

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

ATC(U) EXAMINATIONS

LEVEL THREE

INTRODUCTION TO FINANCIAL REPORTING – PAPER 12

TUESDAY, 13 DECEMBER 2005

INSTRUCTIONS TO CANDIDATES:

1. Time allowed: **3 hours**
2. Attempt **all** the questions in Section A, any **two** questions in Section B and any **two** questions in Section C.
3. Section A has **one** compulsory question carrying 20 marks.
4. Section B has **three** questions and only **two** are to be attempted. Each question carries 20 marks.
5. Section C has **three** questions and only **two** are to be attempted. Each question carries 20 marks.
6. Please read further instructions on the answer booklet.

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SECTION A: FINANCIAL ACCOUNTING

You have been provided with the following trial balance for Mijeera Limited as at 30 November 2005:

	DR Shs '000'	CR Shs '000'
Bank	67,250	
Inventory at 1 December 2004	1,614,000	
General expenses	807,000	
Electricity charges	121,050	
Marketing and advertising	333,560	
Wages	659,050	
Buildings at cost	6,725,000	
Motor vehicles at cost	215,200	
Plant and machinery at cost	941,500	
Retained earnings at 1 December 2004		376,600
Trade receivables	589,110	
Purchases	2,959,000	
Interest on long-term loans	40,350	
5% long term loans		807,000
Revenue		7,903,220
Discount received		201,750
Trade payables		672,500
Ordinary shares of Shs 1,000 each		2,017,500
Accumulated Depreciation 1 December 2004		
Buildings		2,690,000
Motor vehicles		80,700
Plant and machinery	-	322,800
	<u>15,072,070</u>	<u>15,072,070</u>

The following notes are relevant:

1. Inventory at 30 November 2005 was valued at Shs. 1,076,000,000.
2. Marketing and advertising expenses include Shs. 8,070,000 paid in advance for a marketing campaign which will begin in January 2006.
3. There are wages outstanding of Shs. 13,450,000 for the year ended 30 November 2005.
4. A customer who owes the company Shs. 51,110,000 ceased trading. The debt is not expected to be recovered.

5. The expenses listed below should be apportioned as follows:

	Cost of sales	Distribution costs	Administrative expenses
General expenses	10%	40%	50%
Electricity charges	50%	30%	20%
Wages and salaries	60%	30%	10%

6. An allowance for doubtful debts is to be established amounting to 5% of trade receivables.
7. Depreciation is to be provided for as follows:
- (i) Buildings at 5% per annum on their original cost, allocated 50% to cost of sales, 20% to distribution costs and 30% to administrative expenses.
 - (ii) Motor vehicles at 25% per annum their written down value, allocated to distribution costs.
 - (iii) Plant and machinery at 20% per annum of their written down value, allocated to cost of sales.
8. No dividends have been paid or declared.
9. Income tax of Shs. 336,250,000 is to be provided for the year.
10. Audit fee not yet accrued amounts to Shs. 26,900,000.

Required:

Prepare the following Financial Statements for the year ended 30 November 2005 for Mijeera Ltd in accordance with **IAS 1: Presentation of Financial Statements**:

- (i) An Income Statement. (12 marks)
 - (ii) A Balance Sheet. (8 marks)
- (Total 20 marks)**

You are advised to show workings where appropriate.

SECTION B: FINANCIAL ACCOUNTING**Question 2**

The directors of Mukono Ltd., a clothes wholesaler, are reviewing the company's draft financial statements for the year ended 30 November 2005, which show a profit of Shs. 1,210,500,000 before tax.

The following matters require consideration:

- (a) The closing inventory includes:
 - (i) 3,000 skirts at cost of Shs. 53,800,000. Since the balance sheet date they have all been sold for Shs. 87,425,000 with selling expenses of Shs. 4,035,000.
 - (ii) 2,000 jackets at cost of Shs. 80,700,000. Since the balance sheet date half the jackets have been sold for Shs. 33,625,000 (selling expenses Shs. 2,421,000) and the remainder are expected to sell for Shs. 26,900,000 with selling expenses of Shs. 2,690,000.
- (b) An employee dismissed in August 2005 began action for damages for wrongful dismissal in October 2005. She is claiming Shs. 134,500,000 in damages. Mukono Ltd is resisting the claim and the company's lawyers have advised that the employee has a 30% chance of success in her claim. In the meantime, the reporting company has recognised the Shs 134,500,000 as a liability on the balance sheet.
- (c) In December 2005 a fire destroyed part of the company's warehouse with an uninsured loss of inventory worth Shs. 242,100,000 and damage to the building, also uninsured, of Shs. 306,660,000.
The financial statements currently make no mention of the fire losses.
- (d) No depreciation expense has been provided for regarding assets that are actually dormant.

Required:

Explain to the Directors how these issues should be dealt with in the financial statements for the year ended 30 November 2005.

