

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

FINANCIAL REPORTING - PAPER 16

TUESDAY, 14 DECEMBER 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.

SECTION A**Question 1**

- (a) In carrying out its work to improve the quality of IAS and IFRS, the IASB has issued IFRS 3 among other standards to replace IAS 22 Business Combinations and SIC 9, 22 & 28.

Required:

- (i) What were the major reasons for replacing IAS 22 and the interpretations therefore? **(5 marks)**
- (ii) What are the main features of IFRS 3? **(5 marks)**
- (iii) Highlight the main changes from IAS 22. **(5 marks)**
- (b) IFRS 3: Business Combinations also explains the accounting for a reverse acquisition.

Required:

What is a reverse acquisition?

(2 marks)

- (c) On 30 September 2004, Mahishi Company, the entity which issued equity shares in business combination, and therefore the legal parent, is acquired in a reverse acquisition by Mukono Industries, the legal subsidiary. The balance sheets of both Mahishi and Mukono Industries immediately before the business combination were as follows:

	Mahishi Co. Ltd	Mukono Industries Ltd
	Shs million	Shs million
Non-current assets	1,300	3,000
Current Assets	<u>500</u>	<u>700</u>
	<u>1,800</u>	<u>3,700</u>
Non Current Liabilities	400	1,100
Current liabilities	<u>300</u>	<u>600</u>
	<u>700</u>	<u>1,700</u>
Shareholders Equity:		
Retained earnings	800	1,400
Issued shared capital:		
60 million ordinary shares	300	-
100 million ordinary shares	<u>-</u>	<u>600</u>
	<u>1,100</u>	<u>2,000</u>
	<u>1,800</u>	<u>3,700</u>

Additional Information

- (i) On 30 September 2004, Mahishi issued 2.5 shares in exchange for each ordinary share of Mukono Industries. All shareholders of Mukono Industries exchanged their shares in Mukono Industries.
- (ii) The fair value of each ordinary share of Mukono Industries at 30 September 2004 was Shs 40. The quoted market price of Mahishi's ordinary shares at that date was Shs 12.
- (iii) The fair values of Mahishi's identifiable assets and liabilities at 30 September 2004 are the same as their carrying amounts, with the exception of non-current assets. The fair value of Mahishi's non current assets at 30 September 2004 was Shs 1,500,000,000.

Required:

- (i) Calculate the cost of the business combinations. **(3 marks)**
 - (ii) Calculate the goodwill arising on acquisition. **(5 marks)**
 - (iii) Prepare the consolidated balance sheet as at 30 September 2004. **(5 marks)**
- (d) In the process of reviewing the draft financial statements, the Management of Mukono Industries Company Limited discovered the following but they do not know which ones give rise to prior period restatements under the benchmark treatment of IAS 8? Advise them on how they should treat the following:
- (i) A provision for product warranty claims, which was previously estimated at Shs 10 million, is reassessed as Shs 18 million because it has now been found that more defects in the products are arising than was originally foreseen. **(2 marks)**
 - (ii) Depreciation of motor vehicles was previously charged at a rate of 30% on a reducing balance basis. Management decided that it is more appropriate to charge it at 20% on a straight-line basis, because this is a better reflection of the consumption of the benefits of using the vehicles but this decision has not been implemented. **(2 marks)**
 - (iii) It has been discovered that inventory was overstated in the previous year because the spreadsheet on which it was summarised incorrectly added the date into the total value of inventory. The amount of the overstatement was Shs 2 million, which was not material enough to cause the values to be questioned at the time. **(2 marks)**

- (iv) Borrowing costs have previously been capitalised as part of the cost of the construction of certain tangible non-current assets. It has now been decided that it is more appropriate to expense all borrowing costs as incurred.

(2 marks)

- (v) A provision for environmental remediation, which was previously estimated at Shs 20 million, is now reassessed at Shs 28 million. The change is due to the discovery of an error in the original calculation, which had mixed up miles and kilometres in measuring the site in question.

