

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL THREE

FINANCIAL REPORTING - PAPER 13

THURSDAY, 19 JUNE 2008

INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours**
2. Section **A** has **one** compulsory question carrying 30 marks.
3. Section **B** has **three** questions and only **two** questions are to be attempted. Each question carries 15 marks.
4. Section **C** has **three** questions and only **two** questions are to be attempted. Each question carries 20 marks.
5. Tables are provided on page 12.
6. Please, read further instructions on the answer book.

SECTION A: FINANCIAL REPORTING IN THE PRIVATE SECTOR**Question 1**

Spick and Span Limited (S&S Ltd) is a company registered in Uganda. The company's virtuous image is built on the superior quality services it offers in every aspect of its business. In order to prepare flawless financial statements, the directors have approached you as a Certified Public Accountant of Uganda to advise their chief accountant in the following areas:

- (a) S&S Ltd has owned 80% of Pristine Ltd since its incorporation. On 1 July 2006, Pristine Ltd had issued share capital of Shs 360 million. On 30 September 2006, Pristine Ltd issued 100,000 Shs 3,600 ordinary shares to third parties for a consideration of Shs 360 million. At 1 July 2006, Pristine Ltd's reserves were Shs 360 million.

The summarised income statements for the two companies for the year ended 30 June 2007 are as follows:

	S&S Ltd Shs million	Pristine Ltd Shs million
Profit before tax	720	216
Tax	<u>(252)</u>	<u>(75.6)</u>
	468	140.4
Dividend paid	<u>(144)</u>	
Retained for year	<u>324</u>	

Required:

- (i) Explain the circumstances that give rise to a deemed disposal.
(4 marks)
- (ii) What will be the impact of the above share issue on the consolidated income statement of S&S group, ignoring goodwill?
(6 marks)
- (b) S&S Ltd invests in developing software hence incurring significant amounts in research and development costs. During the accounting year under consideration, a total amount of Shs 40 million was spent on such related expenses. Of this amount, Shs 15 million was spent on a project still in the research phase whose outcomes are yet uncertain. The rest of the amount was spent on a project which is in the development phase. The chief accountant is not very conversant with the accounting for development costs but the directors wish to ensure that the treatment strictly complies with **IAS 38: Intangible Assets**.

Required:

Draft a memo advising the directors of S&S Ltd on the recognition criteria and accounting treatment for the above expenses in accordance with **IAS 38: Intangible Assets**.

(8 marks)

- (c) S&S Ltd is allowed a tax deduction equal to the intrinsic value of the share options at the exercise date if the share options were granted in exchange for employee services. The company grants share options to its employees with a fair value of Shs 144 million at the grant date. The share options vest in three years time provided the employees will still be in company service. Given that the intrinsic value of the options is Shs 126 million, the tax rate applicable to the company is 30% and the company expects that all the options will vest and be exercised:

Required:

How will the share options be accounted for in order to comply with **IFRS 2: Share-based Payment** and **IAS 12: Income Taxes**?

(8 marks)

- (d) Few years ago, S&S Ltd had obtained rights to explore and evaluate the county's reserves of gold in the Karamoja area. Results as of now, however, seem to indicate a demonstrable technical feasibility and commercial viability of extracting the gold. The directors are not sure whether this represents impairment in their evaluation and exploration assets.

Required:

Explain the facts and circumstances that would trigger a need to test evaluation and exploration assets for impairment in accordance with **IFRS 6: Exploration for and Evaluation of Mineral Resources**.

(4 marks)**(Total 30 marks)**

SECTION B: FINANCIAL REPORTING IN THE PRIVATE SECTOR**Question 2**

Alpha Ltd, a company registered in Uganda acquired 100% of the ordinary share capital of Beta Ltd which is incorporated in Kenya, on 1 July 2006. The identifiable net assets of Beta Ltd at the time of acquisition by Alpha Ltd were KShs 468,000.

