

**THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD**

A Committee of the Council of ICPAU

**CPA(U) EXAMINATIONS**

**LEVEL FOUR**

**FINANCIAL REPORTING - PAPER 16**

**MONDAY, 17 DECEMBER 2001**

**INSTRUCTIONS TO CANDIDATES**

1. Time allowed: **3 hours**
2. Section **A** has **one** compulsory question carrying 60 marks.
3. Section **B** has **three** questions and only **two** questions are to be attempted.  
Each question carries 20 marks.
4. Please, read further instructions on the answer book.

## **SECTION A**

### **Question 1.**

Crane is a large publicly listed company.

There are problems and issues in relation to the following items extracted from the trial balance of Crane as at 30 November 2001.

| <b>Note</b> |   | <b>Shs.<br/>million</b> |
|-------------|---|-------------------------|
| a           | Lease rental                                      | 100                     |
| b           | Freehold land and buildings (cost Ug. Shs 1,300m) | 1,000                   |
| c           | Plant and machinery (cost Shs. 750m)              | 500                     |
| d           | Equipment (cost Shs. 300m)                        | 198                     |
| e           | Motor vehicles (cost Shs. 600m)                   | 400                     |
| f           | Investment in Murchison Holiday Resort            | 2,500                   |
| g           | Trade receivables                                 | 250                     |
| h           | Provision for restructuring                       | (300)                   |
| i           | Investment in Bwindi Resorts                      | 750                     |

Additional information:

(a) Lease rental:

A lease rental of Shs. 100 million was paid on 1 December 2000. It is the first of five annual payments in advance for an item of equipment. This is a finance lease and the implicit interest rate in the lease is 10% per annum. Useful life of plant and machinery is 4 years.

(b) Freehold land and buildings:

Depreciation on freehold buildings during the year was Shs. 20 million. During the year a piece of freehold land was sold for Shs. 200 million. The land had originally cost Shs. 60 million. The proceeds have been credited to freehold land and building account and no adjustment has been made for the disposal of land.

(c) Plant and Machinery:

Plant costing Shs. 100 million was purchased during the year. There were no disposals during the year.

(d) Equipment:

Equipment was leased during the year (see [a]) above. There were no disposals during the year.

(e) Motor Vehicles:

Motor vehicles costing Shs. 70 million were sold during the year. The carrying value on the date of sale was Shs. 15 million. New vehicles were purchased during the year for Shs. 120 million.

Depreciation:

A full year's charge is made in the year of purchase and none in the year of disposal. The rates and methods are:

Freehold buildings – 2% straight line

Plant and machinery – 10% straight line

Equipment – 10% reducing balance

Motor vehicles – 25% reducing balance.

(f) Investment in Murchison Holiday Resort

On 30 November 2001, Crane acquired the entire share capital of Murchison Holiday Resort for Shs. 2,500 million. The fair value of Murchison Holiday Resort's net assets, other than its intangible long term assets was assessed by Crane to be Shs 1,500 million. The details of Murchison Holiday Resort's intangible assets acquired were;

(i) The brand name of "Delmira Holidays". A rival brand name thought to be of a similar reputation and value to "Delmira Holidays" had recently been sold for a disclosed sum of Shs. 200 million.

(ii) A Government licence to extract natural gas from Lake Albert for next twenty years. The directors of Crane have estimated the licence to be worth Shs. 500 million. There is no fee payable for this licence. No other companies will be given licences to extract natural

gas from Lake Albert and it will be many years before it is known whether natural gas deposits exist in Lake Albert.

- (iii) A fishing quota of 1000 tonnes per annum in River Nile. There is an active trade in these and other quotas. The price per tonne of these fishing quotas at the date of acquisition was Shs. 100,000. The quota is for one year but subject to negotiations, quotas, for further periods may be granted by the Government.
- (iv) The reminder of the long-term intangible assets is attributable to the goodwill of Murchison Holiday Resorts.

- (g) Trade receivables and cash received from UCB Finance:

Trade receivable of Shs. 250 million is after deduction of Shs. 50 million received from UCB Finance on 30 November 2001. The proceeds received from UCB Finance were in relation to some of the trade receivables, transferred by Crane to UCB Finance. Crane will have to refund the cash received to UCB Finance to the extent that these trade receivables are not collected by UCB Finance within six months from 30 November 2001.

