

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

FINANCIAL REPORTING - PAPER 16

TUESDAY, 21 JUNE 2005

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

Musa Technology Limited (MTL) has recorded a tremendous revenue growth for the last five years. To ensure continued growth, the company is planning to introduce share-based payment arrangements for its executives and employees.

The Chief Finance Officer of MTL recently attended a seminar on IFRS 2: Share-based Payment and was surprised to hear that the company will have to reflect in its profit or loss and financial position the effects of share-based transactions.

You have been approached by the management of MTL and they are seeking advice on the accounting issues relating to share-based payment arrangements. In addition, they want you to carry out financial analysis of their financial statements for the years ending 31 December 2004, 31 December 2003 and 31 December 2002.

Required:

- (a) Explain to the management of MTL the following terms which appear in IFRS 2.
 - (i) Share-based payment arrangement. **(3 marks)**
 - (ii) Share-based payment transaction. **(3 marks)**
 - (iii) Equity-settled share-based transaction. **(3 marks)**
 - (iv) Cash-settled share-based transaction. **(3 marks)**
- (b) MTL has presented you with the following three separate hypothetical share-based payment arrangement scenarios.

Scenario 1

Company X grants 200 share options to each of its 400 employees. Each grant is conditional upon the employee working for the entity over next three years. The Company estimates that the fair value of each option on the grant date is Shs. 1,200. On the grant date, the Company also estimates that 60 of its employees will leave during next three year period and therefore forfeit their rights to the options.

During year 1, 10 employees leave. The Company continues to hold the original estimate that 60 employees will leave during the three year period.

During year 2, a further 5 employees leave. The Company revises its estimate of total employee departures over the three year period from 60 employees to 30 employees.

During year 3, a further 5 employees leave.

Scenario 2

Company Y grants 10,000 share options to each of its six directors. Each grant is conditional upon each director remaining on the board for 3 years following the date of the grant and the company's earnings per share increase by at least an average of 10% per year over the three-year period.

The Company estimates that the fair value of each option on the grant date is Shs. 3,000. On the date of grant, the Company estimates that one director will leave during the next three year period and therefore will not be entitled to exercise the option.

By the end of year 1, the Company's earnings per share has increased by 12% and none of the directors have left. The Company expects the earnings per share to increase at a similar rate over next two years. The Company estimates that one director will leave during next two years. By the end of year 2, the Company's earnings per share has increased by 10% and two directors have resigned. The Company expects to achieve the earnings per share target by the end of year 3. The Company does not expect any more directors to resign.

By the end of year 3, the Company's earnings per share increased by 2% resulting in an average increase of 8% over 3 years. As one of the vesting conditions was not satisfied, the options lapsed.

Scenario 3

Company Z grants 10,000 share options to each of its six directors. Each grant is conditional upon each director remaining on the board for 3 years following the date of the grant. The share options cannot be exercised unless the share price has increased from Shs. 5,000 at the beginning of year 1 to above Shs. 6,500 at the end of year 3.

If the share price is above Shs. 6,500 at the end of year 3, the share options can be exercised at any time during the next seven years, i.e by the end of year 10.

The Company estimates the fair value of the share options with this market condition to be Shs. 2,400 per option.

On the date of grant, the Company estimates that one director will leave during the next year and therefore will not be entitled to exercise the option.

By the end of year 1, the share price has increased to Shs. 5,500 and none of the directors have left. The Company estimates that the share

price target will be achieved by the end of year 3 and that one director will leave during next two years.

By the end of year 2, the share price has remained at Shs. 5,500 and two of the directors have left. The Company estimates that the share price target will be achieved by the end of year 3 and no more directors will leave the Company.

By the end of year 3, the share price has dropped back to Shs. 5,000 and the remaining four directors are still with the Company.

Required:

For each of the above scenarios, calculate the amount to be included in the remuneration expense for years 1, 2 and 3.

(6 marks each = 18 marks)

- (c) The following financial information has been extracted from the Company financial statements of MTL.

Income Statement for year ending 31 December:

	2004	2003	2002
	Shs. million	Shs million	Shs million
Sales revenue	13,496	11,554	10,536
Cost of sales	<u>(7,518)</u>	<u>(6,525)</u>	<u>(6,044)</u>
Gross profit	5,978	5,029	4,492
Operating expenses	<u>(1,680)</u>	<u>(1,560)</u>	<u>(1,440)</u>
Operating profit	4,298	3,469	3,052
Interest expense	<u>(468)</u>	<u>(420)</u>	<u>(396)</u>
Profit before tax	3,830	3,049	2,656
Income tax expense	<u>(1,164)</u>	<u>(966)</u>	<u>(883)</u>
Net profit	<u>2,666</u>	<u>2,083</u>	<u>1,773</u>
Dividends	(1,320)	(1,200)	(1,100)
Retained profit	1,346	883	673

Summary Balance Sheet as at 31 December:

	2004	2003	2002
	Shs. million	Shs million	Shs million
Non-current assets	10,376	8,764	8,342
Current assets	3,822	3,475	2,973
Current liabilities	(2,196)	(1,583)	(1,542)
Non-current liabilities	<u>(4,320)</u>	<u>(4,320)</u>	<u>(4,320)</u>
Equity	<u>7,682</u>	<u>6,336</u>	<u>5,453</u>

Required:

Calculate and comment on the following financial ratios for Musa Body Technology for 2002 to 2004:

- (i) Operating margin. (2 marks)
- (ii) Total asset turnover. (2 marks)
- (iii) Income gearing ratio. (2 marks)
- (iv) Capital (or financial) gearing ratio. (2 marks)
- (v) Return on equity (ROE). (2 marks)
- (vi) Earnings per share. (2 marks)
- (vii) Dividend per share. (2 marks)
- (viii) MTL has two billion ordinary shares in issue. There has been no change in share capital since 2002. The shares of MTL are currently trading at Shs 904 per share.

