

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA(U) EXAMINATIONS

### LEVEL FOUR

#### FINANCIAL REPORTING - PAPER 16

**TUESDAY, 11 DECEMBER 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 10.
5. Please, read further instructions on the answer book.

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**SECTION A****Question 1**

Triumph Enterprises Ltd is a public company registered in Uganda. Management is in the process of preparing financial statements for the year ended 30 June 2007 but has approached you for advice in order to comply with International Financial Reporting Standards on the following issues:

- (a) The company uses Uganda shillings (UShs) as its functional currency. At the beginning of the financial year, it had planned to purchase a plant worth US\$ 1 million at the year end. On the advice of a consultant, the company entered into a forward contract on 1 July 2006 to purchase US\$ 1 million on 30 June 2007 for a fixed amount of UShs 1,650 million.

At inception, the forward contract had a fair value of zero and was designated as a cash flow hedge.

At the year end 30 June 2007, the US\$ had appreciated and the value of \$1 million was UShs 1,660 million. The company settled the forward contract with no further change in the exchange rate and purchased the plant.

**Required:**

- (i) Explain to management the meaning of hedge accounting, distinguishing between a fair value hedge and a cash flow hedge.

**(4 marks)**

- (ii) Advise on how the above transactions should be treated in the books of Triumph Enterprises Ltd.

**(5 marks)**

- (b) Due to frequent power cuts in the recent past, the Government of Uganda extended a grant to Triumph Enterprises Ltd worth UShs 30 million to enable it purchase a generator at subsidized rate.

In July 2006, the generator was purchased at UShs 200 million. The machine is estimated to have a useful life of 10 years and will be depreciated on a straight line basis.

**Required:**

Advise Triumph Enterprises Ltd on the accounting treatment of government grants related to assets.

**(5 marks)**

- (c) In the course of the year, the company got a loan from a bank to finance the construction of a new factory in another town. The construction exercise is estimated by site engineers to last three years. The accountant

of Triumph Enterprises Ltd has expensed the related interest on the loan which has led to finance costs look abnormal in the financial statements.

**Required:**

Explain the reasons for capitalising borrowing costs and the accounting rules set out in **IAS 23: Borrowing Costs**, for capitalising interest.

**(4 marks)**

- (d) Triumph Enterprises Ltd has not had an impressive cash performance but in order to cope with industry rivalry, management decided to lease some modern information technology equipment. There are four annual lease payments of US\$ 4 million each commencing on 30 June 2007. The fair value of the equipment is US\$ 11.8 million. The implicit rate of interest is 15%. Experts anticipate that due to rapid technological advancement, the equipment could have a useful life of only four years. The policy of Triumph Enterprises Ltd is to depreciate such assets on a straight line basis.

**Required:**

- (i) Explain to management the accounting treatment of a finance lease in the books of the lessee.

**(4 marks)**

- (ii) Show how the above lease arrangement will be dealt with in the financial statements of Triumph Enterprises Ltd for the year ended 30 June 2007.

**(8 marks)**

- (e) Triumph Enterprises Ltd has an 80% owned subsidiary; Rwanda Telecommunications Ltd. For the year ended 30 June 2007, a gain of US\$ 320 million was made on the translation of the financial statements of the subsidiary. The gain is made up as follows:

	US\$ million
Gain on opening net assets	
Non current assets	180
Inventories	60
Receivables	100
Payables	(80)
Cash	<u>60</u>
	<u>320</u>

**Required:**

- (i) Advise Triumph Enterprises Ltd on the treatment of the above foreign exchange gain in the group financial statements for the year ended 30 June 2007.

**(3 marks)**

- (ii) Explain the factors that management should consider in determining the functional currency of Rwanda Telecommunications Ltd.

**(3 marks)**

- (f) Triumph Enterprises Ltd issued share options on 1 December 2006 to pay for the purchase of inventory. The inventory was eventually sold on 30 June 2007. The value of the inventory on 1 December 2006 was UShs 16 million and this value remained unchanged up to the date of sale. The sale proceeds were UShs 18 million. The shares issued have a market value of UShs 16.3 million.

The company also granted 100 share appreciation rights to each of its 600 employees on 1 July 2006. Management feels that as at the year end of 30 June 2007, 60% of the awards will vest on 30 June 2008. The fair value of each share appreciation right on 30 June 2007 was UShs 2,000.

**Required:**

How will the above issues be dealt with in the financial statements in order to comply with **IFRS 2: Share-based Payment**?

