SOLUTION CORPORATE REPORTING STRATEGY NOV 2009

QUESTION 1

A. Quantitative Factors

(i) Profitability

The GPOL for Hoe Ltd is for better than that for Shea Ltd, suggesting that Hoe Ltd is able to manage its cost of production better than Shea Ltd. This is surprising because Hoe Ltd has to buy its raw materials all the way from Tema which includes the cost of transport. However, the excessive overhead cost of Hoe Ltd, though quite unacceptable may be unavoidable. Because smelting iron requires excessive temperatures, the excessive cost may be due to the cost of electricity or fuel lubricants.

It is also surprising that the two companies were able to attain the same NP% of 12%. It simply means that Hoe Ltd is not able to control its own cost: are there so much obsolete stocks which are not …….? What is the nature of vehicle running costs, finance costs, cost of depreciation, etc?

(ii) Liquidity Ratio

Hoe Ltd has a current ratio of 70:30 as compared to 69:24 for Shea Ltd, or 2:3:1 and 2:9:1 respectively. This means that Shea Ltd is better placed to pay off its short-term commitments than Hoe Ltd. In terms of the quick ratio, this 1:9:2 for Hoe and 1:8:1 for Shea Ltd. The roles have reversed and Hoe Ltd is strong in setting its immediate commitment than Shea Ltd.

(iii) Efficiency Ratio

Hoe Ltd is able to move around the market faster than Shea Ltd and such rapidity can result in a greater volume of sales. However, it collects its debts longer than it pays its …… This means that some of its creditors are pad from its capital reserves. This is not good enough and is the exact opposite of Shea Ltd who forces it to grant it some credit. This is because funds collected from …… can be placed on investment for 4 days before withdrawing same t pay creditors. Shea Ltd is also more efficient in consistently reducing the impact of bad debts on its operations as opposed to the erratic behaviour of bad debts on the operations of Hoe Ltd.

(iv) Gearing Ratios

Hoe Ltd is geared while Shea Ltd is non-geared. What this means is that profit in Hoe Ltd which should have been used to pay dividend to shareholders or ploughed back to the business will now be used to pay interest to providers of medium term finance. In addition, the excessive general and administrative cost seems to suggest that the medium-term facility is not being put to the best of uses.

B. Qualitative Factors

(i) Additional Financing

While Hoe Ltd can raise additional financing by issue the balance of its shares, Shea Ltd cannot. As such, it seems as if She Ltd should be allowed to access the present facility.

(ii) Provision of Jobs

Shea Ltd employs a lot of local people and gives them a means of livelihood. As such, it appears that it should be allowed to access the facility to continue to serve the local people.

(iii) Social Responsibility

Hoe Ltd has undertaken an important social responsibility by constructing the bridge. But the question is, is it a genuine commitment to serve the people or it is to ensure that its ……. enter the town without any problem.

(iv) Sponsorships

HOE is sponsoring C Ltd of 12 gifts …….. This may seem a good gesture to equip people with employable skills. However, a closer look of the issue may suggest that Hoe simply wants to ensure improved operations of its fabrication business into the foreseeable future.

(v) Good Corporate Citizenships

Why did Shea Ltd fail to file the tax returns? There may be no deliberate effect to offend the law. However, the situation is embarrassing enough to compel Shea Ltd to consider engaging a tax expect/legal adviser who will constantly study and warn of the possible business with the law.

C. Final Advice

Given the totality of the effects of the various factors, Shea Ltd appears to be better favoured to be allowed to access the credit facility.

QUESTION 2

Resolutions Reducing Capital, shares or Liabilities (Section 75)

Subject to confirmation by the Court, a company …….. by shares may, by special resolution,

- Reduce its stated capital in any way
- Extinguish or reduce the unpaid liability on any of its shares
- Resolve to pay or return to its shareholders any of its assets which are in excess of the wants of the company
- After the Regulations by canceling any of its shares.

