

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

FINANCIAL REPORTING - PAPER 16

MONDAY, 15 DECEMBER 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.

Question 1

The summarized consolidated financial statements of East African Investments Ltd are as shown below. The company operates in all the three East African countries and is in various business activities.

CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 30 NOVEMBER 2003

	Shs. '000
Revenue	4,570,000
Cost of sales	<u>(2,860,000)</u>
Gross profit	1,710,000
Operating expenses:	
Administration expenses	(640,000)
Distribution costs	(570,000)
Other operating expenses	<u>(125,000)</u>
Operating profit for the year	375,000
Finance costs	(30,000)
Interest receivable	37,000
Investment income	<u>12,000</u>
Profit before tax	394,000
Taxation	<u>(122,000)</u>
Profit after tax	272,000
Minority interest	<u>(62,000)</u>
Group profit for the year	210,000
Dividends	<u>(120,000)</u>
Retained profit for the year	<u>90,000</u>

In relation to the various operations of the company during the year, the following analysis has been made with regards its revenues and expenses:

Analysis of Revenue and Expenses

	Revenue		Expenses				
	External	Inter-segment	Interest expense	Interest income	Investment income	Depreciation	Taxation
	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000
Uganda	1,490,000	850,000	30,000	12,000	2,000	50,000	40,000
Kenya	1,950,000	420,000	-	25,000	10,000	32,000	38,000
Tanzania	870,000	-	-	-	-	27,000	28,000
Outside E. Africa	260,000	-	-	-	-	11,000	16,000
Total	4,570,000	1,270,000	30,000	37,000	12,000	120,000	122,000

Analysis of operating profit was as follows:

	Shs '000
Uganda	150,000
Kenya	113,000
Tanzania	75,000
Outside E. Africa	37,000

CONSOLIDATED BALANCE SHEET AS AT 30 NOVEMBER 2003

Shs. (millions)

ASSETS

Non-current assets

Property, plant and equipment	550,000
Investments	100,000
Investments in associates	100,000

Current assets

Inventory	490,000
Trade receivables	320,000
Bank balances	80,000

TOTAL ASSETS 1,640,000

EQUITY AND LIABILITIES

Share capital and reserves

Ordinary share capital – fully paid	500,000
Capital reserves	150,000
Accumulated profits	<u>260,000</u>
	910,000
Minority interest	140,000

Non-current liabilities:

15% Secured Bonds – 2005/6	200,000
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Current liabilities:

Trade payables	280,000
Tax payable	90,000
Bank overdraft	20,000

TOTAL EQUITY AND LIABILITIES 1,640,000

Assets and liabilities according to the various countries of operation are as follows:

	Assets	Liabilities	Investments in associates	Capital expenditure during the year
	Shs '000	Shs '000	Shs '000	Shs '000
Uganda	720,000	280,000	-	90,000
Kenya	480,000	155,000	-	110,000
Tanzania	210,000	115,000	100,000	40,000
Outside East. Africa	130,000	40,000	-	25,000

Required:

- (a) East African Investments Ltd. wishes to prepare relevant information disclosing the performance of its various segments.
- (i) What needs to be considered when determining what reportable segment needs to be included to accompany the financial statements of the company?
(4 marks)
- (ii) Prepare, as far as the information permits, a geographical segment report for East African Investments Ltd.
(8 marks)

- (b) Some of the company's projects around the region have come under serious criticisms regarding their perceived negative effects on the local environment.

Required:

Advise the directors on the issues relating to the reporting of environmental information in the financial statements.

(8 marks)

- (c) East African Investments Ltd. now wishes to obtain a cross border listing on the stock exchanges of the three East African countries. However, the lead sponsors think there is evidence that the company may face a bleak future.

Required:

Using the financial statements of the company above to illustrate your answer:

- (i) Discuss, in general, the indicators of financial performance and position.
(6 marks)
- (ii) Using ratios, explain why the assertion of the lead sponsors may not have a good ground.
(10 marks)
- (d) In an attempt to make a full disclosure in pursuit of the cross border listing, the Board of Directors has directed that the financial statements should include a Value Added Statement:

Required:

- (i) Explain the purpose and content of the Value Added Statement. **(4 marks)**
 - (ii) Prepare a format of Value Added Statement for presentation to the Board of East African Investments Ltd. for the year ended 30 June 2003. **(4 marks)**
- (e) The directors of the company recently saw a report in The New Vision regarding a major fraud at a Kenyan Bank involving some US\$ 5 million. The report mentioned some people in Uganda who might have been involved in money laundering activities.

