

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL THREE

FINANCIAL REPORTING - PAPER 13

TUESDAY, 07 DECEMBER 2010

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 10.
6. Please, read further instructions on the answer book, before attempting any question.

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

Great National Limited (GNL), is a multinational company with diverse product ranges and operating in many geographical markets. GNL is finalising its financial statements for the year ended 30 November 2010 and seeks your advice on the matters listed below:

- (a) GNL has a piece of property located in a foreign country, which was acquired at a cost of US\$2 million on 30 November 2009 when the exchange rate was US\$1 = Shs 2,000. At 30 November 2010, the property was revalued to US\$2.5 million. The exchange rate at 30 November 2010 was US\$1 = Shs 2,200. The property was carried at its value as at 30 November 2009. The company policy is to revalue property, plant and equipment whenever material differences arise between book and fair value. Depreciation on the property can be assumed to be immaterial.

(5 marks)

- (b) GNL manufactures equipment for the retail industry. The inventory is currently valued at cost. There is market for the partially completed product at each stage of production. The cost structure and expected selling structure of the equipment is as follows:

	Cost per unit Shs million	Selling price per unit Shs million
Production process - 1 st stage	2.2	2.5
Conversion costs to finished product	1.1	
Finished product	3.3	3.8

The selling costs are Shs 200,000 per unit of the finished product and GNL has 100,000 units at the first stage of production and 200,000 units of the finished product at 30 November 2010. Shortly before the year end, a competitor released a new model onto the market which caused the equipment manufactured by GNL to be less attractive to customers. The result was a reduction in the selling price to Shs 3.2 million of the finished product and Shs 2.05million for the first stage product.

(5 marks)

- (c) The directors of GNL announced on 1 December 2009 that a bonus of Shs 4 billion would be paid to the employees of GNL if they achieved a certain production level by 30 November 2010.

The bonus is to be paid partly in cash and partly in share options. Half of the bonus will be paid in cash on 31 May 2011 whether or not the employees are still working for GNL. The other half will be given in share options on the same date, provided that the employees are still in service on 31 May 2011. The exercise price and the number of options will be fixed by management on 31 May 2011. The targeted production was met and management expect 10% of employees to leave between 30 November 2010 and 31 May 2011.

(5 marks)

- (d) GNL has decided to close one of its overseas branches. A board meeting was held on 31 October 2010 when a detailed formal plan was presented to the board. The plan was formalised and accepted at that meeting. The information was communicated to the people affected by this decision on 15 November 2010. The operations of the branch are to be moved to another country from December 2010 but the operating lease on the present buildings of the branch is non-cancellable and runs for another two years, until 30 November 2012. The annual rental of the buildings is Shs 2 billion payable in arrears on 30 November and the lessor has offered to take a single payment of Shs 3.1 billion on 30 November 2011 to settle the outstanding amount owing and terminate the lease on that date. GNL has additionally obtained permission to sublet the building at a rental of Shs 1 billion per year, payable in advance on 1 December. A discount rate of 18% should be used where necessary.

(5 marks)

- (e) GNL owns a building which is currently accounted for using the cost model in IAS 16: Property, plant and equipment. The carrying amount of the property was Shs 10 billion on 30 November 2009. The building had a remaining life of 20 years on 30 November 2009, and GNL uses straight line depreciation. GNL sold the building to a third party on 1 December 2009 and leased it back under a 20 year finance lease agreement. The sale price and fair value are Shs 12 billion which is the present value of the minimum lease payments. The agreement transfers the title of the building to GNL at the end of the lease at no cost. The rental is Shs 2 billion per annum in advance commencing 1 December 2009. The implicit interest rate in the lease is 18%.

(6 marks)

- (f) GNL operates a defined benefit pension plan that provides a pension of 1.2% of the final salary for each year of service,

subject to a minimum of four years service. On 1 December 2009, GNL improved the pension entitlement so that employees receive 1.4% of their final salary for each year of service. This improvement applied to all prior years' service of the employees. As a result, the present value of the defined benefit obligation on 1 December 2009 increased by Shs, 5 billion as follows:

	Shs billion
Employees with more than four years service	3
Employees with less than four years service	
(average service of two years)	<u>2</u>
	<u>5</u>

GNL had not accounted for the improvement in the pension plan.

