

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL THREE

FINANCIAL REPORTING - PAPER 13

TUESDAY, 15 JUNE 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 12.
6. Please, read further instructions on the answer book.

SECTION A: FINANCIAL REPORTING IN THE PRIVATE SECTOR

Question 1

Ultimate Holdings Ltd (UHL) was incorporated in Uganda and is involved in diverse activities in all the five East African Community (EAC) member countries. UHL is in the process of finalising its financial statements for the year ended 31 May 2010 and has approached you for advice and clarifications on several accounting issues:

- (a) The company granted interest free loans to its employees on 1 June 2009 of Shs 100 million. The loans will be paid back on 31 May 2011 as a single payment by the employees. The market rate of interest for a two-year loan on both of the above dates is 18% per annum. The company is not sure of how to account for the loans but wishes to classify them as 'loans and receivables' under International Accounting Standard (IAS) 39: Financial Instruments: Recognition and Measurement.

Required:

Discuss, with relevant computations, how the above transaction should be accounted for in the financial statements of UHL for the year ended 31 May 2010.

(5 marks)

- (b) The company holds certain non-current assets, which are in a development area and carried at cost less depreciation. These assets cost Shs 300 million on 1 December 2008 and are depreciated on a straight-line basis over their useful life of five years.

An impairment review was carried out on 30 November 2009 and the projected cash flows relating to these assets were as follows:

Year to 30 November	2010	2011	2012	2013
Cash flows (Shs million)	28	45	50	55

The company uses a discount rate of 18%. At 31 May 2010, the directors used the same cash flow projections and noticed that the resultant value in use was above the carrying amount of the assets and wished to reverse any impairment losses calculated at 30 November 2009. The government has indicated that it may compensate the company for any loss in value of the assets up to 20% of the impairment loss.

UHL also holds a non-current asset, which was purchased on 1 June 2007 for Shs 200 million with an expected useful life of 10 years. On 1 June 2009, it was revalued to Shs 176 million. At 31 May 2010, the asset was

reviewed for impairment and written down to its recoverable amount of Shs 110 million.

Required:

Discuss, with suitable computations, how to account for any potential impairment of the above non-current assets in the financial statements for the year ended 31 May 2010.

(10 marks)

- (c) The company manufactures and sells building equipment on which it gives a standard one year warranty to all customers. The company has extended the warranty to two years for certain major customers and has insured against the cost of the second year warranty.

The warranty has been extended at nil cost to the customer. The claims made under the extended warranty are made against the company which in turn makes a counter claim against the insurance company. Past experience has shown that 80% of the building equipment will not be subject to warranty claims in the first year, 15% will have minor defects and 5% will require major repairs. UHL estimates that in the second year of warranty, 20% of the items sold will have minor defects and 10% will require major repairs.

For the year to 31 May 2010, the following information is relevant:

	Standard (units)	Extended warranty (units)	Selling price per unit (both) Shs million
Sales	2,000	5,000	2
		Major Repairs Shs	Minor Repairs Shs
Cost of repairs (average)		1,000,000	200,000

Assume that sales of equipment are on 31 May 2010 and any warranty claims are made on 31 May in the year of the claim. Also assume a risk adjusted discount rate of 18%.

Required:

In accordance with International Accounting Standard (IAS) 37: Provisions, Contingent Liabilities and Contingent Assets:

- (i) discuss the principles involved in accounting for claims made under the above warranty provisions.

(6 marks)

- (ii) Show the accounting treatment for the warranty provisions in the scenario above.

(4 marks)

- (d) The following details relate to UHL's defined benefit plan:

	Shs million
Present value of obligation at 1 June 2009	200
Present value of obligation at 31 May 2010	240
Fair value of plan assets at 1 June 2009	190
Fair value of plan assets at 31 May 2010	225
Current service cost	20
Pension benefits paid	19
Total contributions paid to the scheme for year to 31 May 2010	17

Actuarial gains and losses are recognised in other comprehensive income.

The discount rates and expected returns on plan assets for the plan are:

	1 June 2009	31 May 2010
Discount rate	18%	20%
Expected return	10%	12%

Required

Show the accounting treatment for UHL's defined benefit plan for the year ended 31 May 2010 in accordance with International Accounting Standard (IAS) 19: Employee Benefits.