Required:

Explain the following to the directors:

- (i) The terms 'Fraud and Illegal acts'. **(2 marks)**
 - (ii) How to minimize fraud. **(3 marks)**
 - (iii) The term money laundering. **(2 marks)**
 - (iv) Three recognized stages of money laundering. **(5 marks)**
 - (v) Difference between money laundering and fraud. **(2 marks)**
 - (vi) The main threats of failure to stop money laundering. **(2 marks)**
- (Total 60 marks)**

SECTION B**Question 2**

Musoga Ltd. is the parent company of a trading group whose consolidated financial statements for the year ended 30 November 2003 are shown below:

INCOME STATEMENT FOR THE YEAR ENDED 30 NOVEMBER 2003

	Shs.'000
Revenue	1,346,000
Cost of sales	<u>(942,000)</u>
GROSS PROFIT	404,000
Distribution costs	(76,000)
Administration expenses	<u>(99,000)</u>
OPERATING PROFIT	229,000
Finance costs	(57,000)
Investment income	<u>11,000</u>
PROFIT BEFORE TAX	183,000
Tax	<u>(49,000)</u>
PROFIT AFTER TAX	134,000
Minority interest	<u>(12,000)</u>
GROUP PROFIT FOR THE YEAR	122,000
Dividends	<u>(80,000)</u>
RETAINED PROFITS FOR THE YEAR	<u><u>42,000</u></u>

BALANCE SHEET AS AT 30 NOVEMBER 2003

	Year ended 30 November 2002 Shs.'000	Year ended 30 November 2003 Shs.'000
ASSETS		
Non-current assets		
Property, plant and equipment	300,000	320,000
Investments at cost	150,000	170,000
Current assets		
Inventory	130,000	230,000
Receivables	74,000	140,000
Cash balances	<u>12,000</u>	<u>52,000</u>
TOTAL ASSETS	<u>666,000</u>	<u>912,000</u>
EQUITY AND LIABILITIES		
Share capital and reserves		
Ordinary share capital, fully paid of Shs. 1,000 each	300,000	400,000
Share premium	40,000	100,000
Accumulated profits	80,000	122,000
Minority interests	36,000	44,000
Non-current liabilities		
Bank loans	20,000	50,000
Deferred taxation	64,000	75,000
Current liabilities		
Payables	75,000	68,000
Dividends payable to minority interests	2,000	4,000
Dividends payable to shareholders	14,000	16,000
Corporation tax	<u>35,000</u>	<u>33,000</u>
TOTAL EQUITY AND LIABILITIES	<u>666,000</u>	<u>912,000</u>

Notes:

1. The total depreciation charge on all the non-current assets for the year amounted to Shs. 60 million during the year. No assets were disposed of in the year.
2. The tax charge during the year was arrived at as follows:

Corporation tax	38,000
Deferred tax	<u>11,000</u>
	<u>49,000</u>

Required:

- (a) Explain the importance of the cash flow statement in disclosing the financial performance and position of a reporting enterprise. **(5 marks)**
- (b) Prepare the consolidated cash flow statement for Musoga Ltd. for the year ended 30 November 2003. **(15 marks)**
- (Total 20 marks)**

Question 3

Group Z makes an offer for all the equity shares of Company G on 1 July 2003. The consideration for the offer is 500,000 shares in Group Z together with cash of Shs 10 million. The offer was accepted on 1 August, at which point Company G's net assets at carrying values were as follows:

	Shs '000'
Assets	
Goodwill	10,000
Land and buildings	8,000
Plant and equipment	12,000
Net pension asset	4,600
Inventories: finished goods	20,000
Inventories: raw materials	4,000
Accounts receivable	9,000
Cash	<u>400</u>
	<u>68,000</u>
Liabilities	
Accounts payable	9,060
Taxation payable	9,940
Long-term loan	<u>30,000</u>
	<u>49,000</u>

The following additional information is provided:

1. Company G is expected to post a loss of Shs 5 million for the rest of the year to 31 December 2003.
2. Before the end of 2003 Group Z intends to lay off 340 employees of G. This intention was publicly announced when the offer was made and had resulted in disputes with the labour unions before the acquisition even took place. A detailed formal plan was approved by the board of directors of Group Z on 31 August 2003. Total costs associated with the lay-off amount to Shs 11.8 million. In addition to the lay off of employees, Group Z will eventually close one of G's production sites. The best estimate for the costs for the closure is Shs 5.4 million (including clearing the site). Group Z has always denied the

intention to close a production facility and so far only a few members of senior management of Group Z know about the plan.