(4 marks)

Required:

Discuss how the above items (a) to (f) should be dealt with in the financial statements of GNL for the year ended 30 November 2010. Your answer should include appropriate and suitable computations.

(Total 30 marks)

SECTION B: FINANCIAL REPORTING IN THE PRIVATE SECTOR

Question 2

Excel Ltd acquired two subsidiaries, Tours Ltd and Travel Ltd, on 1 December 2008. The details of the acquisitions at that date are as follows:

	Tours Ltd Shs billion	Travel Ltd Shs billion
Ordinary share capital (Shs 100 share)	700	400
Reserves	500	300
Fair value of net assets at acquisition	1,540	800
Fair value of the goodwill attributable to non-controlling interests	20	10
Cost of investment	1,200	540
Ordinary share capital acquired	500	240

The draft statements of comprehensive income for the year ended 30 November 2010 are:

	Excel Ltd Shs billion	Tours Ltd Shs billion	Travel Ltd Shs billion
Revenue	6,000	4,600	1,200
Cost of sales	<u>(4,000)</u>	<u>(3,200)</u>	<u>(600)</u>

Gross profit	2,000	1,400	600
Operating expenses	<u>(880)</u>	<u>(900)</u>	<u>(400)</u>
Profit before tax	1,120	500	200
Income tax expense	<u>(336)</u>	<u>(150)</u>	<u>(60)</u>
Net profit	<u>784</u>	<u>350</u>	<u>140</u>
Retained earnings 1 December 2009	<u>2,800</u>	<u>800</u>	<u>380</u>

The following information is relevant to the preparation of the group financial statements:

- (i) On 1 June 2010, Excel Ltd sold $\frac{1}{7}$ th holding in Tours Ltd for Shs 300 billion. The carrying amount of Tours Ltd's net assets at the date of disposal was Shs 2,015 billion.
- (ii) On 1 September 2010, Excel Ltd disposed of a third of their shares of Travel Ltd bringing their holding to 40%. The proceeds of disposal amounted to Shs 212 billion and the carrying amount of Travel Ltd's net assets at the date of disposal was Shs 985 billion. After the disposal the directors of Excel Ltd had significant influence over Travel Ltd. The fair value of Excel Ltd's interest in Travel Ltd after the disposal was Shs 450 billion.
- (iii) The fair value adjustments have been incorporated into the subsidiaries' records.
- (iv) Ignore any tax implications of any capital gains made by Excel Ltd and assume profits accrue evenly throughout the year.
- (v) Excel Ltd measures the non-controlling interest in subsidiaries on the basis of the "full goodwill" method.

Required:

Prepare a consolidated statement of comprehensive income for Excel Ltd Group for the year ended 30 November 2010 in accordance with International Financial Reporting Standards (IFRS).

(15 marks)

Question 3

- (a) Describe the basis for the recognition of the provision for deferred taxation under IAS 12: Income Taxes.
(5 marks)
- (b) The directors of Partren Ltd are reviewing the procedures for the calculation of the deferred tax provision for their company for the year ended 30 November 2010. The directors wish to know how the provision for deferred taxation would be calculated in the following situations under IAS 12: Income Taxes:

- (i) A wholly owned overseas subsidiary, MAK Ltd, sold goods costing Shs 10 billion to Partren Ltd on 1 September 2010, and these goods had not been sold by Partren Ltd before the year end. Partren Ltd had paid Shs 15 billion for these goods. The directors do not understand how this transaction should be dealt with in the financial statements of the subsidiary and the group for taxation purposes. MAK Ltd pays tax locally at 30%.

(5 marks)

- (ii) KLD Ltd is a wholly owned subsidiary of Partren Ltd, and is a cash generating unit in its own right. The carrying amount of the property, plant and equipment of KLD Ltd at 30 November 2010 was Shs 20 billion and purchased goodwill was Shs 5 billion before any impairment loss. The company had no other assets or liabilities.