MANGO LTD

LIQUIDATION

	GH¢	GH¢
Proceeds		
Building	12,000,000	
20% Debenture	(12,500,000)	NIL
Investments	6,000,000	
Bank loan	(9,000,000)	
Copyrights		100,000
Stocks		2,500,000
Debtors		7,000,000
Equipment, furniture & fittings		1,200,000
Motor vehicles		900,000
		11,700,000
Liquidation expenses		(20,000)
		11,680,000
VAT		(100,000)
Available for unsecured creditors		11,580,000

CAPITAL REDUCTION
COMPUTATION OF LOSSES TO BE WRITTEN OFF

	GH¢
Income surplus account	30,529,000
Reconstruction expenses	12,000
Preference dividend	3,000,000
Copyrights	300,000
Debtors	2,300,000
Stocks	4,000,000
	40,141,000
Less Capital Surplus	400,000
	39,741,000

EXISTING APPORTIONMENT RECONSTRUCTION

	Capital structure GH¢	Loss GH¢	Capital GH¢
Ordinary shares	30,000,000	25,005,000	4,995,000
Preference shares	10,000,000	8,335,000	1,665,000
Preference dividend	3,000,000	2,501,000	499,000
21% Debentures	12,500,000	100,000	12,400,000
Bank loan	9,000,000	600,000	8,400,000
Trade creditors	16,000,000	3,200,000	12,800,000
	80,500,000	39,741,000	40,759,000

The losses arising from the capital reduction may be apportioned as per the preceding table.

This is likely to be accepted by the stakeholders because it gives more favourable position than if the company were liquidated as can be seen from the following table:

	Loss in case of liquidation GH¢	Share of loss on capital reduction GH¢
Ordinary shares	30,000,000	25,005,000
Preference shares	10,000,000	8,335,000
Preference dividend	3,000,000	2,501,000
21% Debentures	203,077	100,000
Bank loan	1,218,461	600,000
Trade creditors	6,498,462	3,200,000
	50,920,000	39,741,000

The ordinary shareholders will fulfil their promise and introduce GH¢6,000,000 for new ordinary shares. In addition they will introduce additional cash of GH¢10,363,000 to bring the company's working capital ratio to 2:1.

The preference shareholding will be issued with new ordinary shares of GH¢499,000 to discharge the preference dividend accrued.

BALANCE SHEET OF MANGO LTD
AFTER RECONSTRUCTION

	GH¢'000	GH'000
Non-Current Assets		
Property, plant & equipment		
Copyrights		
Current Assets		
Stocks	2,701	
Debtors	13,580	
Investments	9,980	
Cash	16,363	
	42,624	
Current Liabilities		
Bank Loan (sec.)	8,400	
Trade Creditors	12,800	
Sundry Creditors (100,000 + 12,000)	112	
	21,312	
Net Current Assets		21,312
		35,922
21% Debentures		(12,400)
		23,522
Financed by:		
Stated Capital		23,522

		Loss	
Ordinary share	30,000,000	25,005,000	25,005,348.81
Preference shares	10,000,000	9,335,000	8,3883,116.27
Preference dividend	3,000,000	2,501,000	25,500,534.881
	43,000,000	35,841,000	35,840,999,.96

Stated Capital

	GH¢'000
Ordinary shares	
- After loss	4,995
- Cash in hand	6,000
- Additional	10,363
Preference shares	21,358
Preference dividend	1,665
Ordinary shares	499
	21,164
	23,522

QUESTION 3

a)

		GH¢
(i)	Borrowing Cost to capitalise	
	Specific loan interest	350,000
	Less interest income	(100,000)
		280,000
	General borrowing	206,250
	Amount eligible for capitalisation	456,250

Working/notes

Expenditures incurred in obtaining a qualifying asset are first allocated to any specific borrowings. The remaining expenditures are allocated to any general borrowings.

Specific borrowings of GH¢3,500,000 are fully utilised; remainder of expenditure is therefore allocated to general borrowings.