3. Up to the date of acquisition, company G has accumulated tax losses carried forward of Shs 10 million. The tax rate is 30%. After the acquisition and the restructuring G will – beyond reasonable doubt – be able to utilise all of the accumulated losses carry-forwards.
4. The goodwill carried in G's balance sheet relates to an acquisition it made three years ago.
5. The market value of the land and buildings is estimated at Shs 10 million. The valuer pointed out in his report that the alternative use value of one of the production sites is Shs 8 million higher, which could be realised if it was closed, the site cleared and the property sold. The valuer believes that the fair value of the plant and equipment is not materially different from its book value.
6. Company G does not carry any intangible assets in its balance sheet. However, it owns the rights to a number of patented products, which was a significant reason for Group Z's desire to buy the company. No active market exists for these intangible assets, but the production director of Group Z believes them to be worth at least Shs 40 million. However, the Chief Financial Officer is sceptical about this, pointing to G's current poor performance; in any event he does not think it likely that an independent expert could be found to give a valuation of the patents.
7. The finished goods are valued at Shs 20 million based on the costs incurred by G to produce the goods. Group Z expects to sell them for Shs 28 million which would – after deduction of the costs of Shs 7 million which will be incurred to sell the goods – will result in an unreasonably low profit of Shs 1 million. Group Z would normally realise a profit of at least Shs 4 million for similar finished goods. The current replacement cost of the raw material inventory amounts to Shs 10 million. The book value of the raw material inventory in G is Shs 4 million on a LIFO basis.
8. The interest on long-term loan is at a fixed rate of 10%, payable annually on 1 August and the principal is repayable on 1 August 2003. Since it was originally taken out, interest rates have fallen and an equivalent loan could now be obtained at 6%.
9. The pension plan asset includes Shs 350 million of actuarial losses that do not require to be recognised under IAS 19. An actuarial appraisal of the plan at the date of acquisition estimates that the investments held have a fair value of Shs 27 million and the pension obligation has a present value of shs 24.4 million.
- 10 Group Z's own share price was Shs 40 when it made the offer on 1 July and Shs 42 when it was accepted on 1 August. It incurred professional fees of Shs 2 million and the chief financial officer has calculated that the cost of senior management time devoted to researching, launching and completing the offer amounted to Shs 800,000.

Required:

Compute the fair values of the assets and liabilities of Company G on the date of acquisition and goodwill or negative goodwill that arises on acquisition. Your answer should explain the reason, for the basis of valuation for the assets and liabilities.

(20 marks)**Question 4**

A company makes an accounting profit of Shs 50 million in year 1 and Shs 70 million in year 2. The tax rate in force for year 1 was 25% (as it had been for many years before) and 20% for year 2 and going forward. In arriving at its profit, the following matters were taken into account:

1. The company made charitable donations of Shs 1 million in each of the two years. These are not deductible for tax purposes.
2. The company received a non-taxable government grant for the purchase of an asset three years before and has been carrying it in deferred income and releasing it to income over the life of the asset. The release for each year was Shs 4 million and the amount of deferred income at the end of years 1 and 2 was Shs 12 million and Shs 8 million respectively.
3. The company has made a provision for warranty costs, but these costs are only allowed as a tax deduction when paid. The movements in the provision over the two years were as follows

Year	1	2
	Shs '000	Shs '000'
Opening balance	15,500	17,500
Charge to income	7,000	8,500
Warranty claims paid	<u>(5,000)</u>	<u>(6,500)</u>
Closing balance	<u>17,500</u>	<u>19,500</u>

4. In Year 1, the local environmental agency brought proceedings against the company in respect of alleged pollution. The company did not admit liability but made a provision in its balance sheet at the end of year 1 for possible fines totalling Shs 17 million. Such fines are not deductible for tax purposes. In year 2, the proceedings were heard in court, and the allegations were not proven. Accordingly, the provision was released in year 2.

5. The company's movements in non-current assets were as follows:

Year	1	2
	Shs '000	Shs '000'
Opening balance	150,000	130,000
Additions	35,000	40,000
Depreciation	(45,000)	(47,000)
Disposals (at net book value)	(10,000)	(12,000)
Revaluation surplus	<u>-</u>	<u>30,000</u>
Closing balance	<u>130,000</u>	<u>141,000</u>

The proceeds of the disposals were Shs 15 million and Shs 10 million respectively, and the resulting gain and loss are included in the accounting profits for each year as disclosed above. The revaluation was made at the end of the year under the allowed alternative rules of IAS 16, and the surplus was taken to equity. This was the first time that a revaluation had been made.

The equivalent movements in the tax base of the non-current assets were as follows:

Year	1	2
	Shs '000	Shs '000'
Opening balance	120,000	100,000
Additions	35,000	40,000
Depreciation for tax purposes	(50,000)	(55,000)
Disposals (at tax base)	(5,000)	(7,000)
Revaluation surplus*	<u>-</u>	<u>0</u>
Closing balance	<u>100,000</u>	<u>78,000</u>

- Revaluations are not recognised for tax purposes.

Under the tax rules, any difference between the disposal proceeds and the tax base of assets sold is treated as a taxable profit or loss in the year of disposal.

Required:

In accordance with **IAS 12: Income Taxes**, calculate the current and deferred tax figures for years 1 and 2 and show how much would be included in the company's income statement.

In addition, present a reconciliation in accordance with paragraph 81(c) of IAS 12 to explain the relationship between tax expense and accounting profit.

(20 marks)