

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

FINANCIAL REPORTING - PAPER 16

TUESDAY, 19 JUNE 2007

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. Tables are provided on page 11.
5. Please, read further instructions on the answer book.

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SECTION A

Question 1

Mamamia Ltd is a company registered in Uganda engaged in the processing of fruit juices. Its head office is situated in Kampala. The company acquired 80% of the ordinary shares in Mambo Ltd, another fruit processing company operating in Western Uganda. With assistance from its external auditors, the company has been complying with International Financial Reporting Standards. However, the draft financial statements for the year ended 31 May 2007 are not yet fully compliant.

Your firm has been appointed auditors for Mamamia Ltd for the year ended 31 May 2007. Mamamia Ltd's Chief Accountant is aware that the financial statements need to be adjusted to comply with the IFRSs; and is seeking your guidance in regard to the following account areas:

(a) Accounting for Impairment Losses

At 31 May 2007, Mamamia Ltd carried out a review for impairment of the net assets of Mambo Ltd, a subsidiary company that was acquired on 1 June 2006. Mambo Ltd comprises a single cash generating unit within the activities undertaken by Mamamia Ltd.

The net assets immediately before the impairment review consisted of the following:

	Carrying value prior to impairment review
	Shs million
Goodwill arising on acquisition	84
UNBS fruit juice processing licence	40
Specialist fruit juice packing plant	97
Other tangible non-current assets	200
Net current assets	60

The following information is relevant to the impairment review:

- Future cash flows expected to arise from the continuation of activities of Mambo Ltd were: 2008: Shs 106 million, 2009: Shs 124 million, 2010: Shs 70 million and 2011: Shs 45 million.
- Mambo Ltd could have been sold on 31 May 2007 for Shs 154 million.

Further investigations revealed the following:

- The fruit processing licence from Uganda National Bureau of Standards (UNBS) had no ascertainable market value, but was expected to generate future economic benefits at least equivalent to its current carrying amount.
- The specialist fruit juice packing machine had been damaged and could no longer be used in the business. Its scrap sale value was Shs 20,000,000.
- For the other tangible non-current assets, the net selling price is not greater than their net book value.
- The net current assets were stated at the lower of cost and net realisable value.

Required:

- (i) Compute the amount of the impairment of Mambo Ltd's cash generating unit arising from the impairment review.
(6 marks)
- (ii) Allocate the impairment loss between the components of Mambo Ltd's net assets.
(4 marks)
- (iii) Show the values of each of the components of the net assets of the Mambo Ltd for inclusion in Mambo Ltd's financial statements immediately after the necessary adjustments have been made, to reflect the results of the impairment review.
(4 marks)

Note: The appropriate discount rate is 11%. Assume you are making your calculations on 31 May 2007.

(b) Accounting for assets held for sale and for continuing use

An extract from the trial balance of Mamamia Ltd (the parent only) showed the following property, plant and equipment:

	Debit Shs Shs million	Credit Ushs Shs million
Land and buildings at cost (Land Shs 40 million)	100	
Plant and equipment at cost	66	
Accumulated depreciation at 1 June 2006		
• Buildings		16
• Plant and equipment		26

- The buildings had an estimated life of 30 years when they were acquired and are depreciated on a straight line basis.
- Mamamia Ltd has a plant that had cost Shs 16,000,000 and which had accumulated depreciation of Shs 6,000,000 by 31 May 2007. Following a review of the company's operations, this plant was made available for sale during the year. Negotiations with a broker concluded that a realistic selling price of this plant would be Shs 7,500,000 and the broker would charge a commission of 8% of the selling price. The plant had not been sold by 31 May 2007. The policy is to depreciate such plants at 20% per annum using the reducing balance method.

Required:

Advise the Chief Accountant on the accounting treatment of the above assets.

(6 marks)**(c) Deferred Taxes**

Although on 1 June 2006 the temporary taxable differences on plant stood at Shs 7,000,000 and on 31 May 2007 declined to Shs 5,000,000, no deferred tax adjustments have been made in the draft financial statements for the year ended 31 May 2007. Assume there were no other temporary differences both on 1 June 2006 and 31 May 2007. Also assume a tax rate of 30%.