The capitalisation rate relating to the general borrowings is the weighted average of the borrowing costs applicable to the entity's borrowings that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

Capitalisation rate = 12.5% (GH¢5m/GH¢12.5m) + 10% (GH¢7.5m/GH¢12.5m) = 11%
Analysis of expenditure and borrowing cost

Date	Expenditure	Amount all to general borrowing	Weighted for period outstanding and interest
	GH¢'000	GH¢'000	GH¢'000
1 January 2008	1,000	-	-
31 March 2008	3,000	500	500x 11% x 9/12 = 41.25
30 September 2008	6,000	6,000	6,000 x 11% x 3/12 = 165.00
31 December 2008	1,000	1,000	1,000 x 11% x 0/12 = 0.
	11,000		206.25

(ii)

Fair value less costs to sell	=	GH¢14m
Value in use	=	PV of cash flows from use less the carrying amount of the provision/liability
	=	GH¢16.5m – Gh¢3.0m = GH¢13.5m
Recoverable amount	=	Higher of these two amounts, ie GH¢14m
Carrying value	=	GH¢15m
Impairment loss	=	GH¢1.0m

The carrying value should be reduced to GH¢14m

(iii) Under the residual valuation of equity component approach, the liability component is first valued and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 15%, the market interest rate for similar bonds having no conversion rights.

	GH¢
Present value of the principal GH¢5,000,000 payable at the end of the three years	3,290,000
Present value of the interest GH¢500,000 payable annually in arrears for three years	1,142,000
Total Liability component	4,432,000
Equity component (difference)	568,000
	5,000,000

		Present Value	Annuity Factor
Discount Factors at 15% Year	1	0.870	0.870
	2	0.756	1.626
	3	0.658	2.284

b)

(i) Under constant purchasing power (CPP) accounting, also called general purchasing power (GPP) accounting, the accounts are adjusted so that all figures are shown in terms of money with the same purchasing power. It is thus necessary to adjust items by means of a general price index. The accounts are usually adjusted to reflect prices at the Statement of Financial Position date, in which case a current purchasing power statement has been prepared. Current purchasing power accounting is therefore the usual application of constant purchasing power accounting.

In converting the figures in the basic historical cost accounts to those in the supplementary current purchasing power statement, a distinction is drawn between

- Monetary
- Non-monetary item

CPP accounts are prepared by updating all items in the income statement, and all non-monetary items in the Statement of Financial Position, by the CPP-factor:

$$\text{CPP factor} = \frac{\text{Index at the Statement of financial Position date}}{\text{Index at date of entry in accounts}}$$

Depreciation is adjusted by reference to the date of acquisition of the related non-monetary asset item.

Monetary items in the Statement of Financial Position are not adjusted, because their values in CPP units are their monetary amount.

In the CPP accounts, it is necessary to compute a gain or loss from holding monetary items in times of inflation. In principle, this can be found by adjusting all entries in the accounts for each monetary item by the CPP factor, so that the difference between the 'CPP balance' and the actual monetary balance represents the gain or loss on holding that item.

CPP measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation. It is fundamental idea of CPP that capital should be maintained in terms of the same monetary purchasing power so that P = D + VA – VOE.

(ii) Holding gain is the excess of replacement cost of an item of inventory over its historical cost. It may be realised or unrealised. E.g. an item of inventory was purchased on 1 December 2008 for GH¢250. By 31 December 2008, the year end, the item still remained in stock and the replacement cost was GH¢270. The item was sold in January 2009 for GH¢300, on which date the replacement cost of the item was GH¢280. With this example, the unrealised holding gain as at 31 December 2008 was GH¢20. This becomes realised in January 2009 when the asset was sold, together with another realised holding gain of GH¢10 (GH¢280 – GH¢270).

How holding gains are treated depends on one's view of capital maintenance. Proponents of the maintenance of financial capital in money terms view the holding gains as an item of profit. Profit is considered to be the total gain arising during the period which could be

distributed in full while still maintaining capital in the sense of the original investment, at the level which existed at the beginning of the period.

Proponents of physical capital maintenance concept do not recognise holding gains as distributable profit. It is maintained as a reserve to enable the entity maintain its operational capability.