- (h) Provision for restructuring:

The Board of Crane passed a resolution to close down some of the holiday resorts in Kenya. A provision of Shs. 300 million was made in the accounts to 30 November 2001. To date, no announcements regarding restructuring have been made and no detailed formal plan for restructuring exists.

- (i) Investment in Bwindi Resort:

- i) Crane acquired 25% of the ordinary share capital of Bwindi Resort on 1 December 2000 at a cost of Shs. 750 million when Bwindi Resort's accumulated reserves were Shs. 100 million.

- ii) On 1 December 2000 the following fair values were attributed to the net assets of Bwindi Resort:

|   | Shs. million. |
|---|---------------|
| Tangible non-current assets (carrying value Shs. 1,000 million) | 1,500         |
| Current assets  | 1,000         |
| Current liabilities   | <u>(500)</u>  |
|   | <u>2,000</u>  |

The fair values have not been incorporated in the accounts of Bwindi Resort. The increase in fair values relate solely to tangible non-current assets.

- (iii) The policy of Crane is to amortise goodwill over 5 years on a straight line basis starting from the date of acquisition. Tangible non-current assets of Bwindi Resort consist of freehold buildings and the policy of Crane is to depreciate buildings at 2% per annum on the straight line basis.
- (iv) The following are financial statements of Bwindi Resort:  
Income Statement for year ended 30 November, 2001

|                     | Shs. million |
|---------------------|--------------|
| Revenue             | 650          |
| Cost of Sales       | <u>(330)</u> |
| Gross Profit        | 320          |
| Net Operating Costs | <u>(100)</u> |
| Operating Profit    | 220          |
| Interest payable    | <u>(20)</u>  |
| Profit before tax   | 200          |
| Income tax expense  | <u>(60)</u>  |
| Profit after tax    | <u>140</u>   |

Balance Sheet at 30 November 2001

|                                  | Shs. Million |
|----------------------------------|--------------|
| Non-current tangible assets      | 980          |
| Current assets                   | <u>1,260</u> |
|                                  | <u>2,240</u> |
| Capital and Reserves:            |              |
| Ordinary shares of Shs. 100 each | 1,000        |
| Share premium account            | 400          |
| Accumulated Profits              | <u>240</u>   |
|                                  | 1,640        |
| Current liabilities              | <u>600</u>   |
|                                  | <u>2,240</u> |

**Required:**

- (a) (i) Prepare calculations to show the effect on the Income Statement of Crane for the year ended 30 November 2001 and the balance sheet as at 30 November 2001 of treating the finance lease in accordance with IAS 17 (revised) 'Leases'.

**(5 marks)**

- (ii) Discuss the current problems relating to the recognition and classification of leases.

**(5 marks)**

- (b) Prepare a schedule of the movements of the cost and depreciation between 1 December 2000 and 30 November 2001 for each of the items of property, plant and equipment.  
Your answer should incorporate the calculations from part a (i) above but ignore information given in notes (f) and (i).

**(10 marks)**

- (c) In relation to acquisition of Murchison Holiday Resorts, identify the intangible long – term assets which would be separately recognized in accordance with IAS 38 'Intangible Assets'. Your answer should include an explanation justifying your treatment of each item.

**(8 marks)**

- (d) The principle of 'substance over form' is included in the IASC's 'Framework for the preparation and presentation of Financial Statements'. Explain the principle of 'substance over form' and describe why the substance rather than legal form is used to account for transactions. Comment on the treatment adopted by Crane for the cash received from UCB Finance.

**(8 marks)**

- (e) Provision for restructuring

- (i) Define "provision" and explain the recognition criteria for provisions.

**(5 marks)**

- (ii) Comment on the accounting treatment adopted by Crane for closure of some of the holiday resorts in Kenya.

**(5 marks)**

- (f) Investment in Bwindi Resort

- (i) Explain the criteria which distinguish an associate from a jointly controlled entity.

**(5 marks)**

- (ii) On the assumption that the investment in Bwindi Resort is classified as an investment in a jointly controlled entity, show how this investment in Bwindi Resort would be stated under the benchmark treatment and the allowed alternative treatment in the consolidated balance sheet and income statement of Crane under IAS 31 "Financial Reporting of interests in Joint Ventures".

**(9 marks)**

**(Total 60 marks)**

## SECTION B

### Question 2.

Desderio Ltd acquired 64,000 of Sentongo Ltd's equity shares paying Shs. 450 per ordinary share and Shs. 6,000 (at par) for its 6% redeemable preference shares on 1 December 1997. The accumulated retained profits of Sentongo on 1 December 2000 were Shs. 8 million.