(2 marks)

- (e) Mukono Industries Company Limited buys production machinery for Shs 100 million and depreciates it on a reducing balance basis at 30% per annum. For tax purposes, the equipment is depreciated at 25% per annum on a straight-line basis. The company's accounting profit (after depreciation) for each of the Years 1 to 5 is Shs 10 million. The tax rate is 30%, and losses may be carried back for up to three years to be relieved against taxable profits of these years.

Required:

Calculate the current and deferred tax figures for each of the five years and show how they would be included in the company's income statement.

(15 marks)

- (f) Explain to management the importance of complying with International Financial Reporting Standards.

(5 marks)**(Total 60 marks)****Question 2**

In July 2002, a company made an acquisition of 100% of a subsidiary. The date of its transition to International Financial Reporting Standards (IFRSs) is 1 January 2004, and the company intends to make use of the exemption from retrospective statement of the acquisition accounting as provided in IFRS 1: First-time Adoption to International Financial Reporting Standards. The identifiable assets and liabilities recognised under previous GAAP at the date of acquisition were as follows:

	Fair Value	Tax Base	Temporary Difference
	Shs '000	Shs '000	Shs '000
Investment properties	2,100,000	1,800,000	300,000
Intangible assets	107,000	0	107,000
Other assets	8,617,000	7,998,000	619,000
Restructuring provision	(190,000)	0	(190,000)
Other liabilities	(159,000)	(159,000)	0
	<u>10,475,000</u>	<u>9,639,000</u>	<u>836,000</u>

Additional information:

1. The tax rate in force is 30%.
2. Investment properties are stated at cost; no depreciation has been charged under previous GAAP. The property has a useful economic life of 25 years at acquisition.
3. The intangible assets comprise of an assembled workforce and have not been depreciated since acquisition.
4. The restructuring provision relates to post-acquisition restructuring and has given rise to a temporary difference that has resulted in a deferred tax asset. None of the provision has yet been used at 1 January 2004.
5. The subsidiary has a defined benefit pension scheme with a net deficit at acquisition of Shs 80 million and a net deficit at transition of Shs 69 million. This has tax base of Nil.
6. Development costs that would qualify for recognition as an asset were not recognised at the acquisition date. At that date, they had a fair value of Shs 578 million, an expected life of 10 years and a tax base of Nil.

Required:

- (a) What are the adjustments required in relation to the investment property?
(4 marks)
 - (b) Can the assembled workforce continue to be recognised as an asset under IFRS? If not, what is the journal required to adjust this?
(4 marks)
 - (c) Can the restructuring provision be recognised under IFRS? If not, what journal adjustments are required?
(4 marks)
 - (d) How should the deficit on the defined benefit pension scheme be recognised?
(4 marks)
 - (e) Should the development costs be recognised? If so, what are the journal adjustments required?
(4 marks)
- (Total 20 marks)**

Question 3

The accountant of Sembabule Group of Companies has prepared the draft consolidated financial statements to be discussed at their Board meeting on 15 August 2004. However, the accountant is not familiar with preparing the group cash flow statement and has approached you for assistance.

The summarized draft group consolidated financial statements are shown below.

<u>Sembabule Limited</u>		
<u>Draft Consolidated Balance Sheet as at 30 June 2004</u>		
	30 June 2004	30 June 2003
	Shs million	Shs million
ASSETS		
Non Current Assets		
Property and Equipment	784	491
Goodwill	<u>18</u>	<u>-</u>
	<u>802</u>	<u>491</u>
Current Assets		
Inventories	217	120
Receivables	246	182
Cash and Bank	<u>106</u>	<u>97</u>
	<u>569</u>	<u>399</u>
TOTAL ASSETS	<u>1,371</u>	<u>890</u>
EQUITY AND LIABILITIES		
Share Capital and Reserves		
Called up share capital	600	450
Reserves - other	36	36
Accumulated Profits	<u>159</u>	<u>26</u>
Equity Shareholders' funds	<u>795</u>	<u>512</u>
Minority interest	<u>58</u>	<u>-</u>
	<u>853</u>	<u>512</u>
Non-Current Liabilities		
10% Debentures	<u>180</u>	<u>150</u>
Current Liabilities		
Payables	168	83
Taxation	120	115
Proposed dividends	<u>50</u>	<u>30</u>
	<u>338</u>	<u>228</u>
TOTAL EQUITY AND LIABILITIES	<u>1,371</u>	<u>890</u>

