

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

FINANCIAL REPORTING - PAPER 16

TUESDAY, 22 JUNE 2004

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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SECTION A

Question 1

The directors of Kiconco Ltd, a listed company, are in the process of finalising the company's financial statements for the year ended 31 May 2004.

Kiconco Ltd is incorporated in Uganda and it prepares its financial statements in compliance with International Accounting Standards (IASs). You have been approached by the directors for advice on a few outstanding issues which are;

1. Kiconco Ltd has capitalised and treated as property, plant and equipment an amount of Shs 20 million deposited as initial payment towards an operating lease. The asset is being depreciated over 5 years on a straight line basis. This initial deposit has substantially reduced the annual rental expense to Shs 10 million per year.
2. The directors have included an extraordinary loss of Shs 100 million in the draft Income Statement. This loss is based on estimates of the extent of damage caused by the LRA rebels in Northern Uganda recently. The rebels burnt down some assets and properties belonging to Kiconco Ltd in the Gulu area on the 10 April 2004. These properties were not insured.

In addition, the directors believe that as a result of the rebel activity, the value of many properties owned by the company in Northern Uganda are adversely affected. The business in Gulu has also been adversely affected and is likely to make heavy losses in the year ended 31 May 2005. The directors wish to recognise a provision for future operating losses in the current year.

3. Kiconco Ltd issued a Shs 6 billion 8% convertible loan stock at par on 1 June 2003. The stockholders have an option to convert it into equity shares or redeem it at par on 31 May 2008. The current market interest rate is 10% and the conversion terms are that each Shs 20,000 loan stock will be convertible into 4 equity shares of Kiconco Ltd.
4. On 1 June 2002, Kiconco Ltd acquired a wholly owned subsidiary **C&E Ltd**. Former shareholders of C & E disputed the amount paid for the purchase consideration, which had been partly based on the future performance of the subsidiary. The actual amount paid on the date of acquisition had been used in the calculation of goodwill that is included in the draft financial statements.

On 31 May 2004, Court decided in favour of the previous shareholders and Kiconco Ltd is now required to pay an additional Shs 12 million to the former shareholders of C & E Ltd within 60 days of the Court's ruling date. The directors have not accounted for this additional purchase consideration and do not know how to deal with it. Goodwill is written off over 5 years with a full year's amortisation in the year of acquisition.

In another acquisition during the current year, the fair value exercise has resulted into a "Negative goodwill" figure of Shs 15 million and the directors are unsure of its treatment in the group financial statements.

5. The directors of Kiconco Ltd have gathered the following information about a company, Xavier Ltd, in which they have a minority shareholding and are planning to increase their shareholding in the near future.

Year ended 31 May	2004	2003	2002
	Shs	Shs	Shs
Basic Earnings Per Share	50	40	28
Net Profit After Tax	196 million	120 million	85 million

The directors have also been told that the earnings per share figures are a reliable measure of a company's performance other than the trend of profitability levels. They are also confused by the company disclosing a diluted earnings per share figure which is lower than the basic earnings per share.

6. Kiconco Ltd also owns a subsidiary company called Bob Ltd and an extract of Bob Ltd's balance sheet as at 31 May 2004 is as follows:

	Shs millions
Franchise costs	50
Goodwill	80
Plant and machinery	100
Reconditioned lorries (at cost)	90
Other total net assets	<u>50</u>
	<u><u>370</u></u>

The franchise agreement contains a "sale back" clause that allows for Bob Ltd to forego the franchise and have a repayment of Shs 30,000,000 from the franchisee called Best Foods. The directors have estimated that the lorries have a realisable value of Shs 115,000,000. Bob Ltd's value in use at 31 May 2004 is Shs 240,000,000.

7. In the year ending 31 May 2004, Kiconco Ltd has invested in a substantial project on Ssesse Islands. This project involves preparation of land for a palm oil plantation. The company has spent large sums of money on research and development on this project during the year. These expenses have been capitalised as intangible assets.