**(5 marks)**

- (g) At the beginning of July 2003, Triumph Enterprises Ltd issued a five year debt instrument of UShs 150 million that has an effective and original interest of 7%, receivable at the end of each year and a principal amount of UShs 150 million at maturity. At the beginning of June 2006, there was evidence of impairment due to financial difficulties of the borrower. It is estimated that the remaining future cash flows will be UShs 75 million instead of UShs 160.50 million.

**Required:**

What is the accounting treatment of an impairment of a financial instrument in accordance with **IAS 39: Financial Instruments, Recognition and Measurement**?

**(5 marks)**

- (h) Over the years, Triumph Enterprises Ltd has established a good customer image and has a patent right for its newly developed innovation. Management are considering recognizing the triumphant brand as an intangible asset on the balance sheet.

**Required:**

Explain to management the meaning of an intangible asset and the recognition criteria for intangible assets.

**(4 marks)**

- (i) Triumph Enterprises Ltd operates a defined benefit retirement plan. The plan showed the following information as at 30 June 2007:

Discount rate at the start of the year	8%
Expected rate of return on plan assets at start of year	10%
	<b>Ushs million</b>
Current service costs	260
Benefits paid	300
Contributions received	180
Present value of obligation at the start of year	2,000
Present value of obligation at the year end	2,200
Market value of plan assets at the start of the year	2,000
Market value of plan assets at the year end	2,380

There was no unrecognized actuarial gains or losses at the beginning of the year.

**Required:**

- (i) Explain the difference between a defined contribution plan and a defined benefit plan.

**(2 marks)**

- (ii) Compute the actuarial gains or losses on the present value of the obligations and on the market value of the plan assets for the year ended 30 June 2007

**(4 marks)**

- (iii) In as far as the information permits, calculate the figures to appear in the income statement and the balance sheet at the end of the year, 30 June 2007.

**(4 marks)****(Total 60 marks)**

**SECTION B****Question 2**

United We Stand Ltd (UWSL), a public limited company, purchased shares in two public limited companies. The details of the purchases are as follows:

	<b>Crown Ltd</b>	<b>Regal Ltd</b>
Date of share purchase	1 Feb 2006	1 Jul 2006
	<b>Shs billion</b>	<b>Shs billion</b>
Ordinary share capital of Shs 1,000 per share	800	600
Accumulated reserves on acquisition	400	200
Cost of investment	1,130	820
Ordinary share capital acquired of Shs 1,000 per share	600	480
Fair value of net assets on acquisition	1,400	900

The draft income statements for the three companies for the year ended 30 June 2007 are:

	<b>UWSL</b>	<b>Crown Ltd</b>	<b>Regal Ltd</b>
	<b>Shs billion</b>	<b>Shs billion</b>	<b>Shs billion</b>
Revenue	4,000	3,200	2500
Cost of sales	<u>(3,000)</u>	<u>(2,800)</u>	<u>(2,360)</u>
Gross profit	1,000	400	140
Distribution costs	(240)	(80)	(52)
Administrative expenses	<u>(200)</u>	<u>(72)</u>	<u>(68)</u>
Profit from operations	560	248	20
Interest expense	(20)	(8)	(40)
Dividends received (includes group income)	<u>100</u>	<u>-</u>	<u>-</u>
Profit/(loss) before tax	640	240	(20)
Income tax expense	<u>(180)</u>	<u>(72)</u>	<u>(12)</u>
Net profit /(loss) from ordinary activities	<u>(460)</u>	<u>168</u>	<u>(32)</u>
Accumulated profit at 1 July 2006	700	500	200

Additional information:

- (i) On 1 January 2007, UWSL sold the following shareholdings in the companies:

	<b>Crown Ltd</b>	<b>Regal Ltd</b>
	<b>Shs billion</b>	<b>Shs billion</b>
Sale of ordinary share capital of Shs 1,000 per share	120	240
Sale proceeds	280	400

- (ii) Crown Ltd sold Shs 200 billion of goods to UWSL during the year. The opening inventory of such goods held by UWSL was Shs 40 billion and the

closing inventory Shs 60 billion. The profit on these goods was 20% on selling price.

