

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

FINANCIAL REPORTING - PAPER 16

MONDAY, 12 DECEMBER 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

Rwizi, a publicly listed multinational company, has operations in the East African region. The management of Rwizi Group has recently been changed, leading to appointment of two new executive directors and a new finance director. The new finance director is a retired accountant who is out of date with the current issues relating to corporate reporting. Whilst reviewing the group's draft financial statements for the year ended 30 June 2005, he has come up with a number of queries and he needs your guidance to resolve these queries. Rwizi has a number of subsidiaries which are engaged in activities which include computer software, agriculture, transport and constructions work.

- (a) Computer Ltd., a subsidiary of Rwizi has two centres that are involved in development and sale of computer software. In the year ended 30 June 2004, Computer Ltd had allocated indirect overheads in the ratio 6:4 between development and distribution cost centres respectively. This allocation was changed to a ratio of 1:1 between development and distribution cost centers in the year ending 30 June 2005.

In the year ended 30 June 2004, direct labour costs and attributable overhead costs incurred in the development of original software relating to finished software packages were included in Work in Progress in the Balance Sheet Inventory totals but those relating to the year ending 30 June 2005 have been included in Cost of Sales in the Income Statement. Computer Ltd. has previously included Overhead Costs relating to Software sales in cost of sales and now wishes to change this and include them in Distribution Costs.

Computer Ltd. has previously been expensing interest cost incurred on borrowings relating to construction of computer hardware to the income statement. It now wishes to capitalize such interest and change the method of depreciation from the straight line method over 4 years useful life to a 30% charge per year on a reducing balance basis.

Required:

Advise the director whether the above changes and treatment adopted by Computer Ltd. are permitted under IFRSs and if yes, how should they be dealt with in the financial statements of Computer Ltd?

(15 marks)

- (b) Musa Farm Ltd., another subsidiary of Rwizi, is involved in production, processing and sales of agricultural products. It operates a defined benefit plan. A full actuarial valuation by the Actuary revealed that the present value of the pension obligations on 30 June 2004 was Shs 15 billion and

Shs 20 billion on 30 June 2005. The fair value of the scheme assets (Bonds and Securities) was as below:

	30 June 2005 (Shs. billions)	30 June 2004 (Shs. billions)
Fixed interest/index linked bonds	3.8	6
Equities	13.0	19
Other investments	<u>2.9</u>	<u>4.5</u>
	<u>19.7</u>	<u>29.5</u>

The Actuaries have taken into account of all the changes to the scheme this year which include improved benefits relating to the past services. These benefits vested immediately. The past service cost is Shs 0.25 billion and the current service cost for this year is Shs 0.7 billion. To date, no actuarial gains or losses have been recognized in the income statement.

The expected return on scheme assets for the year ended 30 June 2005 is Shs 2.95 billion and interest on pension liabilities for the year is Shs 2.3 billion. The company has made a Shs 0.6 billion contribution into the pension fund during this period. The net cumulative unrecognized gains at 1 July 2004 were Shs 2.47 billion. The average expected remaining service lives of existing employees is 10 years.

Required:

Advise the Finance Director about the impact of the above on the financial statements of Musa Farm Ltd for the year ended 30 June 2005.

(12 marks)

- (c) On 1 July 2004, Musa Farm Ltd. purchased a dairy building for Shs 100 million. The building qualified for a government grant of Shs. 20 million. The grant has been treated as a deferred credit in the financial statements and the company is entitled to wear and tear allowance on the building cost net of government grant. The dairy building is depreciated on a straight line basis over 10 years and a wear and tear allowance of 25% per annum on reducing balance basis on cost net of government grant can be claimed.

In addition to the above, on 30 June 2005:

- (i) There are other temporary differences of Shs 400 million in respect of deferred tax liabilities.
- (ii) The directors have made a provision for warranties of Shs 40 million that is deductible for tax purposes when costs are actually incurred.
- (iii) The company has unused tax losses of Shs 700 million.
- (iv) Taxation is at a rate of 30%.

