

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA(U) MODEL EXAMINATIONS

### LEVEL THREE

#### FINANCIAL REPORTING - PAPER 13

**APRIL 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. Please, read further instructions on the answer book.

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## SECTION A: FINANCIAL REPORTING IN THE PRIVATE SECTOR

### Question 1

- (a) Craneland Business Enterprises Limited (CBEL) is incorporated in Uganda. The directors of CBEL agree with the fact that for financial statements to present fairly the financial position, financial performance and cash flows of an entity, they should comply with pronounced International Financial Reporting Standards. In order to achieve this fair presentation, the directors resolved to use the services of a professional accountant on the following issues:

At the beginning of year 1, CBEL granted 100 share options to each of the 500 employees. The share options will vest at the end of year 3, provided the employees remain in service by that time.

The share options can be exercised not later than 5 years from the grant date provided they have vested.

The exercise price is Shs 600 and the entity's share price is also Shs 600 at the date of grant. At the date of grant, the entity concludes that it can not estimate reliably the fair value of the share options granted.

At the end of Year 1, 30 employees have ceased employment. CBEL estimates that a further 70 employees will leave during years 2 and 3 hence the entity estimates that 60% of the shares will vest.

At the end of year 2, twenty employees leave and CBEL revises its estimates of the number of the share options it expects to vest to 80%.

During year 3, 20 employees leave hence the share options that vest are for only 430 employees.

CBEL's share price during years 1 to 5 and the number of share options exercised by the employees during the years are set out below. Share options exercised during a particular year were all exercised at the end of that year.

Year	Share price at year end Shs	Number of share options exercised at year end
1	650	0
2	700	0
3	750	12,000
4	800	16,000
5	900	15,000

**Required:**

Explain the meaning of the term intrinsic value in respect of IFRS 2: Share-based Payment and its application in accounting for the above share based payments for the five years.

**(6 marks)**

- (b) CBEL has a 100% owned subsidiary, Starlight Limited which is a listed company. On the 1 January 2007, Starlight issued one new share for every two existing shares by way of rights at Shs 600 per share. The pre-issue market price was Shs 1,200 per share. Starlight's profit attributable to the ordinary share holders has the following record:

	2007	2006
	Shs '000	Shs '000
Ordinary profit attributable to the ordinary shareholders for the year ending 30 June	220,000	184,000
Number of ordinary shares in issue at 30 June	1,500	1,000

**Required:**

Compute the earnings per share for Starlight Limited to comply with the requirements of IAS 33: Earnings Per Share.

**(7 marks)**

- (c) CBEL and its 100% held subsidiary, Starlight Ltd are coffee suppliers to the restaurant industry. A key customer, Snappy Ltd has been experiencing financial difficulties. It was agreed that the CBEL Group would acquire a strategic 30% holding in Snappy and assist in the company's turnaround. The holding was acquired by way of a fresh issue of shares by Snappy for an amount of Shs 150 million in July 2007.

During the financial year ended 31 March 2008, the CBEL group entered into the following transactions with Snappy:

- CBEL loaned Ushs.500 million to Snappy to acquire new equipment. The loan bears interest at a market rate, and the capital is repayable in 15 years time. All Snappy's property, plant and equipment have been pledged as security for this loan.
- Starlight loaned Shs 100 million to Snappy for working capital purposes. The loan bears interest at prime rate. No date has been set for the repayment thereof.
- The current account in CBEL's trial balance indicates that Snappy owes CBEL Shs 70 million. It relates to sales from CBEL to Snappy during March 2008. The current account is cleared at the beginning of the following month.

During the year ended 31 March 2008 CBEL's share of Snappy's net loss amounted to Shs 300 million.

CBEL, Starlight and Snappy all report in terms of IFRS in the financial period ending 31 March 2008.