- (iii) At the date of acquisition, the fair value of the tangible depreciable non-current assets of Crown Ltd was Shs 20 billion above their carrying value and that of the non-depreciable land was Shs 180 billion above its carrying value. The fair value of the tangible non-current assets of Regal Ltd was equivalent to its carrying value. Depreciation on all group tangible non-current assets is at 20% per annum on the carrying value of the asset with a full year's charge in the year of acquisition.
- (iv) UWSL is carrying out a review of the carrying value of goodwill as at 30 June 2007. This first year review is based upon the following information:

#### **Crown Ltd**

On acquisition, the management of UWSL expected pre-tax profits for the year to 30 June 2007 to be Shs 230 billion.

#### **Regal Ltd**

On acquisition, it was anticipated that Regal Ltd would be profitable for at least five years. At 30 June 2007 changes in business regulations have resulted in the net assets having a value in use of Shs 920 billion and an estimated net selling price of Shs 860 billion as at 30 June 2007 of Regal Ltd as a cash generating unit.

The directors of Regal Ltd are currently developing a new product which will hopefully increase the value in use of Regal Ltd in future years.

- (v) UWSL had paid a dividend of Shs 40 billion and Crown Ltd had paid a dividend of Shs 80 billion in May 2007.
- (vi) The fair value adjustments had not been incorporated into the subsidiary's records and the sale of shares had not been accounted for by UWSL. Assume that profits accrue evenly and that there are no other items of income, expense or capital other than those mentioned above. Taxation on any capital gain can be ignored.
- (vii) Depreciation is charged to the income statement as part of cost of sales.
- (viii) Ignore any inter company profits in inventory when calculating the gain/loss on disposal of shares.

#### **Required:**

Prepare a consolidated income statement for the United We Stand Group for the year ended 30 June 2007 in accordance with International Financial Reporting Standards.

**(20 marks)**

### Question 3

Trinity Enterprises Ltd (TEL) has not been preparing a complete set of financial statements that fully comply with International Financial Reporting Standards (IFRSs). However, for the year ended 31 December 2006 the accountant of TEL wants to prepare financial statements that comply with IFRSs and has approached you for guidance. The summarized consolidated balance sheet of TEL that is not fully compliant with IFRSs at 1 January 2005 is:

	Shs million	Shs million
<b>Non-current assets</b>		
Property, plant and equipment		2,000
Goodwill		900
Development costs		<u>800</u>
		3,700
<b>Current assets</b>		
Inventory	300	
Trade receivables	500	
Bank	<u>40</u>	
	840	
<b>Current liabilities</b>	<u>(640)</u>	
Net current assets		<u>200</u>
		3,900
<b>Non-current liabilities</b>		
Restructuring provision	(500)	
Deferred tax	(600)	<u>(1,100)</u>
		<u>2,800</u>
Issued capital		1,000
Retained earnings		<u>1,800</u>
		<u>2,800</u>

Additional information:

- (i) TEL's depreciation policy for its property, plant and equipment has been based on tax rules set by its government. The carrying value of property, plant and equipment as at 1 January 2005 would have been Shs 1,600 million.
- (ii) The development costs originate from TEL's subsidiary and do not qualify for recognition under IFRSs. They have a tax base of nil and the deferred tax related to these costs is Shs 200 million.
- (iii) The inventory has been valued at prime cost. Under IFRSs, it would include an additional Shs 60 million.
- (iv) The restructuring provision does not qualify for recognition under IFRSs.



- (v) Based on IFRSs, the deferred tax provision required at 1 January 2005 including the effects of the development expenditure is Shs 720 million.

**Required:**

- (a) Advise the accountant of TEL on the accounting areas where the company has not been complying with International Financial Reporting Standards, stating the required adjustments towards IFRS compliance. **(7 marks)**
- (b) Prepare an adjusted summarized balance sheet for TEL as at 1 January 2005 taking into account the requirements of IFRSs.

**(13 marks)**

**(Total 20 marks)**

**Question 4**

Corporate governance is the system by which companies are directed and managed. It influences how objectives of the company are set and achieved, how risks are monitored and assessed and how performance is optimised.

On learning that good corporate governance is central to good corporate performance, and that good corporate governance structures encourage companies to create value (through entrepreneurship, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved, the management of AB Ltd are excited about putting in place an effective corporate governance system. You have been approached as an expert to give guidance to the management of AB Ltd on corporate governance issues.

