

# THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

*A Committee of the Council of ICPAU*

## CPA(U) EXAMINATIONS

### LEVEL THREE

#### FINANCIAL REPORTING - PAPER 13

**THURSDAY, 18 JUNE 2009**

#### INSTRUCTIONS TO CANDIDATES

1. Time allowed: **3 hours 15 minutes**.  
The first 15 minutes of this examination have been designated for reading time. You may not start to write your answer during this time.
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

Ken-Win Limited (KWL) is a business entity incorporated in Uganda whose accounting year ends 30 June. The directors have contracted you as consultant to provide professional advice on the accounting treatment of the following transactions in the books of KWL.

- (a) KWL acquired a strategic 25% shareholding of Twilight Ltd on 1 July 2007. The purchase consideration was 300,000 KWL Shs 1,000 ordinary shares valued at Shs 500 million and cash of Shs 100 million. KWL has significant influence over Twilight Ltd. The investment is stated at cost in the group draft statement of financial position. The reserves of Twilight Ltd at the date of acquisition were Shs 200 million and Shs 320 million at 30 June 2008. Twilight Ltd had sold goods during the period to 30 June 2008 to KWL at Shs 160 million. The cost of the goods was Shs 80 million and were still held as inventory by KWL at 30 June 2008. There was no goodwill arising on the acquisition of Twilight Ltd.

#### Required:

Advise on how the investment in Twilight Ltd should be accounted for and reported in the group financial statements of KWL in order to comply with International Financial Reporting Standards.

**(7 marks)**

- (b) KWL is leasing a plant under a finance lease over a five year period. The plant's cash price which was established to be equal to the present value of the minimum lease payments for the asset at the inception of the lease on 1 July 2007 was Shs 48 million. Such assets are depreciated on a straight line basis. This asset has a useful life of five years and no residual value. The annual lease payments are Shs 12 million payable in arrears on 30 June and the implicit interest rate is 8% per annum. The company can claim a tax deduction from the annual rental payments because the finance lease does not qualify for tax relief but the directors are unsure of the treatment for deferred taxation in respect of leases. The corporation tax rate is 30%.

#### Required:

Discuss, with suitable computations, how the leasing of the plant will impact on the accounting for deferred tax under **IAS 12: Income Taxes** in the group financial statements of KWL.

**(6 marks)**

- (c) KWL has a 100% equity holding in Mansion Heaven Ltd (MHL). MHL is a real estate dealer of apartments. The apartments take many years before they are availed for use.

On 1 July 2007 MHL sold a new estate of apartments to High Stride Bank Ltd for Shs 12 billion. The estate had cost MHL Shs 8 billion.

It will be ten years before this estate is ready for use. MHL will be responsible for the finishing process. When the estate is ready it will have a market price of Shs 48 billion.

MHL has an option to repurchase the estate in ten years time (on 1 July 2017) for Shs 31,124,908,000.

**Required:**

Discuss the reporting of the commercial substance of these transactions by MHL with extracts from the statements of financial position and statements of comprehensive income of MHL for reporting periods ending June 2008, 2009, 2017 and 2018. Assume that MHL repurchases the estate in 2018 and immediately resells it at the expected market price of Shs 48 billion. The prevailing market rate of interest for projects of this nature is 10%.

**(10 marks)**

- (d) On 1 July 2007, KWL issued a zero-coupon bond. The net proceeds were Shs 125 million. It will be redeemed in four years' time at a premium of Shs 71,689,920.

**Required**

Show how this bond will be reported in the financial statements of KWL.

**(7 marks)**

**(Total 30 marks)**

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

GreenWealth Ltd (GWL) is a company that deals in the production of farm inputs. The draft consolidated financial statements for GWL group are as follows:

**Draft Consolidated Statement of Financial Position as at 30 June**

	<b>2008</b>	<b>2007</b>
	<b>Shs '000'</b>	<b>Shs '000'</b>
Assets		
Non-current assets:		
Property, plant & equipment (note 1)	450,000	350,000
Goodwill	61,000	35,000
Investment in associate	125,000	130,000
Current assets:		
Inventory	400,000	300,000
Receivables	200,000	150,000
Cash	<u>74,000</u>	<u>226,000</u>
	<u>1,310,000</u>	<u>1,191,000</u>
Equity and liabilities		
Equity:		
Share capital: Shs100 shares	450,000	400,000
Share premium	225,000	200,000
Retained earnings	68,000	35,800
Non-controlling interests	<u>125,000</u>	<u>122,200</u>
	<u>868,000</u>	<u>758,000</u>
Non-current liabilities:		
Long-term loan	175,000	240,000
Deferred tax	4,000	3,000
Current liabilities:		
Payables	250,000	180,000
Current tax payable	7,000	6,000
Dividends	<u>6,000</u>	<u>4,000</u>
	<u>442,000</u>	<u>433,000</u>
	<u>1,310,000</u>	<u>1,191,000</u>