(5 marks)**Total 30 marks**

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

Rock Ltd operates in the manufacturing sector. The draft statements of financial position of the group companies are as follows at 31 May 2010:

	Rock Ltd Shs billion	Mines Ltd Shs billion
Assets:		
Non-current assets		
Property, plant and equipment	350	<u>200</u>
Investments in subsidiaries:		
Mines Ltd	250	
Build Ltd	<u>200</u>	
	<u>800</u>	<u>200</u>
Current assets	<u>350</u>	<u>100</u>
Total assets	<u>1,150</u>	<u>300</u>
Equity and liabilities:		
Share capital	400	75
Retained earnings	<u>400</u>	<u>125</u>
Total equity	<u>800</u>	<u>200</u>
Non-current liabilities	<u>100</u>	<u>50</u>
Current liabilities	<u>250</u>	<u>50</u>
Total equity and liabilities	<u>1,150</u>	<u>300</u>

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

- (i) On 1 February 2009, Rock Ltd acquired 60% of the equity interest of Mines Ltd. The purchase consideration was cash of Shs 200 billion. The fair value of the identifiable net assets was Shs 250 billion. The excess of the fair value of the net assets is due to an increase in the value of non-depreciable land.

Rock Ltd wishes to use the "full goodwill" method for all acquisitions. The fair value of the non-controlling interest in Mines Ltd was Shs 125 billion on 1 February 2009 and the retained earnings of Mines Ltd on 1 February were Shs 55 billion.

Rock Ltd acquired a further 20% interest from the non-controlling interests in Mines Ltd on 31 May 2010 for a cash consideration of Shs 50 billion.

- (ii) On 1 February 2009, Rock Ltd acquired 100% of the equity interest in Build Ltd, for a cash consideration of Shs 400 billion. Build Ltd's identifiable net assets were fair valued at Shs 380 billion.

On 31 May 2010, Rock Ltd disposed of 60% of the equity of Build Ltd when the identifiable net assets were Shs 350 billion. The sale proceeds were Shs 200 billion and the remaining equity interest was fair valued at Shs 134 billion. Rock Ltd could still exert significant influence after the disposal of the interest. The only accounting entry made in Rock Ltd's financial statements was to increase cash and reduce the cost of investment in Build Ltd.

Required:

- (a) Calculate the gain or loss arising on the disposal of the equity interest in Build Ltd.
(5 marks)
- (b) Prepare a consolidated statement of financial position of the Rock Group as at 31 May 2010 in accordance with International Financial Reporting Standards.
(10 marks)

(Total 15 marks)

Question 3

The finance director of Shame Ltd, a highly respected company in Uganda is in the process of finalizing the draft audited financial statements for the year ended 31 December 2009. He has received a few queries from the auditors and needs your advice before he goes to discuss the issues raised below by the auditors with the CEO and board chairman.

1. Shame Ltd acquired a property on 1 January 2009 as a result of a failed account receivable collection. The property's value was assessed at Shs 200 million. The account receivable amounted to Shs 200 million and the property taken over was intended for resale to recover the account receivable. The company has incurred repairs totaling Shs 50 million to have the property sold at Shs 320 million on 30 April 2010. This property was classified as 'held for sale' under International Financial Reporting Standard (IFRS) 5: Non-current Assets Held for Sale and Discontinued Operations at year end and recorded at Shs 270 million (Shs 320 less repair costs). Depreciation was not charged and the property is normally depreciated at 5% per annum.
2. For the last four years, Shame Ltd has increased its dividends per share by 6% annually and this strategy has gained Shame Ltd and its shareholders high business respectability. On 18 January 2010, the directors proposed a

dividend per share of Shs 300 for the year ended 31 December 2009 to result into a dividend amount of Shs 90 million to be paid out soon. This has already been approved by the shareholders. The directors would like to include a provision in the financial statements on the basis that a valid expectation was created by the dividend trends.

3. The finance director has specifically been asked to describe issues relating to substance over form as per guidance provided by IFRSs. There are a few transactions that Shame Ltd has been involved in that require careful analysis of the substance rather than the legal nature in deciding how to treat them in the financial statements.

Required:

- (a) Advise the finance director on the appropriate treatment of scenarios 1 and 2 above.

(9 marks)

- (b) Giving relevant examples to illustrate your answer, explain the principle of substance over form.

(6 marks)

(Total 15 marks)

Question 4

An investor has recently completed all the compliance requirements with Uganda Revenue Authority and is set to start operations on his allocated plot in Namanve Industrial Area. He has just seen the press release by the Institute of Certified Public Accountants of Uganda (ICPAU) describing small and medium-sized entities (SMEs) and their related compliance with IFRS for SMEs.