QUESTION 4

a)

(i) Net Asset Basis

	GH¢
Property, plant & equipment	150,000
Patent (GH¢30,000 x 3.6048 x 75%)	81,108
Stock	35,000
Debtors (27,000 – 5,400)	21,600
Bank & Cash	15,600
Creditors	(22,800)
Medium Term Loan	(18,000)
8% Cumulative Preference shares	(20,000)
Net Assets	242,408

Value Per Share = GH¢242,408 / 200,000

= GH¢1.212

(ii) Dividend Yield

Shares are valued by reference to expected future dividends.

Value per share = Expected Future Dividends x 100 / Expected Dividend Yield

Banku Ltd is not listed, so it must offer a dividend that compares favourably with those of its competitors.

Dividend Per Share = GH¢12,000 / 200,000 shares = GH¢0.06

Dividend yield = 3.6

Mark up dividend yield by 30%
to account for uncertainty = 3.60 x 1.3 = 4.68

Value Per Share = GH¢0.06 x 100 / 4.68

= GH¢1.282

Earnings Yield
Value of share = PE Ratio x EPS

Banku Ltd is not listed so we use the PE Ratio of its competitor which is listed and mark down because profit growth is uncertain and the shares are less marketable.

PE Ratio of competitor	=	6
Mark down by 30% (say)	=	(1.8)
Adjusted PE Ratio to Use		4.2

$$\text{Average profits} = \frac{34.605 + 32{,}500 + 26{,}050 + 12{,}400 + 21{,}000}{5 \text{ years}}$$

$$= 126{,}535 \div 5$$

		GH¢
Estimated Further Profits	=	25,311
Less Tax	=	6,328
		18,983
Less: Preference dividends		1,600
Due to Ordinary Shareholders		17,383

$$\text{Value Per Share} = \frac{4.2 \times 17{,}383}{200{,}000}$$

$$= \text{GH¢}0.365$$

b) Factors to be Considered in Determining Further Estimated Profits

- Economic predictions of the industrial sector in which the company operates.
- The level of profitability that the company can achieve in the ….. share it can expect to hold.
- Any changes in the strategic development of the company, e.g. possible changes to product mix, manufacturing method, …… distribution, financial arrangements, etc.
- The likelihood or otherwise of the company maintaining its pass management team and organisational structure and whether these will affect future levels of performance and profitability.
- The budgets and forecasts produced by management would also be of ……. together with variance reports for pass periods so that an assessment of the accuracy of management's plans could be made.
- Any changes to the financial structure of the company with particular reference to the changes in the level of interest-bearing loans.
- The accounting policies adopted by the company.

Note

…….. Discount Factor for Patent

Year 1	$\frac{1}{1.2}$	0.8929
2	$\frac{1}{1.12 \times 1.12}$	0.7972
3	$\frac{1}{1.12 \times 1.12 \times 1.12}$	0.7118
4	$\frac{1}{1.12 \times 1.12 \times 1.12 \times 1.12}$	0.6355
5	$\frac{1}{1.12 \times 1.12 \times 1.12 \times 1.12 \times 1.12}$	0.5674
	Total	3.6048

Valuation of Business (Shares)

(i) Using Net Asset Basis

This method is adopted when valuing company on going concern or liquidation.

This method act as asset …… and as a security of investment to support other valuation methods.

The price per share is calculated as

Net Assets available to ordinary shareholders …… by number of ordinary share issued.

The price per share is calculated as follows:

		GH¢
Property, Plant & Equipment		150,000
Patent (30,000 x 3.605)		108,150
Inventory		35,000
Trade Rec		21,600
Bank & Cash		15,600
		330,350
Less Liabilities		
Trade payable	22,800	
Interest Loan	18,100	
Direct shares	20,000	(60,900)
		269,450

Net Assets per share

$\frac{269,450}{200,000} = 1.34725$

GH¢1.35

The dividend yield method adopted when ……. small holding on going concern basis. The price per share is derived as follows:

$$NY = \frac{do}{r}$$

or

$$NY = \frac{do(1 + g)}{r - g}$$

Since Banku is not listed it will be appropriate to adopt similar quoted company dividend yield and add a NSR premium to cover it because it is a private company.