The draft Balance Sheets of the two companies at 30 November 2001 are:

|                                     | <b>DESDERIO LTD</b> |                       | <b>SENTONGO LTD</b> |                      |
|-------------------------------------|---------------------|-----------------------|---------------------|----------------------|
|                                     | Shs'000             | Shs'000               | Shs'000             | Shs'000              |
| <b>Assets</b>                       |                     |                       |                     |                      |
| Non-current assets:                 |                     |                       |                     |                      |
| Property, plant and equipment       | 48,600              |                       | 25,000              |                      |
| Investment in Sentongo:             |                     |                       |                     |                      |
| Equity                              | 28,800              |                       | -                   |                      |
| Preference shares                   | <u>600</u>          |                       | <u>-</u>            |                      |
|                                     |                     | 78,000                |                     | 25,000               |
| Current assets:                     |                     |                       |                     |                      |
| Inventories                         | 18,000              |                       | 7,000               |                      |
| Trade receivables                   | 20,000              |                       | 10,000              |                      |
| Cash and Bank                       | <u>1,000</u>        |                       | <u>-</u>            |                      |
|                                     |                     | <u>39,000</u>         |                     | <u>17,000</u>        |
| <b>Total Assets</b>                 |                     | <b><u>117,000</u></b> |                     | <b><u>42,000</u></b> |
| <b>Equity and Liabilities</b>       |                     |                       |                     |                      |
| Capital and reserves:               |                     |                       |                     |                      |
| Equity Capital Shs 100 each         | 20,000              |                       | 8,000               |                      |
| Accumulated retained profits        | <u>80,000</u>       |                       | <u>20,000</u>       |                      |
|                                     | -                   | 100,000               | -                   | 28,000               |
| Non-current liabilities:            |                     |                       |                     |                      |
| 8% Debentures                       | 10,000              |                       | 5,000               |                      |
| 6% redeemable preference share:     |                     |                       |                     |                      |
| Shs. 100 each                       | <u>-</u>            | <u>10,000</u>         | <u>3,000</u>        | <u>8,000</u>         |
| Current Liabilities:                |                     |                       |                     |                      |
| Trade payables                      | 4,000               |                       | 3,000               |                      |
| Bank Overdraft                      | -                   |                       | 1,000               |                      |
| Provision for income taxes          | <u>3,000</u>        |                       | <u>2,000</u>        |                      |
|                                     | -                   | <u>7,000</u>          | -                   | <u>6,000</u>         |
| <b>Total equity and liabilities</b> |                     | <b><u>117,000</u></b> |                     | <b><u>42,000</u></b> |



The following information is relevant:

- (i) At the date that Sentongo was acquired, its property, plant and equipment included:
- Plant that had a fair value of Shs. 5 million in excess of its carrying value, and
  - Inventories that had a fair value of Shs. 1 million in excess of its carrying value. The plant had a remaining useful life of 5 years and the group calculates depreciation on a straight-line basis.

All of the inventories at the date of acquisition had been sold during the year ended 30 November 1998. The book values of Sentongo's other net assets were considered to be a reasonable approximation to their fair values. The fair value adjustments had not been incorporated into Sentongo's accounting records.

- (ii) The inventory of Desderio on 30 November 2001 contains goods at a transfer price of Ug. Shs. 2.5 million that were supplied by Sentongo who had marked them up with a profit of 25% on cost. Unrealised profits are adjusted for against the profits of the company that made them. The balance on the current accounts of the parent and subsidiary was Shs. 1 million on 30 November 2001.
- (iii) Desderio calculates fair values and minority interests using the allowed alternative treatment in IAS 22 "Business Combinations".
- (iv) Consolidation goodwill is written off on a straight-line basis over a five-year life.
- (v) Sentongo paid the preference dividend on 30 November and this has been accounted for in Desderio's accounts.

**Required:**

- (a) Discuss the benchmark and allowed alternative treatment in IAS 22 in respect of the fair values of net assets and minority interest.
- (4 marks)**
- (b) Prepare the consolidated Balance Sheet of Desderio Ltd at 30 November 2001 using the allowed alternative in IAS 22.

**(16 marks)**  
**(Total 20 marks)**

**Question 3**

1AS 36: Impairment of Assets states that “an enterprise should assess at each balance sheet date whether there is an indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset”.