(20 marks)

Question 3

The following information is available for Akokoro Ltd as at 30 November:

	2005		2004	
	Shs '000	Shs '000	Shs '000	Shs '000
Non-current assets				
Cost or valuation		38,500		28,000
Accumulated depreciation		<u>(19,600)</u>		<u>(16,800)</u>
Net book value		18,900		11,200
Current assets				
Inventories	11,900		13,300	
Receivables	13,300		10,150	
Cash at bank	<u>1,400</u>	<u>26,600</u>	<u>350</u>	<u>23,800</u>
Total Assets		<u>45,500</u>		<u>35,000</u>
Equity and liability				
Capital reserves				
Ordinary share capital	3,500		3,500	
Revaluation reserve	5,250		3,500	
Retained earning	<u>10,850</u>	19,600	<u>7,700</u>	14,700
Non-current liabilities				
10% Debentures		10,500		7,000,000
Current liabilities				
Trade payables	12,950		11,200	
Income tax	<u>2,450</u>	<u>15,400</u>	<u>2,100</u>	<u>13,300</u>
Total Equity and Liabilities		<u>45,500</u>		<u>35,000</u>

Summarised income statement for the year ended 30 November 2005.

	Shs '000
Profit from operations	9,275
Debenture interest	<u>(1,050)</u>
	8,225
Income tax expense	<u>(2,450)</u>
Net profit for the period	<u>5,775</u>

Notes:

1. During the year non-current assets which had cost Shs. 2,800,000, with a net book value of Shs. 1,225,000, were sold for Shs. 1,750,000.
2. The revaluation surplus arose from the revaluation of some land that was not being depreciated.
3. The 2004 income tax liability was settled at the amount provided for at 30 November 2004.

4. The additional debentures were issued on 1 December 2004. Interest was paid on 31 May 2005 and 30 November 2005.
5. Dividends paid during the year amounted to Shs. 2,625,000.

Required:

Prepare the company's cash flow statement for the year ended 30 November 2005, using the indirect method of IAS 7.

(20 marks)

Question 4

Explain the repercussions of each of the following weaknesses in the context of Local governments.

- (a) Recording the commitments column of the vote book only at the point of payment. **(3 marks)**
 - (b) Failure to record expenditure abstracts. **(3 marks)**
 - (c) Failure to maintain a general ledger. **(3 marks)**
 - (d) Failure to get a budget approved. **(3 marks)**
 - (e) Untimely bank reconciliations. **(2 marks)**
 - (f) Untimely reconciliation of expenditure totals in the vote books and the General Ledger. **(3 marks)**
 - (g) Charging expenditures incurred on wrong account codes. **(3 marks)**
- (Total 20 marks)**

SECTION C: AUDIT THEORY

Question 5

An auditor may obtain audit evidence by one or more of the following procedures:

1. Inspection.
2. Observation.
3. Recalculation.
4. Analytical procedures.

Required:

- (a) Explain what each of those procedures involves. **(8 marks)**
- (b) For each procedure in (a) above give two examples of the audit work to be done during the course of an audit stating clearly in each example the purpose of carrying out the procedure. **(12 marks)**

(Total 20 marks)

Question 6

- (a) Provided the auditor possesses professional objectivity, he does not have to be seen to be independent.

Required:

- (i) Explain the term professional objectivity. **(4 marks)**
- (ii) Comment on the validity of the above statement. **(6 marks)**

- (b) ICPAU's Code of Ethics describes a number of **Dos** and **Don'ts** for its members especially towards maintaining auditor independence.

The following scenarios are presented to you:

On 10 December 2005, the audit engagement partner of Kanakulya & Co. visited the offices of Globe Limited to plan the final audit procedures for the year ended 31 December 2005. A week later, each of the five partners of Kanakulya & Co. received an unsolicited letter from the MD of Globe Limited offering three year free medical treatment at AAR with effect from 1 January 2006. Such annual medical insurance normally costs US\$5,250,000 per individual and the offer was not made to any one else.

The wife of one of the audit managers of Kwanga & Co. – a large audit firm and auditors of Nakutaaka Ltd, has recently been appointed as the Financial Director of Nakutaaka Ltd. Immediately prior to her appointment she had been employed by one of Nakutaaka Ltd's competitors. Each of the directors of Nakutaaka Ltd is entitled to an annual bonus based on the reported profit.

Required:

For each of the above scenarios:

- (i) Comment on any concerns you may have regarding the threat to auditor independence and objectivity. **(6 marks)**
- (ii) Recommend the appropriate action to be taken by the audit firm to safeguard against any threat identified. **(4 marks)**

(Total 20 marks)

Question 7

There are a number of differences between the roles of internal auditors and external auditors.

Required:

- (a) Contrast the objectives and scope of an internal auditor's work for a limited liability company with that of an external auditor auditing its financial statements.
(6 marks)
- (b) Discuss the extent to which each should be expected to detect fraud.
(4 marks)
- (c) Explain the matters that external auditors should consider when evaluating and testing work carried out by internal auditors with a view to relying on it their work.
(10 marks)

(Total 20 marks)