As at the end of the financial year 2006/2007, the following balances were extracted from the books of the two companies:

	Alpha Ltd US\$ '000	Beta Ltd KShs '000
Non-current assets at cost	18,000	600
Inventory 30 June 2007	4,800	372
Investment in Beta	12,000	-
Cash	1,200	45
Expenses	10,800	360
Depreciation	1,800	96
Dividend paid	<u>1,200</u>	<u>66</u>
	<u>49,800</u>	<u>1,539</u>
Issued share capital	6,000	300
Reserves 30 June 2006	15,300	213
Trading income	18,000	570
Payables	2,100	90
Dividend received	1,200	-
Accumulated depreciation	7,200	216
Long-term loan	-	<u>150</u>
	<u>49,800</u>	<u>1,539</u>

Additional information:

- (i) Beta Ltd acquired all its non-current assets on 1 April 2005. At that time, Beta Ltd did not have sufficient cash to pay for the purchase hence secured a loan of KShs 150,000 which it had not repaid by 30 June 2007.
- (ii) Alpha Ltd uses the closing rate method of currency translation as per **IAS 21: The Effects of Changes in Foreign Exchange Rates**, using the average rate to translate income statement items.

- (iii) The following table provides the movement in exchange rates between the KShs and the US\$:

30 March 2005	US\$ 24 = KShs 1
1 July 2006	US\$ 23 = KShs 1
1 July 2007	US\$ 22 = KShs 1
Average 2006/2007	US\$ 21 = KShs 1
30 June 2007	US\$ 20 = KShs 1

Required:

Prepare:

- (a) a consolidated income statement for the year ended 30 June 2007 for the Alpha Ltd group. **(8 marks)**
- (b) a consolidated balance sheet for the Alpha Ltd group as at 30 June 2007. **(4 marks)**
- (c) a schedule of movement in group reserves.

(3 marks)

(Total 15 marks)

Question 3

Balyaki Limited develops and manufactures bee-keeping tool kits. It sells its products to a variety of vendors around Uganda, who in turn sell to the individual bee-keepers.

The company is in the process of finalising its draft financial statements for the year ended 31 May 2008. The Finance Director is locked in a major debate with the partner in charge of external audit.

During the year the company spent a material sum of amount attending a major Bee-Keepers Trade Fair. This was the first time that the company was attending that event. The trade fair is the biggest opportunity for all bee-keeping interested individuals in the region. The bee-keepers show attracts potential bee-keepers as well. The show lasted for one week in November 2007. It is now June 2008 and not a single order has been generated from the potential customers who attended Balyaki's presentation at the trade fair.

The audit partner feels very strongly that the cost of attending the fair should be written off as an expense. Balyaki's Finance Director feels equally strong that the cost should be capitalised as an asset. He argues that the contacts made at the fair are likely to take years to generate new business and that the investment in show-attendance should be carried forward until those orders start coming in. He further argues that the cost should be capitalised on the grounds that it meets the definition of an asset, as laid down by the International Accounting

Standards Board (IASB)'s Framework for the preparation and presentation of financial statements.

Required:

- (a) Explain the importance of IASB's Framework in the reporting of corporate performance and whether it takes into account the business and legal constraints placed upon companies.

(7 marks)

- (b) Discuss the Finance Director's assertion that the money spent on attending the Bee-Keepers' Trade Fair should be treated as an asset.

(8 marks)

(Total 15 marks)

Question 4

- (a) Explain the functions of the Capital Markets Authority (CMA) in Uganda.

(4 marks)

- (b) **IFRS 7:** Financial Instruments: Disclosures, requires an enterprise to disclose information that enables users of the financial statements to evaluate the significance of financial instruments for financial position and performance and information about the nature and extent of risks arising from financial instruments.

Required:

Explain the terms 'market risk', 'credit risk' and 'liquidity risk' and the disclosure requirements in respect of **IFRS 7:** Financial Instruments: Disclosures.

