

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA(U) EXAMINATIONS

### LEVEL THREE

#### ADVANCED FINANCIAL ACCOUNTING – PAPER 11

**MONDAY, 17 DECEMBER 2001**

#### INSTRUCTIONS TO CANDIDATES

1. Time Allowed: **3 hours**
2. Attempt **four** questions in **Section A**. Question **one** is compulsory and carries **30 marks**. The other **three** questions are to be chosen from the remaining **four** questions in the section, each carrying **20 marks**.
3. **Section B** has **two** questions and only **one** question is to be attempted. Each question carries **10 marks**.
4. Please read further instructions on the answer book.

## SECTION A

### Question 1

The Mamba Co. Ltd. has had financial difficulties over the last two years of its operations. Revenue has declined due to the company's failure to adjust quickly to stiff competition from foreign investors. Management is considering alternatives of saving the company from total collapse and is preparing for the eventuality of failure.

The company has made a resolution to issue new share capital in order to redeem two loans that are overdue for repayment. The resolution is for the company to issue 200,000 new ordinary shares of Shs. 4,000 each at Shs. 5,500 per share to a joint venture partner for cash and to redeem the 15% Loan Stock (redeemable at 15% premium but issued at par). The company has also negotiated to convert the 20% commercial credit facility into ordinary shares at the rate of Shs. 5,000 of the facility for one ordinary share in the company.

### BALANCE SHEET AS AT 30 JUNE 2001

	Shs million
<b>ASSETS</b>	
<b>Non-current assets:</b>	
Property plant and equipment	1,250
Investments	120
Intangible property	250
<b>Current assets</b>	
Inventory	185
Receivables	92
Cash at hand	2
	<hr/> 1,899 <hr/>
<b>EQUITY AND LIABILITIES</b>	
<b>Share capital and reserves</b>	
Ordinary share capital (issued and fully paid)	500
Share premium account	50
Capital reserve	10
Revenue reserve	(40)
<b>Long term liabilities</b>	
15% Loan stock (secured on properties)	700
20% Commercial credit facility (floating charge)	450

**Current liabilities**

Payables	61
Taxation	78
Bank overdraft (second charge on properties)	90
	<hr/>
	1,899

The assets of the company were valued to facilitate negotiations with the new shareholders and are expected to be worth the following amounts:

	Shs million
Property, plant and equipment:	
Properties used to secure Loan stock	1,100
Plant and equipment	270
Investments	132
Intangible assets	150
Inventory	160
Receivables:	
Certain to be received	50
Doubtful (Shs. 35 m) – expected to realise	25
Bad	7

Out of the payables in the current liabilities, about Shs. 8 million is estimated to be preferential.

The management has requested you to provide appropriate information to enable them decide the best course of action to take.

**Required:**

(a) Prepare journal entries to record the transactions arising from the issue of new shares and the redemption of the loan capital.

**(6marks)**

(b) Explain how a company can reduce its ordinary share capital in accordance with the Companies Act. How would such a reduction be accounted for?

**(4 marks)**

(c) If Mamba Ltd. chose to issue the new shares and to redeem the loans as suggested, present the balance sheet of the company as it would appear immediately after all the related transactions but before the valuations of assets have been completed.

**(10 marks)**

- (d) Incase Mamba Co. Ltd. chose to liquidate the company, prepare a statement of affairs of the company as it would be required by Court if the company were to petition for a winding up immediately.

(10 marks)  
(Total 30 marks)

## Question 2

Francis Opolot was an unmarried man at the time of his death on 30 June 2000. He had instructed his father Morris to go to his lawyers, Osende and Company Advocates, to retrieve his Will upon his death. At the time of his death, he had the following assets in his estate:

	Shs
▪ House on mailo land at Kabusu	33,000,000
▪ Commuter taxi	7,000,000
▪ Personal saloon car	4,500,000
▪ Land and house in Serere Soroti district	12,300,000
▪ Personal effects	1,200,000
▪ Household property	2,300,000
▪ Bank account balance	1,750,000
▪ Investment in 3,000 shares of Shs. 1,000 each in Kawuku Estate Co. Ltd.	
▪ Investment in Shs. 10 million 15% Royal Holdings Co. Ltd bonds (interest 30 April and 31 October)	

The shares traded on the Securities market on 30 June 2000 at Shs 1,450 while the bonds closed at Shs 95 on the same day.

