

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA(U) EXAMINATIONS

### LEVEL FOUR

#### FINANCIAL REPORTING - PAPER 16

**MONDAY, 16 JUNE 2003**

#### 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.

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## Question 1

X Ltd. is a company listed on the Uganda Securities Exchange and is involved in diverse activities. X's year end is 31 May 2003 and is in process of finalizing its financial statements. X is seeking your advice on how to deal with the following issues in compliance with International Financial Reporting Standards (IFRSs).

1. X owns a plantation of 200 trees, which were planted five years earlier and will take twenty years to mature. These trees will ultimately be processed into building materials for houses or furniture. There are no market – determined prices or values available for trees in their present state. Only mature trees have established fair values by reference to a quoted price in an active market. The fair value (inclusive of current transport costs to get 200 logs to the market) for a mature tree of the same grade as in the plantation is:

As at 1 June 2002	Shs. 200,000
As at 31 May 2003	Shs. 225,000

X's weighted average cost of capital is 10% per annum.

2. On 1 June 2002 X issued Shs. 200 million 8% convertible loan stock at par. The stock is convertible into equity shares, or redeemable at par on 31 May 2007, at the option of the stockholders. The terms of conversion are that each Shs. 1,000 of loan stock will be convertible into one equity share of X. If the option to convert to equity had not been included in the terms of the issue, then a coupon (interest) rate of 12% would have been required to attract subscribers for the stock.

The value of Shs. 100 receivable at the end of year at a discount rate of 12% can be taken as:

Year	Shs.
1	89
2	80
3	71
4	64
5	57

3. On 31 May 2003 X disposed of its hotel division, which was based in Kenya and is no longer involved in this activity. The details of the hotel division's results in the current year up to the date of disposal are:

	Shs. million
Sales revenue	500
Cost of sales	<u>(400)</u>
Gross profit	100
Other operating expenses	<u>(120)</u>
Loss before tax	<u>(20)</u>

The hotel division's results in the year to 31 May 2002 were:

	Shs. million
Sales revenue	400
Cost of sales	<u>(300)</u>
Gross profit	100
Other operating expenses	<u>(110)</u>
Loss before tax	<u>(10)</u>

During the year ended 31 May 2002, X had sold its engineering division and the following information relating to engineering division was reported under discontinuing operations:

	Shs. million
Sales revenue	250
Cost of sales	<u>(200)</u>
Gross profit	50
Other operating expenses	<u>(100)</u>
Loss before tax	<u>(50)</u>

4. X owns several properties which are revalued each year. Three of its properties are rented out under annual contracts. Details of these properties and their valuations are:

Property	Type	Life	Cost	Value at 31 May 2003	Value at 31 May 2002
			Shs. 'm'	Shs. 'm'	Shs. 'm'
A	Freehold	50 years	200	300	270
B	Freehold	25 years	150	190	150
C	Freehold	20 years	100	120	135

All three properties were acquired on 1 June 1998.

Property A is let to a subsidiary of X on normal commercial terms. The other properties are let out on normal commercial terms to companies not related to X. Where possible, X wishes to adopt the benchmark treatment in IAS 16: Property, Plant and Equipment.

5. X acquired a building on 1 June 2002 under an operating lease. The building is being used as corporate head office and it is a requirement of the lease term that the building is returned in good condition. The lease term is for five years and X intends to refurbish the building in five years' time at a cost of Shs. 30 million in order to meet the requirements of the lease. Currently there is evidence that due to severe rain damage the company will have to spend Shs. 5 million next year on having the exterior of the building renovated. X feels that this expenditure will reduce the refurbishment cost at the end of the lease by an equivalent amount.

In addition, X has a leasehold property (depreciated historical cost Shs. 80 million at 31 May 2003). This property was modified during the year to include a restaurant/canteen facility for the employees. The lease term requires that the property must be restored to its original state when the lease expires in 10 years' time. The present value of the costs of reinstatement are likely to be Shs. 8 million.