Required:

Recommend the accounting treatment for dealing with the reduction in the taxable temporary differences.

(4 marks)**(d) Dividends (In the parent's financial statements)**

An interim dividend of Shs 15,000,000 was paid. The interim dividends paid include half of the full year's preference dividend. On 25 May 2007 the directors declared a final dividend of Shs 12,000 per share plus the balance of the preference dividend. There are 40 million ordinary shares each with a nominal value of Shs 10. There are also 10% redeemable preference shares Shs 1 each totalling Shs 100,000,000. The preference shares are redeemable at par in 2008.

Required:

Advise on the accounting treatment for both the interim and final dividends.

(4 marks)

(e) Accounting policies

Mamamia Ltd sells the packed juice through several retail outlets. In the past the company has undertaken responsibility for any spoilage. The company had not recognised sales in income until the fruits had been successfully sold off to consumers by the retailers because some of the juices could get spoilt in the hands of the retailers in which case the company would have had to refund the retailers. From 1 June 2006 the company changed the trading terms with the retailers. Under the new terms, the risk for any spoilage of the juices in the hands of the retailers rests with the retailers. The retailers are no longer entitled to any refunds. Because of this the company will now recognise sales when the retailers take possession of the juices, rather than when the retailers have successfully sold off to the final consumers.

Required:

Discuss whether the above represents a change in accounting policy.

(5 marks)**(f) Discovered Fraud**

On 6 June 2007 the company's auditors (your firm) discovered a fraud in the Procurement Department. A senior member of staff had been authorising payments for goods that had never been received. The payments were made to a fictitious company that could not be traced. The member of staff was immediately dismissed. Calculations show that the total amount of the fraud to the date of its discovery was Shs 240,000,000 of which Shs 210,000,000 related to the year to 31 May 2007.

The company also contacted its insurers in respect of the fraud. Mamamia Ltd is insured for theft, but the insurance company maintains that this is commercial fraud and is not covered by the theft clause in the insurance policy. Mamamia Ltd had not yet obtained the opinion from its lawyers.

Required:

Advise on how the fraud should be treated in Mamamia's financial statements for the year to 31 May 2007.

(10 marks)**(g) Employee Benefits**

Mamamia operates a pension plan that provides a pension of 20% of final salary for each year of service. The benefits become vested after five years which is the current minimum contract period. The employment contracts state that whoever terminates services before expiry of the

contract forfeits the benefits. In the history of Mamamia Ltd, staff generally serve for long periods and it is unlikely that any will terminate their contracts in the next three years.

On 31 May 2007, the company improved the Pension Scheme to 25% of the final salary for each year of service starting from 31 May 2002. At the date of improvement, the present value of additional benefits for service from 31 May 2002 to 31 May 2007 was as follows:

	Shs million
Employees with more than five years of service at 31 May 2007	75
Employees with less than five years of service at 31 May 2007 (Average period until vesting: 3 years)	<u>60</u>
	<u>135</u>

Required:

Advise the Chief Accountant on the amount of liability that should be recognized as at 31 May 2007 and that to be recognized for the next three years from 31 May 2007.

(6 marks)

(h) Financial Instruments

Mamamia Ltd supplies both registered retailers and wholesalers in Kikuubo. Due to competition, Mamamia Ltd has introduced a three month credit service to its customers. On 1 June 2006 Mamamia Ltd entered into an agreement with Cash for Receivables Ltd, whereby it transferred title of 90% of the Receivables total plus rights to a future sum, the amount of which depended on whether and when debtors paid.

Cash for Receivables Ltd has a right of recourse against Mamamia Ltd for any losses up to an agreed maximum amount.

The position at the year end was that title had been transferred with an invoice value of Shs 67 million. Mamamia Ltd was subject, under agreement, to a maximum potential debit of Shs 800,000 to cover losses.

Required:

- (i) Advise the Chief Accountant on the circumstances under which an enterprise should derecognize a financial asset or liability.

(6 marks)

- (ii) Derive amounts for inclusion in both the Balance Sheet and Income Statement regarding these financial dealings.

(5 marks)

(Total 60 marks)

SECTION B

Question 2

Kwacha is a limited company dealing in servicing of computer equipment for customers in and around Kampala. Kwacha Ltd is planning to list on the Uganda Securities Exchange. In preparation for listing, it wants to benchmark its performance with other companies operating in the same industry.