An impairment loss of Shs 7 billion had occurred at 30 November 2010. The tax base of the property, plant and equipment of KLD Ltd was Shs 14 billion as at 30 November 2010. The directors wish to know how the impairment loss will affect the deferred tax provision for the year. Impairment losses are not an allowable expense for taxation purposes.

(5 marks)

Required:

Discuss, with suitable computations, how the situations (i) and (ii) above will impact on the accounting for deferred tax under IAS 12: Income Taxes in the group financial statements of Partren Ltd.

(Total 15 marks)

Question 4

- (a) There is an increasing global movement towards the harmonisation of financial reporting standards. Advocates believe this will reduce troubles that have plagued the accounting profession over time.

Required:

Analyse the need for harmonisation of International Financial Reporting standards (IFRS).

(7 marks)

- (b) The IFRS for small and medium-sized enterprises (SMEs) was issued by the International Accounting Standards Board on 9 July

2009. The Institute of Certified Public Accountants of Uganda (ICPAU) subsequently issued implementation guidelines In December 2009.

Required:

Define an SME as per the ICPAU guidelines.

(8 marks)

(Total 15 marks)

SECTION C: FINANCIAL REPORTING IN THE PUBLIC SECTOR

Question 5

- (a) Public sector entities such as national governments and public sector financial institutions may hold a wide range of financial instruments. Such transactions in financial instruments may result in an entity assuming or transferring to another party financial risks.

Required:

Discuss the risks financial instruments may pose as per IPSAS 15: Financial Instruments: Disclosure and Presentation.

(5 marks)

- (b) IPSAS 15: Financial Instruments: Disclosure and Presentation, require entities to disclose information about the extent and nature of financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows.

Required:

Analyse the terms and conditions that may warrant disclosure where the financial instrument creates a potentially significant exposure to risk.

(5 marks)

- (c) A local government authority issued 2,000 convertible bonds at the start of 2010. The bonds have a three year term, and are issued at par with the face value of Shs 1,000 per bond, giving total proceeds of Shs 2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds were issued, the prevailing market interest rate for similar debt without a conversion options was 9%. At the issue date, the market price of one ordinary share was Shs 3 per share. The dividends expected over the three year term of the bonds amount to Shs 0.14 per share at the end of each year. The risk-free annual interest rate for a three year term is 5%

Required:

Using the residual valuation approach, determine the equity and liability component in the financial instrument.

(10 marks)

(Total 20 marks)

Question 6

- (a) International Public Sector Accounting Standards (IPSAS) require that public entities prepare financial statements that provide information that meets a number of qualitative characteristics under 'encouraged additional disclosures'.

Required:

- (i) Explain the **four** principal qualitative characteristics of financial reporting.
(4 marks)
 - (ii) Discuss the major constraints to presentation of qualitative financial statements.
(4 marks)
 - (iii) Explain the characteristics of a Government Business Enterprise under the cash basis of accounting.
(6 marks)
- (b) IPSAS 3: Accounting Policies, Changes in Accounting Estimates and Errors requires an entity to account for a change in accounting policy resulting from the initial application of an IPSAS in accordance with the specific transitional provisions, if any, in that standard.

Aware that you are soon completing your CPA(U) course, the accounting officer to the Municipal Council of your municipality has approached you and inquired on how to handle changing accounting policies under IPSAS to enable him prepare financial statements for the period ending 31 December 2010.

Required:

Advise the accounting officer, on the necessary disclosures for changes relating to initial application of an IPSAS, where it is impracticable to determine the amounts of the adjustable effect.

(6 marks)

(Total 20 marks)

Question 7

- (a) The Permanent Secretary, Ministry of Local Government has released a circular directing all chief finance officers to prepare and circulate an explanatory memo to the chief administrative officers and town clerks on the terms used in the presentation of budget information in financial statements.

Required:

Assuming that you are a chief finance officer, write a memo explaining the following terms, giving appropriate examples in each case:

- (i) Appropriation.
- (ii) Approved budget.
- (iii) Comparable basis.
- (iv) Final budget.
- (v) Original budget.