Mr. Opolot once worked for a small manufacturing company and was registered with the National Social Security Fund. His benefits have been found to have accumulated to Shs. 1,400,000.

Upon reading his Will it was found that he had the wishes to have his estate shared out as follows:

- The Kabusu property for his mother Esther for life, remainder to his son James.
- Personal effects for his brothers Robert and Fred equally.
- Household property to his mother.
- The commuter taxi and personal car to his father.
- The remainder of the estate to his son James.

His father, after confirming that he was named the executor in the Will verified all the claimants from the estate and accepted the following debts including those listed by the deceased before death:

	Shs
House servants – wages	200,000
Jambo Clinic – medical bills	140,000
Uganda Revenue Authority – income tax	1,320,000
Eugene Kote – bet on KCC v Villa match	100,000

The funeral expenses amounted to Shs. 540,000 which were paid immediately.

During the year the following events took place:

- (i) Kawuku Estates Co. Ltd. made a bonus issue of 2 to 5 and a rights issue of 1 to 5 (before the bonus issue) at Shs. 1,400 per share. Morris sold the rights for Shs. 100 each on 15 April 2001.
- (ii) The debts were all paid after the funeral.
- (iii) The Kabusu property was immediately rented out for Shs. 200,000 per month payable 6 months in advance.
- (iv) Mr. Opolot's mother also died on 1 April 2001 leaving all her estate to her grandson, James. Her average expenditure per month was Shs 200,000 and her funeral expenses amounted to Shs 1,050,000. Both expenses were met out of rental income.
- (v) Legacies were promptly accented to on 30 June 2001 after paying estate expenses amounting to Shs. 250,000 met from income from investments.
- (vi) The NSSF benefits were received in full on 28 February 2001.

**Required:**

- (a) Write up the estate capital (corpus) account as it would appear on the date of Mr. Francis Opolot's death.

**(5 marks)**

- (b) Prepare the estate income account for the period up to 30 June 2001

**(5 marks)**

- (c) (i) Prepare the Esther – legatee account.

**(3 marks)**

- (ii) If Esther (Mr. Opolot's mother) died intestate and had no other children, how would her estate devolve?

**(2 marks)**

- (d) Complete the estate capital account up to 30 June 2001 taking into account all transactions carried out by Morris, the executor.

**(5 marks)**

**(Total 20 marks)**

**Question 3**

Exotic Plastics (Zim) Ltd (located in Harare, Zimbabwe) is a fully owned subsidiary of Exotic Plastics (Uganda) Ltd. The company manufactures plastic casings for domestic and automobile appliances that are shipped to Uganda as inputs for the manufacturing operations of the parent company, and also supplies some small orders within Zimbabwe.

The company has submitted its financial statements for the year ended 30 November 2001, that have been prepared in Zimbabwe dollars (Z\$) in accordance with International Accounting Standards (IAS). The financial statements are reproduced below.

**BALANCE SHEET AS AT 30 NOVEMBER 2001**

	Z\$'000
<b>ASSETS</b>	
<b>Non-current assets</b>	
Property	6,300
Plant and equipment	5,600
Patents and brands	4,250
<b>Current assets</b>	
Inventories	7,500
Receivables	3,600
Investments	2,000
Cash and bank balances	<u>1,500</u>
	<u><b>30,750</b></u>
<b>EQUITY AND LIABILITIES</b>	
<b>Share capital and reserves</b>	
Ordinary share capital	10,000
Capital reserve	1,000
Share premium	2,000
Revenue reserve	3,350
<b>Non-current liabilities</b>	
12% Bank loan	10,000
<b>Current liabilities</b>	
Trade payables	4,200
Other payables	120
Tax arrears	<u>80</u>
	<u><b>30,750</b></u>

EXOTIC PLASTICS (ZIM) LTD.