The management of Kwacha Ltd requested for statistics from Uganda Bureau of Statistics relating to the financial performance of companies in the computer industry sector. The following information was produced by the Uganda Bureau of Statistics:

Average Industrial Ratios in the Computer Industry for periods ended between 1 July 2005 and 30 September 2006

Return on capital employed	22.1%
Net assets turnover	1.8 times
Gross profit margin	30%
Net profit (before tax) margin	12.5%
Current ratio	1.6:1
Quick ratio	0.9:1
Inventory holding period	46 days
Trade receivables collection period	45 days
Trade payables payment period	55 days
Debt to equity ratio	40%
Dividend yield	6%
Dividend cover	3 times

Kwacha's financial statements for the year to 30 September 2006 are set out below:

Income Statement	Shs '000'
Turnover	303,125
Cost of sales	<u>(233,750)</u>
Gross profit	69,375
Other operating expenses	<u>(26,875)</u>
Operating profit	42,500
Interest payable	(4,250)
Exceptional item [note (ii)]	<u>(15,000)</u>
Profit before taxation	23,250
Taxation	<u>(11,250)</u>
Profit after taxation	12,000
Dividends	<u>(11,250)</u>
Net profit for the period	750
Profit and loss reserve - 1 October 2005	<u>22,375</u>
Profit and loss reserve - 30 September 2006	<u><u>23,125</u></u>

Balance Sheet

	Shs '000'	Shs '000'
Property, plant and equipment (note i)		67,500
Current Assets		
Inventory	34,375	
Trade receivables	40,000	
Bank	<u>-</u>	
	<u>74,375</u>	
Creditors: amounts falling due within one year		
Bank overdraft	4,375	
Trade payables	43,750	
Proposed dividends	3,750	
Taxation	<u>10,625</u>	
	<u>(62,500)</u>	11,875
Creditors: amounts falling due after more than one year.		
8% loan notes		<u>(37,500)</u>
		<u>41,875</u>
Share Capital and Reserves		
Ordinary shares (Shs 31,250 each)		18,750
Profit and loss account reserve		<u>23,125</u>
		<u>41,875</u>

Notes:

- (i) The details of the property, plant and equipment are:

	Cost	Accumulated	NBV
		Depreciation	
	Shs '000'	Shs '000'	Shs '000'
At 30 Sept 2006	3,600	3,060	540

- (ii) The exceptional item relates to losses on the service equipment / software and antivirus CDs that had become worthless due to the acquisition by all customers of computers that now use flash disks instead of floppy diskettes.
- (iii) The market price of Kwacha's shares throughout the year averaged Shs 750 each.

Required:

- (a) Using the statistics from above, assess Kwacha Ltd's financial performance and advise management of Kwacha Ltd on the operating results for the year ended 30 September 2006.

(15 marks)

- (b) Give reasons why ratio analysis cannot, at times, be relied upon to compare a company's financial performance with other companies in the same industry.

(5 marks)**(Total 20 marks)****Question 3**

Booma is a well built stadium but is now in a significant cash flow crisis. There is a 'genius' proposal that has been drafted by the Finance Director in an attempt to improve the cash flow of Booma. The Director needs your advice regarding the implications.

Sale and lease back the Stadium

The Stadium is currently accounted for using the cost model in IAS 16, 'Property, Plant and Equipment'. The carrying value will be Shs 120 million at 31 December 2007. The Stadium will have a remaining life of 20 years at 31 December 2007, and uses straight line depreciation. It is proposed to sell the Stadium to Balaba on 1 January 2008 and lease it back under a 20 year finance lease. The sale price and fair value are Shs 15 million which is the present value of the minimum lease payments. The agreement transfers the title of the Stadium back to Booma at the end of the lease period at NIL cost. The rental is Shs 12 million per annum in advance commencing on 1 January 2008. The Finance Director is strongly opposed to treating this transaction as the raising of a secured loan. The implicit rate on the finance in the lease is 5.6%.

Required:

- (a) Discuss the economic substance of the above sale and lease back proposal.