# **Draft Consolidated Statement of Comprehensive Income for the year ended 30 June 2008**

	Shs'000'	Shs '000'
Operating profit		60,000
Share of associate's profit		12,000
Interest		<u>(6,000)</u>
		66,000
Tax :		
Current tax	13,000	
Deferred tax	3,200	
Share of associate's tax	<u>3,600</u>	
		<u>(19,800)</u>
Profit after tax		46,200
Non-controlling interests		<u>(4,000)</u>
Profit attributable to the equity holders of GWL		42,200
Dividends:		
Interim (paid)	4,000	
Final (proposed)	<u>6,000</u>	
		<u>(10,000)</u>
Retained profit for the year		<u><u>32,200</u></u>

## **Additional information:**

- (i) Property plant and equipment

	Cost	Aggregate depreciation	Net book value
	Shs '000'	Shs '000'	Shs '000'
1 July 2007	500,000	(150,000)	350,000
Additions:			
Kendo	60,000	(15,000)	45,000
Others	77,500	-	77,500
Depreciation charge for the year	<u>-</u>	<u>(22,500)</u>	<u>(22,500)</u>
	<u><u>637,500</u></u>	<u><u>(187,500)</u></u>	<u><u>450,000</u></u>

- (ii) GWL acquired shares in Kendo Ltd on the 1 July 2007. The details of the acquisition are as follows:

	Shs '000'	Shs '000'
Consideration:		
500,000 Shs 100 shares at Shs 150 per share		75,000
Cash		<u>25,000</u>
		100,000
Assets acquired:		
Property plant and equipment	45,000	
Inventory	40,000	
Receivables	20,000	
Payables	(25,000)	
Cash	24,000	
Tax	<u>(30,000)</u>	
		(74,000)
Goodwill		<u>26,000</u>

**Required:**

Prepare a consolidated statement of cash flows for the GWL group for the year ended 30 June 2008 using the indirect method, complying, as far as possible, with the requirements of **IAS 7: Statement of Cash Flows**.

**(15 marks)**

**Question 3**

- (a) Related party relationships are a common feature of business. **IAS 24: Related Party Disclosures** seeks to ensure that financial statements contain the necessary disclosures to make users aware of the possibility that the financial position and operating results of the reporting enterprise may have been affected by the existence of related parties.

**Required:**

- (i) Explain the main circumstances that give rise to related parties.

**(4 marks)**

- (ii) Explain why the disclosure of related party relationships and transactions may be important.

**(4 marks)**

- (b) Fine Deal Ltd owns 100% of the equity shares of Alpha Ltd and 55% of the equity shares of Omega Ltd. During the year ended 30 June 2008 Omega Ltd made several sales of goods to Alpha Ltd. These sales totalled Shs 3 million and had cost Omega Ltd Shs 2,800,000 to produce. Omega Ltd made the sales on the instructions of the Board of Directors of Fine

Deal Ltd. You ascertain that one of the directors of Omega Ltd, who is not a director of Fine Deal Ltd, is unhappy with the parent company's instructions because the goods could have been sold to other companies outside the group at a far higher price of Shs 4 million. All directors within the group benefit from a profit sharing scheme.

**Required:**

Discuss the related party issues in the above scenario and how they should be dealt with in accordance with **IAS 24: Related Party Disclosures** and the implications this may have for other interested parties.

**(7 marks)**

**(Total 15 marks)**

**Question 4**

The Finance Director of Koro Motors Ltd has learnt that an entity shall calculate diluted earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and if presented, profit or loss from continuing operations attributable to those equity holders.

**Required:**

- (a) Describe to the Finance Director what should be presented in Koro Motors financial statements as guided by **IAS 33: Earnings per Share**.

**(3 marks)**

- (b) The following information is from Koro Motors Ltd's financial statements for the year ended 31 December 2008:

	<b>Shs '000'</b>
Profit from continuing operations attributable to the parent entity	16,400
Less dividends on preference shares	<u>(6,400)</u>
Profit from continuing operations attributable to ordinary equity holders of the parent entity	10,000
Loss from discontinued operations attributable to parent entity	<u>(4,000)</u>
Profit attributable to ordinary equity holders of the parent entity	<u><u>6,000</u></u>

There were 2 million per ordinary shares outstanding at 31 December 2008.

Average fair value ordinary share during the year was Shs 75.

**Potential Ordinary Shares**

Options	100,000 shares with an exercise price of Shs 60.
Convertible preference shares	800,000 shares with a par value of Shs 100 entitled to a cumulative dividend of Shs 8 per share. Each preference share is convertible to 2 ordinary shares.

The tax rate is 40%

**Required:**

Advise the Finance Director as to how **IAS 33**: Earnings per Share shall be applied to Koro Motor's financial statements based on the above data.