Sembabule Ltd had acquired a majority of the voting rights in the subsidiary Mbule Ltd in 2004 when that company's net assets at fair values comprised:

	Shs million
Property and equipment	92
Inventory	76
Receivables	40
Cash and Bank	43
Payables	<u>(54)</u>
Net assets	<u>197</u>

Of this figure, Shs 24 million was attributed to minority interest

The purchase consideration, Shs 200 million was discharged by the 150,000 ordinary shares at par and the payment of Shs 50 million in cash.

Sembabule Ltd amortises goodwill on consolidation over 3 years.

The additional debentures were issued on 1 July 2004

Sembabule Limited

Draft Consolidated Income Statement for the year ended 30 June 2004

	Shs million	Shs million
Profit before depreciation and amortisation		775
Depreciation		(254)
Amortisation of goodwill		<u>(9)</u>
Profit on ordinary activities before Tax		512
Corporation Tax		<u>(160)</u>
Profit on ordinary activities after Tax		352
Minority Interest		<u>(34)</u>
		318
Extra ordinary losses	(175)	
Tax relief on extra ordinary losses	<u>40</u>	<u>(135)</u>
Profit for the year		183
Dividends proposed		<u>(50)</u>
Retained profit: for the year		133
: Brought forward		<u>26</u>
: Carried forward		<u>159</u>

Required:

Prepare Sembabule Ltd's Group Cash Flow Statement for the year ended 30 June 2004.

(20 marks)

Question 4

East African Development Bank (EADB) has been approached by Mburo Investments Ltd for a loan of Shs. 100 million for five (5) years at an interest rate of 10% per annum. EADB wants your advice as a Portfolio Manager. EADB has been provided with the following information.

Mburo Investments Ltd
Balance Sheet as at 30 June

	2002	2003	2004
	Shs million	Shs million	Shs million
Share Capital	100	120	120
Accumulated profits	82	115	152
12% Debenture	<u>75</u>	<u>110</u>	<u>110</u>
	<u>257</u>	<u>345</u>	<u>382</u>
Non-Current Assets			
Freehold property	66	66	66
Plant and machinery	<u>67</u>	<u>120</u>	<u>145</u>
	<u>133</u>	<u>186</u>	<u>211</u>
Current Assets			
Inventories	136	220	290
Receivables	<u>91</u>	<u>138</u>	<u>166</u>
	<u>227</u>	<u>358</u>	<u>456</u>
Current liabilities			
Payables	23	35	50
Income Tax	28	31	35
Bank Overdraft	<u>52</u>	<u>133</u>	<u>200</u>
	<u>103</u>	<u>199</u>	<u>285</u>
Net current Assets	<u>124</u>	<u>159</u>	<u>171</u>

Mburo Investments Ltd
Income Statement for the year ended 30 June

	2002	2003	2004
	Shs million	Shs million	Shs million
Sales revenue	578	761	890
Less Cost of sales	<u>(434)</u>	<u>(586)</u>	<u>(694)</u>
	144	175	196
Other costs	<u>(67)</u>	<u>(87)</u>	<u>(100)</u>
	77	88	96
Corporation Tax	(28)	(31)	(35)
Dividends	<u>(20)</u>	<u>(24)</u>	<u>(24)</u>
Profits retained	<u>29</u>	<u>33</u>	<u>37</u>

Notes:

1. Sales of non-current assets have been insignificant.
2. EADB has been provided with the following by Mburo Investments Ltd as to why they need further capital:
 - (a) The additional plant will cost Shs 150 million.
 - (b) Sales will be increased by 40%. Two months' credit will be given to customers and one month's credit will be extended by suppliers. Inventories will represent 3 months' Cost of Sales. The anticipated rate of gross profit will be 20%.
 - (c) The directors state that the overhead expenses will not increase significantly as a result of the increased activity.

Required:

Prepare a report to EADB, in consideration to the financial statements of Mburo Investments Ltd and advise them (EADB) on the proposition. Show all the necessary workings that support your advice.

(20 marks)