(11 marks)

(Total 15 marks)

SECTION C: FINANCIAL REPORTING IN THE PUBLIC SECTOR

Question 5

The Works Department of the government has a contract to build a bridge on a main highway to an upcountry municipality. The department is funded by Appropriation. The construction contract identifies construction requirements including anticipated costs, technical specifications and timing of completion but does not provide for any recovery of construction costs directly from the department.

The construction contract is a key management planning and accountability document attesting to the design and construction qualities of the bridge. It is used as input in assessing the performance of the contracting parties in delivering services of agreed technical specifications. It is also used as an input to future cost projections and apparently, it is a non-commercial project.

The initial estimate of contract costs is Shs 20 billion. It will take three years to build the bridge. An Aid Agency has agreed to provide funding of Shs 10 billion being half of the construction costs; this is specified in the construction contract.

By the end of year 1, the estimate of contract costs has increased to Shs 20.125 billion. The Aid Agency agrees to fund half of this increase in estimated costs.

In year 2, the government approves a variation resulting in estimated additional contract costs of Shs 375 million. The Aid Agency agrees to fund 50% of this variation. At the end of year 2, costs incurred include Shs 250 million for standard materials stored at the site to be used in year 3 to complete the project.

The Works Department determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to-date bears to the latest estimated total contract costs.

A summary of the financial data during the construction period is as follows:

	Year 1	Year 2	Year 3
	Shs million	Shs million	Shs million
Initial amount of revenue agreed in contract	10,000	10,000	10,000
Variation in contract revenue	-	250	250
Total contract revenue	10,000	10,250	10,250
Contract costs incurred to-date	5,232.5	15,420	20,500
Contract costs to complete	14,892.5	5,080	-
Total estimated contract costs	20,125	20,500	20,500
Stage of completion	26%	74%	100%

The stage of completion for year 2 (74%) is determined by excluding from contract costs incurred for work performed to-date the Shs 250 million for standard materials stored at the site for use in year 3.

Required:

- (a) Explain the meaning of the term 'Appropriation'.
(2 marks)
 - (b) Show how the contract revenue and expenses will be recognised in the statement of financial performance over the three years in accordance with **IPSAS 11**: Construction Contracts.
(14 marks)
 - (c) Explain the disclosure requirements of **IPSAS 23**: Revenue from Non-Exchange Transactions (Taxes and Transfers) in the general purpose financial statements of a government entity.
(4 marks)
- (Total 20 marks)**

Question 6

- (a) According to **IPSAS 21**: Impairment of Non-Cash-Generating Assets, a non-cash-generating asset for the government is said to be impaired when the carrying amount of the asset exceeds its recoverable service amount.

Required:

What are the internal and external indicators of impairment in a non-cash generating asset?

(3 marks)

- (b) IPSAS 21 defines the value in use of a non-cash-generating asset as the present value of the asset's remaining service potential. The present value of the remaining service potential of the asset is determined using any of the approaches identified in the standard.

Required:

Explain the following approaches which appear in IPSAS 21:

- (i) Depreciated Replacement Cost Approach. (2 marks)
 - (ii) Restoration Cost Approach. (2 marks)
 - (iii) Service Units Approach. (2 marks)
- (c) (i) In 1992, a district authority constructed a primary school at a cost of Shs 1 billion, to serve a population averaging 900 pupils per year.

The entity estimated the school would be used for 50 years. In 2007, the enrollment declined from 900 to 250 students as a result of the

population shift caused by the extreme flooding and submergence of many settlements in the area. The management decided to close three of the five blocks constructed. The district authority has no expectation that enrollments will increase in the future such that the other blocks would be reopened. The current replacement cost of one of the blocks is estimated at Shs 260 million.

Required:

Evaluate the impairment using the Depreciated Replacement Cost Approach.

(4 marks)

- (ii) In 2003, the district acquired a double cabin 4 wheel-drive pick up vehicle at a cost of Shs 40 million to be used by the internal audit department. The district estimated the vehicle to have a useful life of 8 years. In 2007, the vehicle sustained damage in a road accident requiring Shs 8 million to be restored to a usable condition. The restoration would not affect the useful life of the asset. The cost of a new vehicle to deliver a similar service was Shs 50 million in 2007.