The dividend yield of similar quoted company – Okro Ltd is given below

PPS = GH¢540
EPS = GH¢0.90
DPO = 60%
∴ DPS = GH¢0.90 x 60%
= 0.54

$$\text{Dividend Yield} = \frac{DPS}{NPS}$$

$$\frac{0.54}{5.40} \times 100\%$$

= 10%

Since Banku is unquoted it is expected to pay a higher dividend. Hence 1075 = 15%

Bank Ltd ordinary dividend = 12,000

$$NV = \frac{12,000}{0.15} = 80,000$$

$$\text{Price per share} = \frac{80,000}{200,000}$$

= GH¢0.40

$$\text{or DPS of Banku} = \frac{12,000}{200,000} = GH¢0.06$$

$$PPS = \frac{0.06}{0.15}$$

= GH¢0.40

Using Earning Basis

The earning basis can be earning yield or P/E ratio method. The objective is to value the shares on going concern when the acquirer has …….. interest.

Price per share = P/E x EPS

or $\frac{\text{EPS}}{\text{Earnings Yield}}$

The earnings yield of …… which is similar quoted company is calculated as follows:

PPS	=	5.40
EPS	=	0.90
P/E ratio	=	$\frac{5.40}{0.90}$
	=	6 times

Since Banku is not quoted its P/E ratio should be 80% of Okra Ltd. Hence 80% x 6 = 4.8 times

Earnings per share of Banku Ltd is = 24354/200,000
= GH¢0.12177

NV = 4.8 x .12177 = GH¢0.58

or

Earnings Yield = $\frac{0.90}{5.4}$ = 17.6%

PPS = 0.12177/17…….

QUESTION 5

Reasons for choosing or nor preparing Group Accounts

1. Where at the end of the Company's financial year the holding company is of itself another subsidiary of another company.

2. Consolidation of the accounts may be considered impracticable.

3. Consolidation may be of any real value to the members and Debenture holders, in view of the insignificance of the accounts involved.

4. Consolidation may give misleading or harmful results of the company's or any of its subsidiaries.

5. The business of the holding company and that of the subsidiary may be so different that they can not reasonably be treated as a single undertaken.

6. Consolidation may delay and expenses out of proportion to the benefits to be obtained by consolidation to members and debenture holders.

AFIANEPA CO. LTD AND ITS SUBSIDIARY
CONSOLIDATED CASH FLOW STATEMENT FOR THE YEAR ENDED 31 DECEMBER, 2005

				¢'000
Operating Activities				
Operating profits				6,598
Add non-cash items				2,400
Depreciation				
Profit/Loss on disposal				
Book value		4,000		
Less sales value				
Cash	1,200			
Trade in	200	1,200		
Loss on sales				
				2,800
Movement in Working Capital				
Stock (10,200 – 12,400 - 800)				3,000
Trade debtors (10,000 – 9,860 – 600)				360
Trade creditors (6,000 – 5,400 – 350)				250
				15,408
Interest paid (3,200 + 6,000 – 1,200)			(230)	
Dividend received from Associates Co.			1,240	
Dividend group – (3,200 + 6,000 – 1,200)			(8,000)	(8,020)
Monthly interest			(1,030)	
Investment Activities				
Purchase of plant and properties (16,500 – 1,200 – 200 -2,000)			(13,100)	
Cash received from sales of asset			1,000	(13,600)
Cash paid to acquire subsidiary (2,000 – 500)			(1,500)	
Financing Activities				
Issue of share (15,000 – 3,500 – 1,000)			10,500	
Share deals (1,454 – 1,092)			362	9,812
Increase in cash and cash equivalent			(1,050)	3,600

Note to Cash flow statement

1) Analysis of cash and cash equivalent during the year ¢'000

	2005	2004	Change
Cash at Bank	4,680	4,000	680
	4,680	1,400	3,280

2) Purchases Subsidiary

Net asset Acquired

Property, plant and equipment	2,000
Stock	800
Trade debtors	600
Cash	500
Trade payables	(350)
Tax	(200)
	3,350
Minority interest	(670)
Goodwill	320
	3,000
Satisfied by:	
Issue of shares	1,000
Cash	2,000
	3,000