**Required:**

Based on the information above:

- (i) Calculate how much of the loss in Snappy, if any, would be equity accounted by the CBEL Group in the 2008 financial period.  
(10 marks)
  - (ii) Assuming that the CBEL's share of losses in Snappy amounted to Shs 80 million:
    - How does the accountant of CBEL identify if there is an indicator of impairment?  
(3 marks)
    - Having identified an indicator of impairment, how would the accountant of CBEL calculate the impairment?  
(4 marks)
  - (d) Explain the:
    - (i) possible reasons why companies may wish to exclude assets and liabilities from the balance sheet.  
(3 marks)
    - (ii) principle of substance over form and the reasons for introducing the rule of substance over form.  
(3 marks)
- (Total 30 marks)

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

**Question 2**

- (a) Explain the recognition and derecognition criteria for financial instruments.  
(3 marks)
- (b) Pioneer Experts Ltd (PEL) experienced a tremendous growth in demand for its products at the beginning of the 21<sup>st</sup> century but faced cash flow problems at the time. On 1 January 2005 PEL issued a Shs 125,000,000 bond at par. There were no issue costs and the coupon rate was 12% payable annually in arrears on 31 December. The bond was redeemable at par on 1 January 2008. Bondholders may opt for conversion at a rate of four Shs 1,000 shares for every Shs 10,000 owed to the bondholder on 1 January 2008. Bonds issued by similar companies without any conversion rights bear interest at 16%.

**Required:**

Present well reasoned advice to PEL on the accounting treatment and reporting on issues pertaining to the convertible bond in order to comply with IFRSs.

**(12 marks)****(Total 15 marks)****Question 3**

Premium Brewers Enterprises Limited (PBEL) a company registered in Uganda has recently constructed a mega brewing facility and commenced production one year ago (1 June 2007). There is an operating licence given to the company by the Government of Uganda which requires the removal of the facility at the end of its 20 years useful life. PBEL's policy is to depreciate such plants on a straight line basis. The cost of the construction of the facility was Shs 200 billion and the net present value at 1 June 2007 of the future costs to be incurred in order to return the extraction site to its original condition are estimated at Shs 50 billion (using a discount rate of 5% per annum). 80% of these costs relate to the removal of the facility and 20% relate to the rectification of the damage on the environment and streams caused through brewing. The finance director has told the company directors that a provision for decommissioning has to be made but some directors do not seem to understand him well.

**Required:**

- (a) Draft a brief memorandum to the directors of PBEL defining a provision, the recognition criteria and measurement guidance for a provision in line with IAS 37: 'Provisions, Contingent Liabilities and Contingent Assets'.  
**(5 marks)**
- (b) Explain, with reasons and suitable computations, the accounting treatment of the above situation in the financial statements for the year ended 31 May 2008.

**(10 marks)****(Total 15 marks)**

**Question 4**

Hemisphere, a limited company, acquired 75% of Horizon's ordinary shares on 1 July 2006. The purchase consideration consisted of:

- a share exchange of one share issued by Hemisphere for every two shares in Horizon. The market price of Hemisphere's shares at the date of acquisition was Shs 2,000 each.
- an immediate Shs 875 per share in cash.
- a further amount of Shs 40,500,000,000 payable on 1 July 2007.

Hemisphere has only recorded the consideration of Shs 875 per share.

On 1 July 2006 Hemisphere also acquired 40% holding in Dawn Ltd at a cost of Shs 3,500,000,000 while the fair value of Dawn's net assets was Shs 8 billion.

On 1 January 2007, Hemisphere acquired a further 20% holding in Dawn for a price of Shs 3,100,000,000. At that date, the fair value of Dawn's assets was Shs 12 billion. Profits of Dawn Ltd are assumed to accrue evenly throughout the year. The summarised balance sheets of Horizon and Hemisphere which exclude the investment by Hemisphere in Horizon at 30 June 2007 are shown below:

	<b>Hemisphere</b>		<b>Horizon</b>	
	<b>Shs million</b>	<b>Shs million</b>	<b>Shs million</b>	<b>Shs million</b>
Tangible non-current assets		285,000		190,000
Investments		<u>75,000</u>		<u>Nil</u>
		360,000		190,000
Current assets		<u>65,000</u>		<u>45,000</u>
Total assets		<u>425,000</u>		<u>235,000</u>
Share capital and reserves:				
Ordinary shares of Shs 500 each		135,000		40,000
Reserves:				
Share premium		40,000		20,000
Revaluation reserve		20,000		Nil
Retained earnings				
1 July 2006	80,000		60,000	
Year to 30 June 2007	<u>95,000</u>	<u>175,000</u>	<u>50,500</u>	<u>110,500</u>
		370,000		170,500
Non-current liabilities				
10% loan note		Nil		30,000
Current liabilities		55,000		34,500
Total equity and liabilities		<u>425,000</u>		<u>235,000</u>