INCOME STATEMENT FOR THE YEAR ENDED 30 NOVEMBER 2001

	Z\$'000	Z\$'000
Revenue		60,000
Cost of sales		<u>(40,000)</u>
GROSS PROFIT		20,000
Administrative expenses	2,050	
Distribution costs	5,500	
Other operating expenses	<u>450</u>	<u>(8,000)</u>
OPERATING PROFIT		12,000
Finance costs		<u>(20)</u>
PROFIT BEFORE TAX		11,980
Corporation tax		<u>(3,354)</u>
PROFIT AFTER TAX		8,626
Dividends		<u>(4,000)</u>
Retained profit for the year		<u><u>4,626</u></u>

**Notes:**

- (i) All the non-current assets of the company were purchased and paid for on 1 December 1998. The plant and equipment are being depreciated at the rate of 10% and the patents and brands at 5% using the straight line method.
- (ii) The inventories were acquired at a regular rate over three months.
- (iii) Exotic Plastics (Uganda) Ltd. produces its financial statements in Uganda shillings and now wishes to translate the above financial statements into its reporting currency. For that purpose the Chief Accountant of the company has obtained the following movement in the Uganda-Zimbabwe currency exchange rates:

01 December 1998	Z\$1	=	Ushs 440
01 December 2000	Z\$1	=	Ushs 510
30 November 2001	Z\$1	=	Ushs 480
01 September 2001	Z\$1	=	Ushs 500
Average for the year	Z\$1	=	Ushs 495

**Required:**

- a) Differentiate between two methods allowed under IAS 21 – *The Effects of Changes in Foreign Exchange Rates* for the translation of the financial statements of a foreign subsidiary into the reporting currency of its parent.  
(8 marks)
  - b) Prepare translated versions of the financial statements of Exotic Plastics (Zim) Ltd. suitable for consolidation with those of Exotic Plastics (Uganda) Ltd.  
(12 marks)
- (Total 20 marks)**

**Question 4**

The balance sheet of Goats Ltd. as at 1 July 2000 stood as shown below.

	Shs' million
<b>ASSETS</b>	
Property	622
Plant and equipment	211
Current assets	<u>597</u>
	<u>1,430</u>
<b>EQUITY AND LIABILITIES</b>	
Ordinary share capital	1,100
Revenue reserves	188
Current liabilities	<u>142</u>
	<u>1,430</u>

On 1 October, the market values of the assets were as follows:

Property	Shs 778 million
Plant and equipment	Shs 182 million (estimated life is 4 years)

Cattle Ltd. acquired all the shares in Goats Ltd. on 1 October 2000 through an offer of one ordinary share in Cattle Ltd. for every two ordinary shares in Goats Ltd. The two companies are quoted on the Kampala Securities Exchange. On 1 October 2000 their ordinary shares were valued at Shs. 4,500 and Shs. 2,200 for Cattle Ltd and Goats Ltd respectively. The nominal value of both companies' shares is Shs. 1,000 each.



## Advanced Financial Accounting – Paper 11

The two companies produced individual draft financial statements for the financial year ending 30 June 2001 as shown below:

### DRAFT INCOME STATEMENTS FOR THE YEAR ENDED 30 JUNE 2001

	Cattle Ltd. Shs 'M	Goats Ltd. Shs 'M
Revenue	2,515	1,812
Cost of sales	<u>(1,372)</u>	<u>(1057)</u>
Gross profit	1,143	755
Operating expenses	<u>(624)</u>	<u>(453)</u>
Operating profit	519	302
Finance costs and returns	<u>(30)</u>	<u>22</u>
Profit before tax	489	324
Taxation	<u>(151)</u>	<u>(108)</u>
Profit after tax	338	216
Dividends	<u>(225)</u>	<u>(110)</u>
Retained profit for the year	<u>113</u>	<u>106</u>

### DRAFT BALANCE SHEETS AS AT 30 JUNE 2001

	Cattle Ltd. Shs 'M	Goats Ltd. Shs 'M
<b>ASSETS</b>		
Property, plant & equipment	2,034	722
Current assets	<u>594</u>	<u>767</u>
	<u>2,628</u>	<u>1,489</u>
<b>EQUITY AND LIABILITIES</b>		
Ordinary share capital	1,500	750
Revenue reserves	511	524
Long term loan	200	-
Current liabilities	<u>417</u>	<u>215</u>
	<u>2,628</u>	<u>1,489</u>

#### Additional information

- (i) The above financial statements have not taken into account the share exchange that has taken place between the two companies.
- (ii) Goodwill arising on consolidation is assumed to have a useful life of 10 years.
- (iii) Revenue was earned and expenses incurred evenly throughout the year.