Required:

Calculate the company's price earnings ratio.

(2 marks)

- (d) MTL has an item of property, plant and equipment which it intends to sell. The management of MTL has approached you to assist them and make them understand the new requirements of IFRS 5: Non-current Assets Held for Sale and Discontinued Operations.

Required:

- (i) Explain the main features of IFRS 5. (4 marks)
- (ii) Explain to the management the criteria that must be fulfilled for a non-current asset to be classified as held-for-sale. (5 marks)
- (iii) Advise the management of MTL, the IFRSs measurement, presentation and disclosure requirements for non-current assets held for sale. (5 marks)

(5 marks)
(Total 60 marks)

SECTION B**Question 2**

- (a) As the repercussions of recent corporate collapses and the fall of Arthur Anderson sprawl worldwide, the reputation of the accounting profession continues to suffer. The unethical behaviour recognized in the recent corporate collapses and the Enron scandal has increased the challenges facing the accounting profession.

Required:

Discuss, in light of the above extract, the main challenges faced by the accountancy profession today and suggest the ways to overcome such challenges.

(10 marks)

- (b) Mburo Company Ltd has subsidiary, Meya Ltd. The net assets of Meya as at 31 December 2004 are as follows:

Asset	Amount UShs million
Goodwill	2,000
Factory	10,500
Plant and machinery	4,800
Delivery vehicles	1,500
Inventory	2,600
Accounts receivable	2,400
Cash	100
Bank loans	(12,000)
Accounts payable	<u>(1,900)</u>
Total	<u>10,000</u>

Due to a serious decline in demand for Meya's products, Mburo concluded that as required by IAS 36: Impairment of Assets, it is necessary to undertake an impairment review of Meya.

Mburo has provided you with the following information:

- (i) The factory is not of a specialized design and could be sold for UShs 12,000 million.
- (ii) The plant and machinery is, however, highly specialized and does not have value other than as scrap, assessed at UShs 100 million.
- (iii) The delivery vehicles could be sold for UShs 1,200 million (net of costs to sell).
- (iv) Inventory has already been substantially written down to its net realizable value and is therefore expected to be recovered at its book value.

- (v) All the monetary items are expected to be received or settled at their carrying values.
- (vi) The fair value less costs to sell of Meya as a whole cannot be determined, as it is not available for sale. It is considered that Meya is a separate cash generating unit. Meya's value in use is determined at Shs. 6,000 million.

Required:

- (i) Calculate the impairment loss as required under IAS 36: Impairment of Assets. Explain how this impairment loss will be allocated to the assets within the cash generating unit. Ignore any tax effects.
(7 marks)
 - (ii) Assuming that the fortunes of Meya improve in the next year and the revised value in use at the end of next year increases to Shs. 9,000 million, discuss the extent to which the reversal of any previously recognized impairment loss is permitted and if so, how should the reversal be allocated to the assets within the cash generating unit.
(3 marks)
- (Total 20 marks)**

Question 3

- (a) IFRS 3: Business Combinations require that all business combinations shall be accounted for by applying the purchase method. Applying the purchase method involves the following steps:
 1. Identifying the acquirer,
 2. Measuring the cost of the business combination, and
 3. Allocating, at the acquisition date, the cost of business combination to the assets acquired and liabilities assumed.

Required:

In relation to business combination, discuss:

- (i) How an acquirer would be identified.
(6 marks)
- (ii) How the cost of a business combination would be measured.
(6 marks)

- (b) Mabati Ltd has acquired shareholdings in Mapenzi Ltd. The following table shows the way in which the current shareholdings in Mapenzi Ltd were acquired:

Date	Mapenzi Ltd Holding acquired	Fair value of total net assets Shs million	Purchase consideration Shs million
30 June 2002	10%	550	55
31 December 2003	50%	650	400
31 December 2004	20%	800	200

The following balance sheets relate to Mabati Ltd and Mapenzi Ltd as at 31 December 2004:

	Mabati Ltd Shs million	Mapenzi Ltd Shs million
Tangible non-current assets	1,000	500
Cost of investment	655	-
Net current assets	<u>485</u>	<u>250</u>
	<u>2,140</u>	<u>750</u>
Issued capital – ordinary shares of Shs 100 @	1,000	500
Retained earnings b/f	700	100
Profit for the year	400	100
Net current liabilities	<u>40</u>	<u>50</u>
	<u>2,140</u>	<u>750</u>

Additional information:

- The balance on the retained earnings of Mapenzi Ltd on 30 June 2002 was Shs 50 million.
- The increase in the fair values is attributable net current assets and these net current assets had not yet been realized by 31 December 2004.
- Mapenzi is a separate cash generating unit and was tested for impairment on 31 December 2003 and 2004 respectively. It was found that for Mapenzi the recoverable amount on both those dates was higher than the carrying value.

Required:

Prepare the consolidated balance sheet for Mabati Group as at 31 December 2004.

(8 marks)
(Total 20 marks)

Question 4

The Companies Act requires directors of a company to prepare financial statements for each financial year that give a true and fair view of the state of affairs of the company as at the end of the financial year and of the profit or loss of the company for the year.

IAS 1: Presentation of Financial Statements states that ‘financial statements shall present fairly (fair presentation) the financial position, financial performance and cash flows of an entity’.

Required:

Discuss and comment on:

- (a) How true and fair view or fair presentation may be achieved. **(8 marks)**
 - (b) When true and fair or fair presentation override might occur. **(4 marks)**
 - (c) IAS 1 disclosure requirements when true and fair view or fair presentation override occurs. **(8 marks)**
- (Total 20 marks)**