(5 marks)

- (b) With appropriate computations, discuss how the proposal will be dealt with in the financial statements for the year ending 31 December 2008. (Give extracts of the income statement and the balance sheet).

(10 marks)

- (c) Explain the disadvantages of this form of sale and lease back proposal.

(5 marks)**(Total 20 marks)**

Question 4

Muko Ltd, a company dealing in processing of hides and skins for both local and international markets has been advised by other business partners to go public by listing on Uganda Securities Exchange.

The management of Muko Ltd are not sure of the benefits they are going to get on listing their company on the Uganda Securities Exchange and they have approached you for advice.

Required:

- (a) Advise the management of Muko Ltd on the significant benefits that a private company and their shareholders can obtain from going public.
(10 marks)
 - (b) What are the minimum requirements that a company intending to apply for listing, must possess as stipulated in the Uganda Securities Exchange Rules and Regulations?
(6 marks)
 - (c) What major role do accountants / auditors play at the pre-listing period?
(4 marks)
- (Total 20 marks)**

Table 1: PVIF- Present Value of Shs 1 Due at the End of n Periods

Period	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.847	0.833
2	0.842	0.826	0.812	0.797	0.783	0.769	0.756	0.743	0.718	0.694
3	0.772	0.751	0.731	0.712	0.693	0.675	0.658	0.641	0.609	0.579
4	0.708	0.683	0.659	0.636	0.613	0.592	0.572	0.552	0.516	0.482
5	0.650	0.621	0.593	0.567	0.543	0.519	0.497	0.476	0.437	0.402
6	0.596	0.564	0.535	0.507	0.480	0.456	0.432	0.410	0.370	0.335
7	0.547	0.513	0.482	0.452	0.425	0.400	0.376	0.354	0.314	0.279
8	0.502	0.467	0.434	0.404	0.376	0.351	0.327	0.305	0.266	0.233
9	0.460	0.424	0.391	0.361	0.333	0.308	0.284	0.263	0.225	0.194
10	0.422	0.386	0.352	0.322	0.295	0.270	0.247	0.227	0.191	0.162
11	0.388	0.350	0.317	0.287	0.261	0.237	0.215	0.195	0.162	0.135
12	0.356	0.319	0.286	0.257	0.231	0.208	0.187	0.168	0.137	0.112
13	0.326	0.290	0.258	0.229	0.204	0.182	0.163	0.145	0.116	0.093
14	0.299	0.263	0.232	0.205	0.181	0.160	0.141	0.125	0.099	0.078
15	0.275	0.239	0.209	0.183	0.160	0.140	0.123	0.108	0.084	0.065

TABLE 2: PVAF - Present Value of an Annuity of Shs 1 per Period for n Periods

Period	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.847	0.833
2	1.759	1.736	1.713	1.690	1.668	1.647	1.626	1.605	1.566	1.528
3	2.531	2.487	2.444	2.402	2.361	2.322	2.283	2.246	2.174	2.106
4	3.240	3.170	3.102	3.037	2.974	2.914	2.855	2.798	2.690	2.589
5	3.890	3.791	3.696	3.605	3.517	3.433	3.352	3.274	3.127	2.991
6	4.486	4.355	4.231	4.111	3.998	3.889	3.784	3.685	3.498	3.326
7	5.033	4.868	4.712	4.564	4.423	4.288	4.160	4.039	3.812	3.605
8	5.535	5.335	5.146	4.968	4.799	4.639	4.487	4.344	4.078	3.837
9	5.995	5.759	5.537	5.328	5.132	4.946	4.772	4.607	4.303	4.031
10	6.418	6.145	5.889	5.650	5.426	5.216	5.019	4.833	4.494	4.192
11	6.805	6.495	6.207	5.938	5.687	5.453	5.234	5.029	4.656	4.327
12	7.161	6.814	6.492	6.194	5.918	5.660	5.421	5.197	4.793	4.439
13	7.487	7.103	6.750	6.424	6.122	5.842	5.583	5.342	4.910	4.533
14	7.786	7.367	6.982	6.628	6.302	6.002	5.724	5.468	5.008	4.611
15	8.061	7.606	7.191	6.811	6.462	6.142	5.847	5.575	5.092	4.675