6. On 1 June 2002 X had inventory of timber which had cost Shs. 200 million two years ago. By 1 June 2002, the value of timber had risen to Shs. 300 million. It will be a further three years before this timber is sold. On 1 June 2002 X entered into an arrangement to sell to Nile Bank the timber for Shs. 220 million. X has an option to buy back the timber at cost of Shs. 220 million plus accumulated interest at 8% per annum. This will be charged from 1 June 2002. X intends to buy back the timber in 3 years' time when the market value of timber is likely to be Shs. 420 million.
7. On 31 May 2003 X acquired 100% of issued ordinary share capital of Y for Shs. 1,000 million paid on 31 May 2003 and Shs. 250 million to be paid on 31 May 2005. X's weighted average cost of capital is 10% per annum. The fair value of identifiable net tangible assets on 31 May 2003 was Shs 900 million.

In addition, Y has in its balance sheet brand names currently utilised by the company. The carrying value of brand names is Shs. 100 million. The directors of Y felt that they were worth Shs 125 million but there is no readily ascertainable market value on 31 May 2003, nor any information to verify the directors' estimated value.

**Required:**

Discuss how the above issues should be dealt with in the financial statements of X, stating the nature of accounting entries required.

Allocation of marks:

- |                               |                         |
|-------------------------------|-------------------------|
| 1. Plantation                 | (12 marks)              |
| 2. Convertible loan stock     | (10 marks)              |
| 3. Disposal of hotel division | (8 marks)               |
| 4. Properties                 | (6 marks)               |
| 5. Buildings                  | (10 marks)              |
| 6. Timber                     | (8 marks)               |
| 7. Acquisition of Y           | (6 marks)               |
|                               | <b>(Total 60 marks)</b> |

**Question 2**

- (a) With reference to IAS 37 "Provisions, Contingent Liabilities and Contingent Assets", explain:
- (i) Why there was a need for more detailed guidance on accounting for provisions and the circumstances under which a provision should be recognized in the financial statements according to IAS 37.  
(6 marks)
  - (ii) How the following should be accounted for under IAS 37?
    - 1. An onerous contract acquired as part of a purchase of shares in a subsidiary.  
(2 marks)
    - 2. Environmental liabilities arising out of past obligations.  
(2 marks)
    - 3. Decommissioning costs to be incurred at the end of a project.  
(2 marks)
- (b) With reference to IAS 36 'Impairment of Assets', describe the circumstances which indicate that an impairment loss relating to an asset may have occurred and explain how IAS 36 deals with the recognition and measurement of the impairment of assets.  
(8 marks)
- (Total 20 marks)**

## Question 3

The following information relates to Mukasa Ltd, Bosco Ltd. and Sentongo Ltd.

1. The draft income statements for the year ended 31 May 2003 are:

	Mukasa Shs. 'm'	Bosco Shs. 'm'	Sentongo Shs. 'm'
Revenue	30,000	5,000	8,000
Cost of sales	<u>(20,000)</u>	<u>(3,500)</u>	<u>(5,200)</u>
Gross profit	10,000	1,500	2,800
Distribution costs	<u>(3,000)</u>	<u>(500)</u>	<u>(700)</u>
Administrative expenses	<u>(300)</u>	<u>(50)</u>	<u>(50)</u>
Profit from operations	6,700	950	2,050
Interest expense	<u>(50)</u>	<u>(20)</u>	<u>(10)</u>
Interest income	25	5	40
Dividends receivable (all inter company)	<u>214</u>	<u>-</u>	<u>-</u>
Profit before taxation	6,889	935	2,080
Income tax expenses	<u>(2,069)</u>	<u>(280)</u>	<u>(622)</u>
Net profits attributed to ordinary shareholders	<u>4,820</u>	<u>655</u>	<u>1,458</u>
2. Accumulated profits at 1 June 2002	20,500	2,400	435.5
3. Dividends:			
Paid	-	-	-
Proposed	400	160	200

4. Mukasa acquired 80% of the issued equity capital of Bosco on 1 June 2000 when the accumulated profits of Bosco were Shs. 400 million. The cost of the shares was Shs. 1,000 million and the equity capital and share premium of Bosco at that date were respectively Shs. 450 million and Shs. 150 million.