## Additional information:

- i. Dawn's profit for the year ended 30 June 2007 is Shs 7 billion and the opening reserves are Shs 9 billion.
- ii. Hemisphere group's policy is to consider the time value of money in respect of future cash flows and the group uses a cost of capital of 8% per annum.
- iii. Hemisphere has a policy of revaluing land and buildings to fair value. At the date of acquisition, Horizon's land and buildings had a fair value of Shs 10 billion in excess of their carrying amounts, and at 30 June 2007 this had increased by a further Shs 2 billion (ignore any additional depreciation).
- iv. Horizon had established a line of products under the brand name of win-line. Acting on behalf of Hemisphere, a firm of specialists had valued the brand name at Shs 20 billion with an estimated life of 10 years as at 1 July 2006. The brand is not included in Horizon's balance sheet
- v. On 1 January 2007 Horizon issued Shs 30 billion 10% (actual and effective rate) loan note and Hemisphere subscribed for Shs 10 billion of this issue. Horizon has not paid any interest on this loan, but it has recorded the amount due as a current liability. Hemisphere has also accrued for its interest receivable on this loan.
- vi. Post-acquisition; Horizon sold goods at a price of Shs 9 billion to Hemisphere; Shs 2.5 billion of these goods were still in the inventory of Hemisphere at 30 June 2006. Horizon applied a mark-up on cost of 25% to these goods.
- vii. A post-acquisition impairment test on the consolidated goodwill in Horizon concluded that it should be written down by Shs 1 billion.
- viii. Immediately after acquisition, Hemisphere sold to Horizon an item of plant for Shs 7.5 billion that it had manufactured at a cost of Shs 5 billion. The plant had an estimated life of five years (straight-line depreciation) and no residual value.

**Required:**

- (a) Prepare a consolidated balance sheet of Hemisphere and its subsidiary Horizon at 30 June 2007 excluding the effect of investment in Dawn Ltd.  
**(11 marks)**
- (b) With the necessary computations, explain how the issues pertaining to Dawn Ltd will be incorporated in the group statements in order to comply with IFRSs.

**(4 marks)****(Total 15 marks)**

## SECTION C: FINANCIAL REPORTING IN THE PUBLIC SECTOR

### Question 5

- (a) Government accounting is the process of recording, analyzing, classifying, summarizing, communicating and interpreting financial information about government in aggregate and in detail reflecting transactions and other economic events involving the receipt, spending, transfer, usability and disposition of assets and liabilities.

Currently, the Government of Uganda uses the four main bases of accounting but transitioning to full accrual basis of accounting;

- cash basis
- modified cash basis
- full accruals basis
- modified accruals basis

It is argued that government is not a profit making organisation and therefore should use a cash basis of accounting. However, proponents of the accruals basis of accounting argue that accruals basis is ordinarily necessary for the fair presentation of financial statements.

#### Required:

- (i) Discuss the above **four** main bases of accounting. (8 marks)
- (ii) What are the arguments put forward for using accruals basis of accounting as opposed to cash basis of accounting? (4 marks)
- (iii) Mention at least **three** relevant considerations by a developing country in adopting full accruals accounting. (2 marks)
- (b) The following is an extract of a statement of financial performance from an entity prepared under the accruals basis for the year ended 30 June 2007.

	Shs million	Shs million
Sales		700
Cost of sales	500	
Operating expenses	125	
Depreciation expense	<u>25</u>	
		(650)
Net income		<u><u>50</u></u>



The following extract from the balance sheet as at 30 June 2007 is also presented:

	30 June 2007 Shs million	30 June 2006 Shs million
<b>Assets:</b>		
Cash	105	50
Accounts receivable net	150	100
Merchandise inventory	130	150
Equipment	350	250
Accumulated depreciation(equipment)	(50)	(25)
<b>Liabilities and shareholders' equity</b>		
Accounts payable	45	75
Accrued liabilities payable	10	-

**Required:**

Prepare a statement of income for the year ended 30 June 2007 using the cash basis of accounting.