He is not sure about whether his company qualifies as an SME in Uganda and he has a few accounting related worries that need clarification. He has approached you for assistance.

Required:

- (a) Describe the characteristics of SMEs in Uganda.

(5 marks)

- (b) What reasons led to the global development of the IFRS for SMEs?

(5 marks)

- (c) Distinguish between a functional currency and a presentation currency.

(5 marks)

(Total 15 marks)

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

- (a) According to International Public Sector Accounting Standard (IPSAS) 26: Impairment of Cash-Generating Assets, estimating the value in use of an asset involves estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal.

Required:

- (i) Explain the basis for estimates of future cash flows. **(3 marks)**
- (ii) Give the main composition of estimates of future cash flows. **(3 marks)**
- (b) At the beginning of 2000, the government through the Ministry of Energy and Mineral Development put into service a power plant that it constructed at Shs 250 billion. At the beginning of 2004, power plants constructed by competitors were put into service resulting into a reduction in revenue produced by the government power plant. Revenue has decreased because the actual volume of electricity generated and the price for the electricity and generation standby capacity have decreased compared to the expectations.

The reduction in revenue is evidence that the economic performance of the asset is worse than expected. Consequently, the government is required to determine the assets' recoverable amount.

The government uses straight line depreciation over a 20 year life for the power plant and anticipates no residual value.

To determine the value in use of the power plant, the government:

- (i) prepares cash flow forecasts derived from the most recent financial budget forecasts for the next 5 years approved by management.

Year	Shs billion
2005	16.8
2006	14.4
2007	14.2
2008	14.1
2009	13.9

- (ii) estimates subsequent cash flows based on declining growth rates of 6% (2006), 5% (2007), 4% (2008) and 3% (2009).

Required:

Using a 6% discount rate, you are required to:

- (i) calculate the recoverable amount of the government's power plant.
(5 marks)
 - (ii) impairment loss on the plant.
(3 marks)
 - (c) Explain the main indicators of asset impairment according to IPSAS 26.
(6 marks)
- (Total 20 marks)**

Question 6

- (a) According to International Public Sector Accounting Standard (IPSAS) 13: Leases, a lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership and as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

Required:

Give the disclosures that leasees are required to make in their financial statements regarding:

- finance leases.
- operating leases.

(8 marks)

- (b) A government ministry enters an agreement to acquire a motor vehicle on a finance lease. The fair value of the motor vehicle at the inception of the lease is Shs 25 million, the annual lease payments are Shs 5,429,000, payable in arrears, the lease term is four years and the guaranteed residual value is Shs 10 million. The lease agreement does not provide for any services additional to the supply of the motor vehicle. The ministry is responsible for all the running costs of the vehicle including insurance, fuel and maintenance. The lease agreement does not specify the interest rate implicit in the lease. The ministry's incremental borrowing rate is 7% per annum. Several financial institutions are advertising loans for motor vehicles at rates varying between 7.5% and 10%.

Required:

Apportion the lease payments between the finance charge and the principal for each of the four years.

(12 marks)
(Total 20 marks)

Question 7

- (a) Construction contracts can either be fixed price contracts or cost plus contracts.

Required:

Describe the main conditions that must be satisfied so as to recognise contract revenue and expenses on both a fixed price contract and a cost plus contract as per International Public Sector Accounting Standard (IPSAS) 11: Construction Contracts.

(6 marks)

- (b) The department of engineering in the Ministry of Works and Transport (the construction contract) has a contract to build a bridge for the ministry. 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 ministry.

The construction contract is a key management planning and accountability document offsetting to the design and construction qualities of the bridge. It is used as an input in assessing the performance of the contracting parties in delivering services of agreed technical specifications within projected cost parameters. It is also used as input to the future cost projections.

The initial estimate of contract costs is Shs 80 million. It will take three years to build the bridge. An aid agency has agreed to provide funding of Shs 40 million, being half of the construction costs. This is specified in the construction contract.

At the end of year 1, the estimate of contract costs has increased to Shs 80.5 million. The Aid Agency agrees to fund half of this increase in estimated costs.

In year 2, the Government on the advice of the ministry approves a variation resulting in estimated additional costs of Shs 1.5 million. The aid agency agrees to fund 50% of this variation. At the end of year 2, Shs 1 million was incurred for standard materials, stored at the site to be used in year 3 to complete the project.

Required:

- (i) Determine the stage of completion for each of the three years.
(6 marks)
- (ii) Show the contract revenue and expenses recognised in the statement of financial performance in the three years.
(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