The fair values of the net assets of Bosco at the date of acquisition were equivalent to their book values.

Mukasa sold half of its holding of the shares in Bosco on 1 December 2002 for Shs. 1,500 million.

The sale of shares in Bosco has not been accounted for by Mukasa, but although the dividends receivable reflect the change in Bosco's shareholding.

5. On 1 September 2002, Mukasa acquired 75% of the issued share capital of Shs. 200 million of Sentongo at a cost of Shs. 790 million.

The net assets of Sentongo acquired on 1 September 2002 and their fair values were as follows:

	Carrying value	Fair value adjustments	Fair values
	Shs. 'm'	Shs. 'm'	Shs. 'm'
Non-current tangible assets	640	(40)	600
Inventories	240	(40)	200
Provision for restructuring	(30)	(20)	(50)
Other net assets	<u>150</u>		<u>150</u>
	<u>1,000</u>	<u>(100)</u>	<u>900</u>

The provision for restructuring of Shs. 30 million in Sentongo's books had been committed, communicated to parties affected by it and provided for on 31 May 2002. A further post acquisition provision of Shs. 20 million is required which relates to the restructuring as a result of the acquisition.

The fair value adjustments had not been incorporated into Sentongo's accounting records.

6. Sentongo sold goods to Mukasa on 31 March 2003 which had a selling value of Shs. 500 million. Sentongo's profit margin on sales to Mukasa is 30%. Mukasa had sold half of these goods by the year end.
7. Mukasa amortises goodwill arising on acquisition of subsidiaries through the income statement over four years with a full year's charge in the year of acquisition.
8. Depreciation is charged on all group non-current assets at 20% per annum on the net book value.
9. Assume that profits accrue evenly.  
Taxation on any profit on sale of shares is to be ignored.
10. Mukasa accounts for acquisitions of subsidiaries by utilizing the allowed alternative treatment under IAS 22 'Business combinations' when allocating the cost of acquisition. The minority interest is charged with any inter group profits incorporated into the subsidiary's financial statements.

**Required:**

Prepare a consolidated income statement for the Mukasa Group for the year ended 31 May 2003 in accordance with International Financial Reporting Standards.

(20 marks)

**Question 4**

The following information relates to Company X for the year ended 31 May 2003:

1. Net profit attributable to the preference and ordinary shareholders of the parent company was Shs 1,000,000. There were no extraordinary items or discontinuing operations during the year.
2. There were 40 million ordinary shares of Shs. 100 per share in issue on 1 June 2002.
3. On 1 September 2002, there was a fresh issue of 10 million shares at the market price of Shs. 1,000 per share.
4. The following share options granted to the directors are outstanding as at 31 May 2003:

	Date of grant	Number	Price per share Shs.	Date by which to be exercised
(a)	1 June 2001	1,000,000	300	31 May 2006
(b)	1 June 2002	1,000,000	600	31 May 2007

No share options were exercised during the year ended 31 May 2003.

The average market price of the shares for the year ending 31 May 2003 was Shs. 900.

5. Convertible loan stock of Shs. 100 million at an interest rate of 6% was issued at par in the year to 31 May 2000. Each Shs. 100 of loan stock is convertible at the holder's option into one share at any time after 1 June 2003.
6. Shs. 50 million of convertible preference shares of Shs. 100 were issued on 1 December 2002. Dividends are paid half yearly on 31 May and 30 November at a rate of 8% per annum. The preference shares are convertible into ordinary shares any time after 31 May 2004 at the option of the preference shareholders on the basis of one ordinary share for two preference shares issued.
7. The rate of taxation is to be taken as 30%.

**Required:**

Calculate the basic and diluted earnings per share for X for the year ended 31 May 2003 in accordance with IAS 33 'Earnings Per Share'.

(20 marks)