**(6 marks)**

**(Total 20 marks)**

**Question 6**

Government of Uganda has put in place an administrative and control framework for the management and accounting of public funds.

**Required:**

Examine the roles and responsibilities of the following:

- (a) The Accountant General. **(10 marks)**
- (b) The Auditor General. **(10 marks)**

**(Total 20 marks)**

**Question 7**

- (a) In the financial year ended 31 December 2007, the Ministry of Health imported anti-malaria drugs from India in two consignments. The first consignment of 2 tons arrived in June at a cost Shs 2 million per ton, excluding freight and insurance which cost Shs 0.8 million and Ushs 0.6 million per ton respectively.

The second consignment of 8 tons arrived in September at a cost Shs 2.2 million per ton, freight and insurance were Ushs 0.9 million and Ushs 0.68 million per ton respectively. The drugs were for distribution free of charge to the public through the District Medical Centres.

At the end of the financial year, the Ministry had 3 tons of anti-malaria drugs in stock,  $\frac{1}{2}$  tone of which had expired. The expired drugs were to be replaced at a total cost of Shs 1.8 million.

**Required:**

- (i) Establish the value of drugs in stock as at 31 December 2007 using **two** appropriate bases of stock valuation. **(6 marks)**
  - (ii) Would your answer be different had the drugs to be distributed at cost price plus a margin of 10%? **(2 marks)**
- (b) During the same period, the Ministry was involved in construction work but since Government of Uganda had just adopted the use of IPSASs, the accountant is seeking your guidance on whether the following transactions should be accounted for as construction contracts under IPSAS 11:
- (i) A Government Commission buys a piece of land in order to build an office block on it to its own design. Shortly after the work has started it contracts to sell the finished building to an institutional investor for a fixed price of Shs 10 million, half of which is payable when the contract is signed and the remainder when the building is complete.
  - (ii) A Public shipbuilding corporation receives an order from a naval authority to design, build and supply 8 fishery protection patrol vessels, with an option for a further 4, on similar terms, if the customer wants to extend its order. The price of each of the eight vessels, when delivered, will be based on a formula which is partly fixed and partly varies according to the prevailing market price of steel at the time of construction. The design phase is expected to take six months, and the vessels will then be built and delivered one at a time, with each vessel taking seven months to supply and deliver.
  - (iii) The same Construction Unit undertakes work, to underpin a building which is subsiding as a result of soil erosion. On completion, the Unit bills its customer for Ushs 2 million, which is its fee for the time, materials and other resources devoted to the work. The work takes three months but spans the balance sheet date, so that none of it had been billed at the year end.
  - (iv) After the first three vessels have been delivered, the customer referred to in (ii) above exercises its option for four further vessels and increases the number by an additional two, making six extra

vessels in all. It agrees a new fixed price for all six, which no longer has any element that varies with the prevailing market price of steel.

**(8 marks)**

- (c) The Ministry of Health owns 10 different properties, the details of which are set out below. In each case below, advise the accountant whether the transaction falls within the definition of an investment property under IPSAS 16: Investment Property; a fixed asset under IPSAS 17: Property, Plant & Equipment; or an item of inventory under IPSAS 12: Inventories.

- (i) Property A is an office block in the course of construction by the Ministry. On completion it will be let out to tenants and held for its rental income and capital growth potential.
- (ii) Property B is a vacant site. The Ministry has not yet determined how it will use the land; it may sell it to a developer, or it may build on it for its own occupation.
- (iii) Property C is another office block. The Ministry uses half of it for its own administrative departments and lets out the other half to other Ministries.
- (iv) Property D is a retail park that has been held for a number of years as an investment but is now for sale.
- (v) Property E is an office block that has been held for many years as an investment but is now being redeveloped with a view to sale.
- (vi) Property F is a similar office block which has also been held as an investment in the past. It is also being redeveloped, but will be retained as an investment in the future.
- (vii) Property G is the Ministry's head office.
- (viii) Property H is a research and development building which belongs to one of the Ministry's property subsidiaries and is let to one of its other subsidiaries for a rental at market rates.

**(4 marks)**

**(Total 20 marks)**

END