. The company has insufficient current assets from which to meet its current liabilities as they fall due.

This is coupled with very clear signs of overtrading, whereby the inventory turnover ratio has increased dramatically on the previous year. The company is holding very low levels of inventory compared to its increased levels of revenue, which may result in stock-outs and loss of goodwill. This low level of inventory appears to be caused by insufficient funds to finance the purchase of inventory. The company must raise further long-term finance if serious liquidity problems are to be avoided.

Solvency

The company is highly geared. Moreover, the gearing ratio in the appendix does not include the excessive overdraft included in current liabilities. Hence, actual gearing is even higher. Similarly,

interest cover at 1.6 times is poor.
The company must raise more funds to survive, particularly if further expansion is to continue. However, lenders will see Digicom Distributors Ltd as a high risk investment and will therefore expect a high return.

Appendix: Accounting ratios

		Year ended 31 August 2015		2014	
Profitability					
Return on capital employed = Operating profit / Total assets – Current liabilities		510 / 6,425	7.9%	(98) / 3,700	-2.6%
Gross profit margin = Gross profit / Revenue		3,600 / 16,000	22.5%	936 / 5,200	18.0%
Efficiency					
Asset turnover Cost of sales / Inventories		12,400 / 778	15.9 times	4,264 / 520	8.2 times
Receivables collection period Receivables / Credit sales	X 365	814 / 16,000x30%	X 365 = 62 days	215 / 5,200x30%	X 365 = 50 days
Payables payment period Payables / Cost of sales	X 365	2,734 / 12,400	X 365 = 80 days	678 / 4,264	X 365 = 58 days
Liquidity					
Current ratio Current assets / Current liabilities		1,842 / 3,709	0.50	1,135 / 828	1.37
Quick ratio Current assets – Inventory / Current liabilities		1,842 – 778 / 3,709	0.29	1,135 – 520 / 828	0.74
Solvency					
Debt/equity ratio Long - term debt / Capital and reserves		2,084 / 4,013	0.52		
Interest cover Operating profit / Interest		510 / 320	1.6		

Solution to the Question No: 3.2

(a) Conslidated statement of comprehensive income :

Consolidated statement of comprehensive income for the year ended 31 December 2012 for the XY Group	
(all workings in Tk.000)	**Tk.000**
Revenue (3,200+2,400 – 300) W1	5,300
Cost of sales (1,800 + 1,400 - 300W1 + 15W1 + 100 w2)	(3,015)
Gross profit	2,285
Administrative expenses (350 + 250 + 40 W3)	(640)
Distribution cost (300+ 150)	(450)
	1,195
Investment income [400-(80% ×400)]	80

Finance cost (140+ 110)	(250)
Profit before tax	1,025
Income tax expenses (160+ 150)	(310)
Profit for the year	715
Other comprehensive income that will not be reclassified to profit or loss	
Revaluation of property, plant and equipment (40+ 30)	70
Tax effect of OCI (12 + 10)	(22)
Other comprehensive income for the year , net of tax	48
Total comprehensive income for the year	763
Profit for the year attributable to:	
Equity holders of the parent	678
Non-controlling interest (W4)	37
	715
Total comprehensive income attributable to:	722
Equity holders of the parent	41
Non-controlling interest (W4)	763

Consolidated statement of change in equity:

Consolidated statement of change in equity for the year ended 31 December 2012	**XY Group**	**NCI**	**Total**
	Tk.000	**Tk.000**	**Tk.000**
Equity at 1 January 2012 (W5/6)	13,520	1,730	15,250
Total comprehensive income (from above)	722	41	763
Dividends	(600)	(80)	(680)
Equity at 31 December 2012	13,642	1,691	15,333

Workings

1. Intra-group sales of Tk.300,000 removed frome both revenue and cost of sales unrealised profit Tk.300,000 × 20% remaining × 25% margine = Tk.15,000 charged to cost of sales.
2. Fair value uplift of Tk.600,000 is depreciation over 6 years resulting in an additional depreciation charge of Tk. 100,000 to cost of sales each year.
3. Goodwill

	Tk.000	Tk.000
Fair value of consideration transferred:		
Transfer of 1 million shares at Tk.3.00 each		3,000
Cash		1,593
Tk. 1,000,000 of cash payable on 1 January 2011 discounted at 0.857 (8% for 2 years)		857
		5,450
Non-controlling interest at FV		1,350
		6,800
Net assets acquired:		
Share capital	1,000	
Retained earnings	5,000	
Fair value uplift	600	
		6,600

Goodwill on acquisition		200
20% impairment		40

4. Non-controlling interest

	AZsPFY Tk.000	AZsTCI Tk.000
Reported in individual accounts	340	360
Less adjustment for unrealized profit (W1)	(15)	(15)
Less additional depreciation on Fv uplift (W2)	(100)	(100)
Less goodwill impairment (W3)	(40)	(40)
	185	205
20% allocated to NCI	37	41

5. Opening equity attributable to XY Group

	Tk.000	Tk.000
Opening equity of XY as per SOCIE		12,000
Change in equity to 1 January 2012:		
Opening equity as per SOCIE fo AZ	8,200	
Less share capital	(1,000)	
Less pre-acquisition earnings	(5,000)	
	2,200	
Less depreciation charged for 3 years following acquisition	(300)	
	1,900	
80% of adjusted post-acquisition RE to 1 January 2012		1,520
		13,520

6. Opening equity attributable to NCI

(all working in Tk.000)	**Tk.000**
NCI at acquisition	1,350
20% of adjusted post-acquisition RE to 1 Jan 2012 (W5) (20% x 1,900)	380
	1,730

b. This further investment now takes the overall holding to 60% and this triggered the threshold that is presumed to give control. Since XY now has the power to controle LM it will fully consolidate in its accounts. In the cosolidated financial statements for the year ended 31 December 2013 this will mean that 100% of the asset and liabilities of LM will be included in the group statement of financial position on a line basis.
In the group statement of comprehensive income the revenue and cost will need to be pro-rated to reflect the fact that the LM will have been a subsidiry for 11 months. A 40% NCI in LM will also be recognised in the group financial statements. Goodwill will be calculate now assuming that XY controls LM. The fair value of existing 10% investment will be assessed at the date the future acuisition is made and this will be part of the consideration transferred.
The dividend income that XY receive from LM will no longer be included in the group income statements as it will now be deemed to be internal and will be eliminated on consolidation.

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