(10 marks)

- (b) IPSAS 24: Presentation of Budget Information in Financial Statements, requires public sector entities to make certain disclosures about the budget and actual amounts in their financial statements or other reports.

Required:

Explain the disclosures that are required of public sector entities.

(5 marks)

- (c) Explain the term aggregation as used in the presentation of budget information.

(5 marks)

(Total 20 marks)

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

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	0.844	0.833
2	0.890	0.873	0.856	0.840	0.824	0.810	0.796	0.782	0.768	0.755	0.742	0.715	0.699
3	0.840	0.816	0.792	0.770	0.750	0.732	0.715	0.699	0.684	0.670	0.656	0.629	0.613
4	0.790	0.767	0.744	0.723	0.704	0.687	0.671	0.656	0.642	0.628	0.614	0.587	0.571
5	0.740	0.718	0.696	0.676	0.658	0.642	0.627	0.613	0.599	0.586	0.572	0.545	0.529
6	0.700	0.679	0.658	0.639	0.622	0.606	0.592	0.578	0.565	0.552	0.539	0.512	0.496
7	0.660	0.640	0.620	0.602	0.586	0.571	0.557	0.544	0.531	0.518	0.505	0.478	0.462
8	0.620	0.599	0.580	0.563	0.548	0.534	0.521	0.508	0.495	0.482	0.469	0.442	0.426
9	0.590	0.570	0.551	0.535	0.520	0.507	0.494	0.481	0.468	0.455	0.442	0.415	0.400
10	0.550	0.530	0.512	0.496	0.482	0.469	0.456	0.443	0.430	0.417	0.404	0.377	0.362
11	0.520	0.500	0.482	0.467	0.454	0.441	0.428	0.415	0.402	0.389	0.376	0.350	0.335
12	0.490	0.470	0.453	0.438	0.426	0.413	0.400	0.387	0.374	0.361	0.348	0.322	0.307
13	0.460	0.440	0.423	0.409	0.397	0.384	0.371	0.358	0.345	0.332	0.319	0.293	0.278
14	0.440	0.420	0.404	0.390	0.378	0.365	0.352	0.339	0.326	0.313	0.300	0.274	0.259
15	0.410	0.390	0.374	0.360	0.348	0.335	0.322	0.309	0.296	0.283	0.270	0.244	0.229

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

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	0.844	0.833
2	1.833	1.808	1.783	1.759	1.736	1.713	1.690	1.667	1.644	1.622	1.600	1.566	1.543
3	2.673	2.624	2.575	2.530	2.486	2.444	2.402	2.361	2.320	2.280	2.240	2.175	2.142
4	3.465	3.387	3.311	3.240	3.173	3.110	3.050	2.991	2.933	2.876	2.820	2.694	2.647
5	4.212	4.103	3.999	3.899	3.799	3.699	3.601	3.504	3.408	3.314	3.221	2.999	2.942
6	4.917	4.767	4.623	4.483	4.350	4.223	4.100	3.979	3.860	3.743	3.628	3.381	3.314
7	5.582	5.383	5.200	5.030	4.866	4.711	4.560	4.413	4.269	4.128	4.000	3.724	3.647
8	6.217	5.977	5.744	5.533	5.333	5.144	4.966	4.791	4.630	4.473	4.330	4.024	3.937

Financial Reporting - Paper 13

	0	1	7	5	5	6	8	9	9	7	4	8	7
	6.80	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	2	5	7	5	9	7	8	2	6	2	7	3	1
	7.36	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	0	4	0	8	5	9	0	6	6	9	3	4	2
	7.88	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	7	9	9	5	5	7	8	7	3	4	9	6	7
	8.38	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	4	3	6	1	4	2	4	8	0	1	7	3	9
	8.85	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	3	8	4	7	3	0	4	2	2	3	2	0	3
	9.29	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	5	4	6	7	2	8	2	2	4	8	8	1
	9.71	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	2	8	9	1	6	1	1	2	2	7	5	2	5