Required:

Explain to the finance director the appropriate accounting treatment of the above in the financial statements of Musa Farm Ltd for the year ended 30th June 2005. Your answer should include the computation for deferred tax balance required on 30 June 2005. Also discuss whether the treatment of the grant in the financial statements is consistent with the IASB's "Framework for the Preparation and Presentation of Financial Statements".

(15 marks)

- (d) MZ Enterprises Ltd., another subsidiary of Rwizi, carries out construction work in Northern Uganda. It has entered into a contract to construct a power dam. The details of the contract are as below:

Starting date	1 January 2004
Total contract price	Shs 400 billion
Approximate duration	3 years
Approximate total cost	Shs 280 billion

Total costs incurred to-date are:

30 June 2004	Shs 90 billion
30 June 2005	Shs 285 billion (including Shs 90 billion up to 30 June 2004).

Valuation of work in progress as certified by independent surveyors:

30 June 2004	Shs 120 billion
30 June 2005	Shs 300 billion (including Shs 120 billion up to 30 June 2004)

The progress payment billings as at 30 June 2005 totaled Shs 250 billion. On 1 July 2004, the parties agreed to a variation in contract that involved additional costs of Shs 20 billion and which would attract additional contract revenue of Shs 50 billion.

MZ computes profits on such contracts using the percentage of completion method. Percentage of completion is determined by reference to the value of work certified. Included in costs for the year ended 30 June 2005 is Shs 25 billion which relates to rectification work arising due to the wrong specifications for materials given by the Firm of Civil Engineers contracted by MZ. MZ hopes to recover these costs from the Civil Engineers' firm and they were not part of the original estimate of costs.

Required:

For the benefit of the Finance Director, prepare extracts of the income statement and balance sheet for the above contract to show how they

would be included in the financial statements of MZ Enterprises Ltd for the year to 30 June 2005. (Show all your workings.)

(8 marks)

- (e) MZ Enterprises Ltd. issued a Shs 600 million 8% convertible loan stock at par on 1 July 2004. Loan stock is convertible into equity shares or redeemable at par on 30 June 2006 at the option of the holders. The conversion arrangement is that each Shs 1,000 of loan stock will be converted into 50 equity shares of MZ. Had the option to convert into equity shares been excluded, the interest (coupon) rate would have to be 12% to attract subscribers.

Shs 1 receivable at the end of each year using a discount rate of 12% has a value of:

	Shillings
Year 1	0.90
Year 2	0.82
Year 3	0.74
Year 4	0.66
Year 5	0.56

Required:

Explain to the finance director how the 8% convertible loan stock will be accounted for in the financial statements of MZ.

(10 marks)

(Total 60 marks)

Question 2

- (a) The management of Mecco Co. Ltd, a foreign subsidiary of MEB has previously considered its functional currency to be the Euro. However, as a result of a change in the circumstances affecting the operations of the entity, management has decided that from 1 January 2005 the functional currency of the entity should be the US \$. The exchange rate at that date was €=US \$1.20. The balance sheet of Mecco Co. at 1 January 2005 in its previous functional currency is as follows:

	€
Non-current assets:	
Property, plant and equipment	200,000
Current assets:	
Inventories	10,000
Receivables	20,000
Cash	<u>5,000</u>
	35,000
Current liabilities:	

Payables	15,000
Taxation	<u>3,000</u>
	<u>18,000</u>
Net current assets	<u>17,000</u>
	217,000
Non-current liabilities:	
Long term loan	<u>120,000</u>
	<u>97,000</u>
Share capital	50,000
Retained earnings	<u>47,000</u>
	<u>97,000</u>

Included within the balance sheet at 1 January 2005 are the following items:

1. Equipment with a cost of €33,000 and a net book value of €16,500. The equipment was originally purchased for £20,000 in 2001 and has been translated at the rate ruling at the date of purchase of £1=€ 1.65.
2. Inventory with a cost of €6,000. These were purchased for US\$6,000 and have been translated at the rate ruling at the date of purchase of €1= US \$1.00.
3. Payables of €5,000 representing the US \$6,000 due in respect of the above inventory, translated at the rate ruling at 1 January 2005.
4. Long term loans of €15,000 representing the outstanding balance of £10,000 on a loan taken out to finance the acquisition of the above equipment translated at £1=€1.50, the rate ruling on 1 January 2005.