Because the processes will involve the use of chemicals, some politicians are opposing the project on environmental grounds and are demanding that the company should keep the environment free of these chemicals and to achieve this, the company should spend certain significant sums. Kiconco Ltd has regularly produced an environmental report as per the agreement signed with the Government of Uganda. The reports have always confirmed that the company is environment friendly.

Required:

Discuss the nature, accounting treatment and effect on the financial statements of the issues in (1) to (7) above. Your answer should deal with the issues in general and specifically and you should make references to the relevant statutory and regulatory authorities while answering this question.

Your answer should include discussions on the following:

Issue:

- (1) (i) Explain the differences between a finance lease and an operating lease and their treatment in the financial Statements, and **(2 marks)**
 - (ii) Whether the directors have correctly accounted for the initial payment of Shs 20 million. **(3 marks)**
- (2) (i) Whether the loss of Shs 100 million has been correctly classified as an extraordinary item in the draft income statement. **(2 marks)**
 - (ii) Impairment of assets in Gulu area, and **(3 marks)**
 - (iii) Provision for future operating losses. **(2 marks)**
- (3) The treatment of the 8% convertible loan stock in the group financial statements. **(5 marks)**
- (4) (i) The treatment of the additional purchase consideration payable to former shareholders of C & E Ltd and its effect on the financial statements to 31 May 2004, and **(4 marks)**
 - (ii) Treatment of “Negative goodwill” in the financial statements. **(5 marks)**
- (5) (i) Why the trend of earnings per share may not necessarily be the same as the trend in reported profits and which of the two will give a more useful measure of a company’s performance. **(4 marks)**
 - (ii) The relevance of the diluted earnings per share and explain how it is computed. **(4 marks)**
- (6) (i) Define an impairment loss and describe the circumstances that may give indications that a company’s assets may have been impaired. **(4 marks)**
 - (ii) Show, with the use of numerical figures given, the effects of the information in (6) above on the Group’s financial statements. **(4 marks)**
- (7) (i) Current reporting requirements of environmental information in Financial Statements. **(4 marks)**

- (ii) Contents and possible benefits of an environmental report.
(5 marks)
- (iii) Requirements of IAS 37: Provisions, Contingent Liabilities and Contingent Assets.
(4 marks)
- (iv) Requirements and recognition criteria for research and development expenditure under IAS 38: Intangible Assets.
(5 marks)
- (Total 60 marks)**

SECTION B

Question 2

Mbarara Conglomerate, a public company, acquired 90% of Lira Enterprises Limited's Shs. 1,000 ordinary shares on 1 January 2002 paying Shs. 3,000 per share. The balance on Lira's accumulated profits at that date was Shs. 90 billion. On 1 April 2003, Mbarara acquired 25% of Arua Exporters Ltd's Shs. 1,000 ordinary shares for Shs. 4,000 per share. Mbarara exercises a significant influence over Arua's operating and financial policies. The balance sheets of the three companies at 31 December 2003 are shown below:

	Mbarara Shs billion	Lira Shs billion	Arua Shs. billion
Assets			
Non-current assets:			
Property, plant and equipment	900	300	200
Investments	<u>330</u>	<u>-</u>	<u>-</u>
	1230	300	200
Current assets	<u>270</u>	<u>200</u>	<u>100</u>
Total assets	<u>1,500</u>	<u>500</u>	<u>300</u>
Equity and Liabilities			
Capital and Reserves:			
Ordinary shares of Shs 1,000 each	500	100	60
Reserves:			
Accumulated profits b/f	600	150	80
Profit for the year to 31 December 2003	<u>100</u>	<u>50</u>	<u>60</u>
	1,200	300	200
Current liabilities	<u>300</u>	<u>200</u>	<u>100</u>
Total equity and liabilities	<u>1,500</u>	<u>500</u>	<u>300</u>

The following information is relevant:

- (i) Fair value adjustments:
On 1 January 2000, the fair values of Lira's assets were equal to their book values with the exception of its plant, which had a fair value of Shs 100 billion in excess of its book value at the date of acquisition. The remaining life of all of Lira's plant at the date of its acquisition was four years. Depreciation of plant is on a straight line basis. Lira has not adjusted the value of its plant as a result of the fair value exercise.