Required:

- (a)
- (i) List external and internal sources of information which indicate that an asset may be impaired.  
**(6 marks)**
  - (ii) Briefly describe the basis in 1AS 36 “Impairment of Assets’ for allocating impairment losses.  
**(6 marks).**
- (b) On 1 June 2001, Mukasa acquired Entertainment World, a company which operates a children’s leisure park consisting of 6 roller coaster rides. The summarized balance sheet at fair values of Entertainment World on 1 June 2001, reflecting the terms of acquisition was:

|  | Shs Million  |
|--|--------------|
| Goodwill   | 500          |
| Property – Land and various administration buildings | 2,000        |
| Motor Vehicles                                       | 1,000        |
| Roller Coaster rides (6)                             | <u>3,000</u> |
|  | <u>6,500</u> |

The carrying value of property and motor vehicles are based on their estimated replacement cost. The roller coaster rides are valued at their net selling price.

On 1 August 2001, one of the roller coaster rides collapsed. The roller coaster ride was beyond repair and no replacement could be obtained. Because of the reduced usage within the leisure park; the value in use of the business after the accident was assessed at Shs 4,600 million.

After the accident, there was a significant drop in number of children using the leisure park. A number of newspapers had started campaigns against Entertainment World. In the light of this the value in use of the business was

re-assessed on 30 August at Shs 4,200 million. On this date Entertainment World received an offer of Shs. 600 million in respect of motor vehicles.

**Required:**

Show how each of the assets of Entertainment World would be valued at 1 August 2001 and 31 August 2001 after recognizing the impairment losses.

**(8 marks)**

**(Total 20 marks)**

**Question 4**

(a) With reference to 1A S 12 'Income Taxes'. Explain the following:

- |       |                                   |                  |
|-------|-----------------------------------|------------------|
| (i)   | A Balance sheet focus.            | <b>(1 mark)</b>  |
| (ii)  | Temporary differences.            | <b>(3 marks)</b> |
| (iii) | Tax base.                         | <b>(1 mark)</b>  |
| (iv)  | Deductible temporary differences. | <b>(3 marks)</b> |
| (v)   | Taxable temporary differences.    | <b>(2 marks)</b> |

Give examples, where appropriate.

(b) A Ltd, a public limited company has adopted the provisions of 1AS.

(i) A Ltd has the following items for which there are temporary differences between the balance sheet carrying amounts and their tax bases on 30 November 2001.

|                               | Carrying value<br>Shs million | Tax base<br>Shs. million |
|-------------------------------|-------------------------------|--------------------------|
| Property, plant and equipment | 37,200                        | 12,900                   |
| Development costs             | 250                           | 0                        |
| Provision for restructuring   | (3,000)                       | -                        |

For all other items on 30 November 2001, there are no temporary differences between the carrying amounts in the balance sheet and their tax base.

(ii) Income statement for the year ended 30 November 2001

|                        | Shs. million |
|------------------------|--------------|
| Profit before taxation | 8,775        |

The profit before taxation of Shs. 8,775 million has been arrived at after charging the following:

|   | Shs. million |
|---|--------------|
| Charitable donations                                  | 500          |
| Fines for environmental pollution                     | 700          |
| Amortisation of development costs                     | 250          |
| Provision for restructuring                           | 3,000        |
| Depreciation charge for plant, property and equipment | 4,800        |

- (iii) Charitable donations are recognized as an expense in the income statement when they are paid and are not deductible for tax purposes.
- (iv) Fines are not deductible for tax purposes.
- (v) In 1998, A Ltd incurred Shs 1,250 million of costs in relation to development of new product. These costs were deducted for tax purposes to 1998. For accounting purposes, A Ltd capitalized this expenditure and amortised it on a straight-line basis over 5 years. At 30 November 2001 the unamortised balance of these product development costs was Shs. 250m
- (vi) On 30 November 2001, A Ltd announced a restructuring programme in relation to a branch based in Kenya. A provision of Shs. 3,000 million for restructuring was made in the income statement for the year ended 30 November 2001. The provision for restructuring is deductible for tax purposes when costs are actually incurred.
- (vii) Wear and tear allowance for property, plant and equipment in the year ended 30 November 2001 amounted to Shs. 8,100 million.
- (viii) Assume a corporation tax rate of 40%.

**Required:**

Calculate:

- (i) The current tax expense for the year ended 30 November 2001.
- (ii) The balance sheet deferred tax liability or asset at 30 November 2001.

**(10 marks)**  
**(Total 20 marks)**