Required:

- (i) Define a functional currency. (2 marks)
- (ii) What are the primary factors that are required by an entity to consider when determining its functional currency? (4 marks)
- (iii) Prepare the balance sheet of Meco Ltd using the adopted functional currency. (4 marks)

(b)

- (i) What is conceptual framework of accounting? (3 marks)
 - (ii) Why is conceptual framework necessary? (3 marks)
 - (iii) Outline specific major areas covered by the IASBs "Framework". (4 marks)
- (Total 20 marks)**

Question 3

Kyoga Miners Ltd is a company that has for the last 5 years been extracting samples of oils from Lake Kyoga in Western Uganda for potential mining of quality oils and gas extraction. The Government of Uganda has recently granted a 10 year licence to Kyoga Miners Ltd to extract oils and gas from Lake Kyoga. The National Environmental Management Authority (NEMA) has been with the task of ensuring that Kyoga's activities do not have detrimental effect to the environment. The directors of Kyoga Miners Ltd have appointed an inhouse committee to review the company's activities in relation to the effects on the environment.

The committee made the following observations:

1. To ensure that no damage is done to the environment, some of the installations being used will be required to be decommissioned at the end of the licence period. The company has been building up a provision to cater for these costs at the end of the project. This total cost is expected to be Shs 800 million.
2. The Government (Regulatory Authority) carries out regular tests to ensure that the emissions to the environment are kept below the agreed limits specified in the license. There have been a few occasions when emissions that have leaked into the lake have been above specified limits and has filed a legal case against Kyoga. The final fines to be imposed are not yet known but are expected to be around Shs 100 million.
3. The company keeps a check on the level of gases released into the atmosphere. If the levels exceed a certain limit, there is a possibility of acid rains with detrimental effects on aquatic life and humans. The general observation is that these have reduced dramatically over time.

The directors are unsure about the possible effects of all the above scenarios to the users of the financial statements. They require advice on the nature of accounting standards or legislation that relates to the environmental reporting and also wish to know what benefits would be gained from environmental reporting in their corporate reports.

Required:

Write a report to the directors of Kyoga Miners Ltd explaining:

- (a) Current environmental reporting guidelines and requirements. **(7 marks)**
 - (b) Advantages of environmental reporting. **(4 marks)**
 - (c) Disclosures that may be included in the corporate reports / environmental reports relating to observations (1), (2) and (3). **(9 marks)**
- (Total 20 marks)**

Question 4

Some of the recent financial scandals and financial irregularities have been committed through related party transactions and dealings. Organisations often carry on their business activities through subsidiaries and associates and it is inevitable that transactions will occur between group companies but in most cases disclosures in this area are regarded as of low priority.

In 2003, the International Accounting Standard Board revised **IAS 24: Related Party Disclosures** to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

Required:

- (a) Define of a related party as per IAS 24?
(3 marks)
- (b) Explain why the disclosure of related party relationships and transactions is an important issue.
(3 marks)
- (c) What are the major disclosure requirements stipulated in IAS 24.
(4 marks)
- (d) Which of the following transactions are likely to require disclosure under IAS 24?
 - (i) A large, interest-free loan to the reporting company from its major shareholder.
 - (ii) The purchase of raw materials from an associate.
 - (iii) The free use of the reporting company's private jet by the major shareholder's husband.
 - (iv) The purchase of consultancy services from a company that has a director who is the Chief Financial Officer of the reporting company.
 - (v) A large loan from the major shareholder, at normal commercial rates of interest.
 - (vi) Sales of finished goods to an otherwise unconnected company that buys 95% of the reporting company's annual output.
 - (vii) A management charge imposed on the reporting company by its parent.
 - (viii) The annual bonus paid to the Chief Executive
 - (ix) A guarantee given to a bank to support a loan from one of the reporting company's fellow subsidiaries.
 - (x) The reporting company's free use of technical know-how which belongs to its parent.

(10 marks)
(Total 20 marks)