Required:

Evaluate the impairment using the Restoration Cost Approach.

(3 marks)

- (d) Explain two external factors that may indicate that an impairment loss recognised in prior periods for a non-cash generating asset of the government may no longer exist or may have decreased.

(4 marks)

(Total 20 marks)

Question 7

- (a) Information about cash receipts, cash payments and cash balances of a government entity is necessary for accountability purposes and provides inputs useful for assessments of the ability of the government to generate adequate cash in the future and the likely sources and uses of cash. In making and evaluating decisions about the allocation of cash resources and the sustainability of government's activities, users of government financial statements require an understanding of the timing and certainty of cash receipts and cash payments. For government entities that are not business enterprises, the International Public Sector Accounting Standards Board (IPSASB) therefore affirms that compliance with the requirements and encouragements of the Cash Basis International Public Sector Accounting Standards (IPSAS) will enhance comprehensive and

transparent financial reporting of the cash receipts, cash payments and cash balances of the government as well as enhancing comparability with the government's own financial statements of previous periods and with the financial statements of other governments which adopt the cash basis of accounting.

Required:

- (i) It has been argued that the above assertion does not go uncontested. Examine the weaknesses of the cash basis of accounting. (8 marks)
- (ii) What are the characteristics of a government business enterprise? (4 marks)
- (b) A government entity has been preparing financial statements on an accruals basis and the following information was extracted from the statement of financial performance for the year ended 30 June 2007:

	Note	Shs million
Revenue		
Taxes	1	4,000
Fees, fines, penalties and licenses	2	800
Revenue from exchange transactions		-
Transfers from other government entities		-
Other revenue	3	<u>100</u>
Total Revenue		<u>4,810</u>
Expenses		
Wages, salaries and employee benefits	3	1,200
Grants and other transfer payments		-
Supplies and consumables used	4	900
Depreciation and amortization expense		1,000
Impairment of property, plant and equipment		400
Other expenses	5	30
Finance costs	6	<u>135</u>
Total Expenses		<u>3,665</u>
Surplus		<u>1,145</u>

Additional information:

1. Tax receivables for the year amount to Shs 1.6 billion and tax arrears received amounted to Shs 1.1 billion.
2. This is a 20% decline in comparison to the previous year's amount. Thirty percent of these revenues always remain in arrears at the year end but records show that such amounts are always cleared in the first quarter of

the new year. There are no prepayments for fines and penalties but prepaid licences and fees at the end of the year amounted to Shs 6 million.

3. The entity was given a grant of Shs 10 million to be received annually by an international organisation to provide scholarships for AIDS orphans and low-income children for a ten year period starting 2005. This is included in other revenues. The children did attend school, but the organisation has not yet sent in the cheque for the year 2006/7. Consequently, the entity has not paid salaries for some staff for the last month amounting to Shs 5 million. In January 2007, the organisation, however, did send the balance of Shs 5 million for the year 2005/6.
4. 10% of the supplies and consumables used are not yet paid for.
5. On 1 May 2007, the entity paid the insurance premium for its fire policy covering the period from 1 July 2007 to 30 June 2008. The amount paid was Shs 2,400,000 and the respective amount for the accounting period is accrued and included in other expenses.
6. Repayments in respect of loans amount to Shs 1.5 billion. The entity was able to pay its outstanding interest amounting to Shs 60 million in this financial year. Some accrued interest amounting to Shs 45 million will be paid at the beginning of the next year. Due to cash flow problems, the entity had to raise another loan equal to the one redeemed in amount.
7. The entity purchased equipment worth Shs 750 million in cash. One third of the amount used was raised from auctioning of the old equipment that was replaced.

Required:

Using the above information, prepare a statement of cash receipts and payments for the year ended 30 June 2007 in accordance with the requirements of the cash basis IPSAS.