**Required:**

- a) Explain the two methods allowed by IAS 22 – Business Combinations for the preparation of the consolidated financial statements in this kind of relationship. Recommend the most appropriate to be used by Cattle Ltd. in this case.

**(4 marks)**

- b) Prepare for Cattle Ltd. a draft consolidated income statement for the year ended 30 June 2001 and the consolidated balance sheet as at that date assuming:
- (i) IAS 22 criteria for the treatment of this business combination as a uniting of interests have been fulfilled; and
  - (ii) IAS 22 criteria for the treatment of this business combination as a uniting of interests have NOT been fulfilled.

**(16 marks)**

**(Total 20 marks)**

**Question 5**

Kapo Plastics Ltd. has recently embarked on a venture to pioneer in the manufacture of computer casings in Uganda with a new factory in Nakawa. The building has been completed but finances have become short and loans hard to secure.

The machinery has not been fully paid for and requires Shs 1 billion before commissioning. The company has resolved to sell the factory land and buildings to the First Industrial Bank. The factory land and buildings cost the company Shs 2.5 billion but is thought to be worth Shs 3 billion by property consultants.

The bank has agreed to buy the property on the following terms:

- To pay on signing the agreement Shs. 1.5 billion for the property;
- Not to resale the building to a third party for at least 10 years; and
- To irrevocably allow Kapo Plastics Ltd. to rent the premises at a fixed amount of Shs 150 million per year for 10 years; and
- To resale the property to Kapo Plastics Ltd. between the 8<sup>th</sup> and 10<sup>th</sup> year at the price of Shs. 1.8 billion.

**Required:**

- (a) Explain the substance of the transaction between the bank and Kapo Plastics Ltd. in view of the conditions and terms regarding the sale of the factory land and buildings.

**(6 marks)**

- (b) Show the journal entries in the books of Kapo Plastics Ltd. to record the transactions of year 1, year 2 and year 10 assuming Kapo Plastics Ltd. does not default on the payments and exercises the right to buy back the property in year 10.

**(8 marks)**

- (c) Discuss the matters that should be included in the notes to the accounts of a company that has acquired assets under a finance lease agreement in accordance with the provisions of IAS 17 – Leases.

**(6 marks)**

**(Total 20 marks)**

## **SECTION B**

### **Question 6**

Pagan Microfinance Ltd. is a company that specialises in providing short term loans to small and medium sized businesses. It has been experiencing some problems with loans and interest recovery from some of its borrowers. The management is investigating the most appropriate way of recovering the loans in future while also dissuading the borrowers from attempting to default.

One of the ways being considered is to bring bankruptcy proceedings to the borrowers. Management is not certain of whether this is appropriate.

You work for a firm specialising in loan recovery, which has been hired to help the management of Pagan Microfinance Ltd.

**Required:**

Outline to the management of Pagan Microfinance Ltd:

- a) The facts they have to prove, before they can institute a successful action in bankruptcy against the defaulters.

**(4 marks)**

- b) The steps followed in a typical bankruptcy case.

**(6 marks)**

**(Total 10 marks)**

**Question 7**

‘Recognition is the process of incorporating in the balance sheet or the income statement an item that meets the definition of an element of financial statements and satisfies the criteria for recognition ... It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or the income statement totals.’

**Source:** *IASC’s Framework for the Preparation and Presentation of Financial Statements.*

**Required:**

- a) Identify the criteria mentioned above and explain how they are applied in the recognition of any two elements of financial statements.  
**(6 marks)**
- b) Briefly explain two bases used in the measurement of the elements of financial statements.  
**(4 marks)**

**(Total 10 marks)**