**Required:**

- (a) Advise the management of AB Ltd on the key elements / features of a strong governance structure. **(9 marks)**
- (b) Explain to the management the main principles of an effective code of corporate governance under the headings:
- (i) Board Effectiveness. **(8 marks)**
- (ii) Accountability and Audit. **(3 marks)**

**(Total 20 marks)**

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

Period	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.93	0.92	0.91	0.90	0.90	0.89	0.88	0.87	0.87	0.86	0.84	0.83
2	0.87	0.85	0.84	0.82	0.81	0.79	0.78	0.76	0.75	0.74	0.71	0.69
3	0.81	0.79	0.77	0.75	0.73	0.71	0.69	0.67	0.65	0.64	0.60	0.57
4	0.76	0.73	0.70	0.68	0.65	0.63	0.61	0.59	0.57	0.55	0.51	0.48
5	0.71	0.68	0.65	0.62	0.59	0.56	0.54	0.51	0.49	0.47	0.43	0.40
6	0.66	0.63	0.59	0.56	0.53	0.50	0.48	0.45	0.43	0.41	0.37	0.33
7	0.62	0.58	0.54	0.51	0.48	0.45	0.42	0.40	0.37	0.35	0.31	0.27
8	0.58	0.54	0.50	0.46	0.43	0.40	0.37	0.35	0.32	0.30	0.26	0.23
9	0.54	0.50	0.46	0.42	0.39	0.36	0.33	0.30	0.28	0.26	0.22	0.19
10	0.50	0.46	0.42	0.38	0.35	0.32	0.29	0.27	0.24	0.22	0.19	0.16
11	0.47	0.42	0.38	0.35	0.31	0.28	0.26	0.23	0.21	0.19	0.16	0.13
12	0.44	0.39	0.35	0.31	0.28	0.25	0.23	0.20	0.18	0.16	0.13	0.11
13	0.41	0.36	0.32	0.29	0.25	0.22	0.20	0.18	0.16	0.14	0.11	0.09
14	0.38	0.34	0.29	0.26	0.23	0.20	0.18	0.16	0.14	0.12	0.09	0.07
15	0.36	0.31	0.27	0.23	0.20	0.18	0.16	0.14	0.12	0.10	0.08	0.06

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

Period	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.93	0.92	0.91	0.90	0.90	0.89	0.88	0.87	0.87	0.86	0.84	0.83
2	1.80	1.78	1.75	1.73	1.71	1.69	1.66	1.64	1.62	1.60	1.56	1.52
3	2.62	2.57	2.53	2.48	2.44	2.40	2.36	2.32	2.28	2.24	2.17	2.10
4	3.38	3.31	3.24	3.17	3.10	3.03	2.97	2.91	2.85	2.79	2.69	2.58
5	4.10	3.99	3.89	3.79	3.69	3.60	3.51	3.43	3.35	3.27	3.12	2.99

	0	3	0	1	6	5	7	3	2	4	7	1
	4.76	4.62	4.48	4.35	4.23	4.11	3.99	3.88	3.78	3.68	3.49	3.32
6	7	3	6	5	1	1	8	9	4	5	8	6
	5.38	5.20	5.03	4.86	4.71	4.56	4.42	4.28	4.16	4.03	3.81	3.60
7	9	6	3	8	2	4	3	8	0	9	2	5
	5.97	5.74	5.53	5.33	5.14	4.96	4.79	4.63	4.48	4.34	4.07	3.83
8	1	7	5	5	6	8	9	9	7	4	8	7
	6.51	6.24	5.99	5.75	5.53	5.32	5.13	4.94	4.77	4.60	4.30	4.03
9	5	7	5	9	7	8	2	6	2	7	3	1
	7.02	6.71	6.41	6.14	5.88	5.65	5.42	5.21	5.01	4.83	4.49	4.19
10	4	0	8	5	9	0	6	6	9	3	4	2
	7.49	7.13	6.80	6.49	6.20	5.93	5.68	5.45	5.23	5.02	4.65	4.32
11	9	9	5	5	7	8	7	3	4	9	6	7
	7.94	7.53	7.16	6.81	6.49	6.19	5.91	5.66	5.42	5.19	4.79	4.43
12	3	6	1	4	2	4	8	0	1	7	3	9
	8.35	7.90	7.48	7.10	6.75	6.42	6.12	5.84	5.58	5.34	4.91	4.53
13	8	4	7	3	0	4	2	2	3	2	0	3
	8.74	8.24	7.78	7.36	6.98	6.62	6.30	6.00	5.72	5.46	5.00	4.61
14	5	4	6	7	2	8	2	2	4	8	8	1
	9.10	8.55	8.06	7.60	7.19	6.81	6.46	6.14	5.84	5.57	5.09	4.67
15	8	9	1	6	1	1	2	2	7	5	2	5