(8 marks)
(Total 20 marks)

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

Period	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.943	0.935	0.926	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.847	0.833
2	0.890	0.873	0.857	0.842	0.826	0.812	0.797	0.783	0.769	0.756	0.743	0.718	0.694
3	0.840	0.816	0.794	0.772	0.751	0.731	0.712	0.693	0.675	0.658	0.641	0.609	0.579
4	0.792	0.763	0.735	0.708	0.683	0.659	0.636	0.613	0.592	0.572	0.552	0.516	0.482
5	0.747	0.713	0.681	0.650	0.621	0.593	0.567	0.543	0.519	0.497	0.476	0.437	0.402
6	0.705	0.666	0.630	0.596	0.564	0.535	0.507	0.480	0.456	0.432	0.410	0.370	0.335
7	0.665	0.623	0.583	0.547	0.513	0.482	0.452	0.425	0.400	0.376	0.354	0.314	0.279
8	0.627	0.582	0.540	0.502	0.467	0.434	0.404	0.376	0.351	0.327	0.305	0.266	0.233
9	0.592	0.544	0.500	0.460	0.424	0.391	0.361	0.333	0.308	0.284	0.263	0.225	0.194
10	0.558	0.508	0.463	0.422	0.386	0.352	0.322	0.295	0.270	0.247	0.227	0.191	0.162
11	0.527	0.475	0.429	0.388	0.350	0.317	0.287	0.261	0.237	0.215	0.195	0.162	0.135
12	0.497	0.444	0.397	0.356	0.319	0.286	0.257	0.231	0.208	0.187	0.168	0.137	0.112
13	0.469	0.415	0.368	0.326	0.290	0.258	0.229	0.204	0.182	0.163	0.145	0.116	0.093
14	0.442	0.388	0.340	0.299	0.263	0.232	0.205	0.181	0.160	0.141	0.125	0.099	0.078
15	0.417	0.362	0.315	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	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%	18%	20%
1	0.943	0.935	0.926	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.847	0.833
2	1.833	1.808	1.783	1.759	1.736	1.713	1.690	1.668	1.647	1.626	1.605	1.566	1.528
3	2.673	2.624	2.577	2.531	2.487	2.444	2.402	2.361	2.322	2.283	2.246	2.174	2.106
4	3.465	3.387	3.312	3.240	3.170	3.102	3.037	2.974	2.914	2.855	2.798	2.690	2.589
5	4.212	4.100	3.993	3.890	3.791	3.696	3.605	3.517	3.433	3.352	3.274	3.127	2.991
6	4.917	4.767	4.623	4.486	4.355	4.231	4.111	3.998	3.889	3.784	3.685	3.498	3.326
7	5.582	5.389	5.206	5.033	4.868	4.712	4.564	4.423	4.288	4.160	4.039	3.812	3.605
8	6.210	5.971	5.747	5.535	5.335	5.146	4.968	4.799	4.639	4.487	4.344	4.078	3.837
9	6.802	6.515	6.247	5.995	5.759	5.537	5.328	5.132	4.946	4.772	4.607	4.303	4.031
10	7.360	7.024	6.710	6.418	6.145	5.889	5.650	5.426	5.216	5.019	4.833	4.494	4.192
11	7.887	7.499	7.139	6.805	6.495	6.207	5.938	5.687	5.453	5.234	5.029	4.656	4.327
12	8.384	7.943	7.536	7.161	6.814	6.492	6.194	5.918	5.660	5.421	5.197	4.793	4.439
13	8.853	8.358	7.904	7.487	7.103	6.750	6.424	6.122	5.842	5.583	5.342	4.910	4.533
14	9.295	8.745	8.244	7.786	7.367	6.982	6.628	6.302	6.002	5.724	5.468	5.008	4.611
15	9.712	9.108	8.559	8.061	7.606	7.191	6.811	6.462	6.142	5.847	5.575	5.092	4.675