On 1 April 2003 the fair values of Arua's assets were equal to their book values.

- (ii) In July 2003, Mbarara sold goods to Arua for Shs 48 billion. These were transferred at a mark up of 20% on cost. One half of these goods were still in the inventory of Arua on 31 December 2003.
- (iii) All inter company current account balances are settled prior to the year end. However, a cheque of Shs. 10 billion from Lira to Mbarara was not received until January 2004. Inter company balances are included in accounts receivable and payable as appropriate.
- (iv) The group accounting policy for goodwill is to write it off on a straight-line basis over a period of three years, with a proportionate charge where it arises part way through an accounting period.
- (v) Mbarara uses the allowed alternative treatment in IAS 22 'Business Combinations' to allocate cost of acquisition.
- (vi) Arua has a large export market to the neighbouring countries. Just before Christmas of 2003, there were serious disturbances across the neighbouring countries. As a result, Arua has lost a significant part of its export market. Mbarara has estimated the value in use of Arua to be Shs 200 billion. Mbarara cannot reliably estimate the selling price of shares in Arua but expects it to be much lower than the value in use.

Required:

Prepare the consolidated balance sheet of Mbarara as at 31 December 2003.

(20 marks)

Question 3

- (a) The dynamic nature of international financial markets has resulted in the widespread use of a variety of financial instruments.

Required:

Explain how the non derivative and derivative financial instruments should be accounted for under IAS 39: Financial Instruments: Recognition and Measurement.

(6 marks)

- (b) On 1 January 2003, Muko, a public limited company, purchased a debt instrument with five years remaining to maturity for its fair value of Shs 100 million (including transaction cost). The instrument has a principal amount of Shs 125 million and carries fixed interest of 4.7% payable annually. The effective interest rate is 10%.

Required:

In relation to the above financial instrument, calculate the amounts to be included in the financial statements of Muko Ltd for the year ended 31 December 2003.

(6 marks)

- (c) On 1 January 2003, Moroto Ltd, a public limited company acquired a ZERO COUPON BOND for Shs 760 million, its fair value. The maturity value of bond is Shs 1000 million. Moroto has classified the bond as an available-for-sale asset

and recognises fair value gains and losses on the bond in equity. The fair value of the bond on 31 December 2003 was Shs 850 million. The effective interest rate is 9.6%.

Required:

In relation to the above financial instrument, calculate the amounts to be included in the financial statements of Moroto Ltd for the year ended 31 December 2003.

(8 marks)

(Total 20 marks)

Question 4

- (a) Discuss how IAS 19: Employee Benefits deals with the method of accounting for retirement benefits in respect of DEFINED BENEFIT PLANS.

(6 marks)

- (b) Dida, a public limited company, operates a funded defined benefit plan. The present value of the obligation and the fair value of the plan assets were both Shs 1,000 billion at 1 January 2003.

Year ended 31 December	2003
Discount rate at start of year	10.0%
Expected rate of return on plan assets at start of year	12.0%
	Shs billion
Current service cost	130
Benefits paid	150
Contributions paid	90
Present value of obligation at 31 December 2003	1,141
Fair value of plan assets at 31 December 2003	1,092

In 2003, the plan was amended to provide additional benefits with effect from 1 January 2003. The present value as at 1 January 2003 of additional benefits for employee service before 1 January 2003 was Shs 50 billion benefits which vested immediately.

The average expected remaining working lives of employees is 10 years and the net cumulative unrecognised actuarial gains on 1 January 2003 were Shs. 140 billion.

Dida Ltd has adopted a policy of recognizing actuarial gains and losses under the minimum requirements of IAS 19.

Required:

Calculate the amount which will be shown as the net plan liability in the balance sheet of Dida Ltd as at 31 December 2003, showing a reconciliation of the movement in the plan net liability during the year and a statement of those amounts which would be included in the Income Statement for the year ended 31 December. All transactions are assumed to occur at the year end.

(14 marks)

(Total 20 marks)