**(8 marks)**

- (c) **IAS 28**: Investments in Associates defines an associate as an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

**Required:**

Describe the various incidences when an associate may not be accounted for using equity method.

**(4 marks)**



**SECTION C: FINANCIAL REPORTING IN THE PUBLIC SECTOR****Question 5**

- (a) On 1 July 2007, the National Roads Agency (NRA), which is a reporting entity of the government entered into an agreement to acquire a road vehicle on a finance lease.

The fair value of the motor vehicle at the inception of the lease was Shs 67,197,595, the annual lease payments are Shs 24 million payable in arrears and the lease term is three years. NRA guaranteed a residual value was Shs 10 million. The road agency is responsible for all the running costs of the vehicle including insurance, fuel and maintenance. The interest rate implicit in the lease agreement is 10%. The department's incremental borrowing rate is 7% per annum but the authorities are not sure of how to report the lease transaction and how to make sense from the interest rates. You have been approached as a resourceful consultant in this area.

**Required:**

Draft a summarised report with relevant computations explaining how the lease transaction will be accounted for and reported in the financial statements of the agency in order to comply with **IPSAS 13**: Leases and **IPSAS 17**, Property, Plant and Equipment.

**(10 marks)**

- (b) The central government on the 30 June 2007 provided a water pump to a government orphanage centre, leaving the orphanage centre to foot the rest of the expenses associated with the installation of the water pump. Due to the urgent need for water, one resident on 1 July 2007 offered to provide the most suitable site for the location of the water pump with a fair value of Shs 1 million at a nominal cost of only compensating him for his immovable structures that were demolished. These structures were valued at Shs 500,000, which was given to him by the orphanage. The Orphanage Centre Authority concludes that this transaction is made of two components; an exchange component and a non-exchange component. As at 30 June 2008, the fair value of the plot of land had risen to Shs 1,400,000.

**Required:**

- (i) Explain what is meant by a non-exchange transaction and the measurement principle that governs the recognition of revenue from a non-exchange transaction as laid out in **IPSAS 23**: Revenue from Non-Exchange Transactions.

**(4 marks)**

- (ii) How will the Orphanage Centre Authority account for the land acquired in its financial statements for the year ending 30 June 2008 in order to comply with **IPSAS 17: Property, Plant and Equipment** and **IPSAS 23: Revenue from Non-Exchange Transactions**?

(6 marks)

(Total 20 marks)

**Question 6**

- (a) In a hyperinflationary economy, reporting of operating results and financial position in the local currency without restatement is not useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same reporting period, is misleading.

**Required:**

Explain the:

- (i) characteristics of the economic environment of a country when restatement of financial statements in accordance with **IPSAS 10: Financial Reporting in Hyperinflationary Economies**. (4 marks)
- (ii) reporting and disclosure requirements for an entity whose functional currency is the currency of a hyperinflationary economy. (4 marks)
- (b) You are provided with the following draft financial statements of a government entity MTZ reporting in the currency of a hyperinflationary economy.

The draft statement of financial position as at 30 June 2008 (unadjusted for the inflation effects) is as follows:

	Shs '000'	Shs '000'
Cash and investments		20,000
Inventories		4,000
<b>Physical assets:</b>		
Historical cost	80,000	
Accumulated depreciation	<u>(40,000)</u>	
Net book value		<u>40,000</u>
		<u>64,000</u>
Borrowings		52,000
Net Assets brought forward		8,000
Net surplus for period		<u>4,000</u>
		<u>64,000</u>

The draft statement of financial performance for the year ending 30 June 2008 (unadjusted) is as follows:

	Shs '000'
Revenues	100,000
Depreciation	(10,000)
Other expenses	<u>(86,000)</u>
Surplus for the year	<u>4,000</u>

**Additional information:**

- (i) Inventory on hand at the end of the reporting period was acquired later in the reporting period when the general inflation index was 180.
- (ii) The general price index was 130 at the beginning of the period, 190 at the end of the period and it averaged 160 during the period.
- (iii) Revenue and expenses, other than depreciation, are assumed to accrue evenly throughout the reporting period.

**Required:**

Advise MTZ on the necessary adjustments to be made in order to restate the financial statements to comply with **IPSAS 10**: Financial Reporting in Hyper Inflationary Economies.

**(12 marks)**  
**(Total 20 marks)**

**Question 7**

- (a) Distinguish between modified accrual basis of accounting and modified cash basis of accounting.  
**(6 marks)**
- (b) Governments are inherently different from businesses. And, the unique characteristics of government have implications for what a government needs to report in its financial statements. The objectives of financial reporting for governments and commercial businesses are not the same. In the public sector, a fundamental principle of accountability requires governments to report "credible" financial information to their legislatures and stakeholders.

**Required:**

Examine the unique characteristics of government and their reporting implications vis-à-vis private commercial business reporting.

**(14 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