

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL TWO

ADVANCED FINANCIAL ACCOUNTING – PAPER 8

MONDAY, 13 JUNE 2011

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 **four** questions and only **three** questions are to be attempted. Each question carries 20 marks.
4. Section **C** has **two** questions and only **one** question is to be attempted. Each question carries 10 marks.
5. Please read further instructions on the answer booklet, before attempting any question.

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SECTION A

Question 1

The following balances were extracted from the books of Dominion Ltd as at 31 May 2011:

	Note	Dr Shs '000'	Cr Shs '000'
Share capital 100,000 shares of Shs 1,000 per share			100,000
Accumulated profits 1 June 2010			95,600
Suspense account	7		60,000
Revaluation reserves			37,000
Trade and other payables			70,600
Taxation	6		4,200
Land and building at valuation	3	300,000	
Plant and equipment at cost	4	169,200	
Plant on lease at cost	9	28,000	
Investment property at valuation 1 June 2010	5	20,000	
Accumulated depreciation:			
Land and building			18,000
Plant and equipment			49,200
Trade and other receivables		62,400	
Inventory 1 June 2010		53,100	
Cash and bank		7,400	
Sales revenue	2		626,000
Investment income			2,400
Purchases		316,900	
Distribution costs		52,800	
Administration costs		46,400	
Finance costs		1,800	
Ordinary dividend paid		5,000	-
		<u>1,063,000</u>	<u>1,063,000</u>

Notes:

1. The inventory at 31 May 2011 was valued at Shs 57 million. This includes Shs 10 million of slow moving goods. Dominion Ltd is trying to sell these to another retailer but has not been successful in obtaining a reasonable offer. The best price it has been offered is Shs 6 million.
2. Dominion Ltd's revenue includes Shs 16 million of revenue for credit sales made on a 'sale or return' basis. At 31 May 2011, customers who had not paid for the goods had the right to return Shs 5.2 million of them. A margin of 30% applies on all sales of this nature. In the past, customers have sometimes returned goods under this type of arrangement.
3. On 1 June 2007 Dominion Ltd had its land and buildings revalued by a firm of surveyors at Shs 300 million, with Shs 60 million of this attributed to the land. At that date, the remaining life of the building was estimated to be 40 years. These figures were incorporated into the

company's books. There has been no significant change in property values since the revaluation. Shs 1 million of the revaluation reserve will be realised in the current year as a result of the depreciation of the buildings.

4. Plant and equipment (other than that referred to in note 3 above) is depreciated at 20% per annum on the reducing balance basis. All depreciation is to be charged to cost of sales.
5. Value of investment property:
1 June 2010 Shs 20 million
31 May 2011 Shs 19.6 million
The company adopts the fair value method in IAS 40: Investment Property of valuing its investment property.
6. The balance on the taxation account in the trial balance is the result of the settlement of the previous year's tax charge. The directors have estimated the provision for income tax for the year to 31 May 2011 at Shs 18.4 million.
7. The suspense account contains the credit entry relating to the issue on 1 October 2010 of Shs 60 million 6% loan stock. Interest is payable six months in arrears. The first payment of interest has been accrued and was due on 1 April 2011.
8. In the current accounting period, Dominion Ltd has spent Shs 10 million sending its staff on specialist training courses. While these courses have been expensive, they have led to a marked improvement in production quality and staff now need less supervision. This in turn has led to an increase in revenue and cost reductions. The directors of Dominion Ltd believe these benefits will continue for at least five years and wish to treat the training costs as an intangible asset instead of administration costs.
9. On 1 June 2010 Dominion Ltd purchased an item of plant for Shs 28 million which it leased to a customer on the same date. The lease period is four years with annual rentals of Shs 8 million in advance. The plant is expected to have a nil residual value at the end of the four years. The Directors have been advised that this is a finance lease.

Required:

In accordance with International Financial Reporting Standards and as far as information permits, prepare for Dominion Ltd for the year ended 31 May 2011:

- (a) A statement of comprehensive income. (10 marks)
- (b) A statement of changes in equity. (5 marks)
- (c) A statement of financial position. (15 marks)

Note: Show all your workings.

(Total 30 marks)

SECTION B**Question 2**

Clay Merchandise Ltd makes clay products and distributes them to various parts of the country. It has recently adopted the International Financial Reporting Standard for Small and Medium Enterprises (IFRS for SMEs) and has subscribed to an interfirm comparison service where all companies in this sector submit accounting ratios, and in return, members receive the average figures for each of the specified ratios taken from all of them in the same sector. The specified ratios and the average figures for Comparator's sector are shown below.

Ratios of companies reporting a full year's results for periods ending between 31 December 2010 and 31 May 2011:

Return on capital employed	21.1%
Net assets turnover	1.5 times
Gross profit margin	25%
Net profit (before tax) margin	10.5%
Current ratio	1.5:1
Quick ratio	0.8:1
Inventory holding period	45 days
Accounts receivable collection period	40 days
Accounts payable payment period	50 days
Debt to equity ratio	35%
Interest cover	4 times

Comparator's financial statements for the year to 31 May 2011 are set out below:

Statement of Comprehensive Income:	Shs million
Sales revenue	48,500
Cost of sales	<u>(37,400)</u>
Gross profit	11,100
Other operating expenses	<u>(4,300)</u>
Operating profit	6,800
Administration costs	<u>(2,400)</u>
Interest payable	<u>(680)</u>
Profit before taxation	3,720
Income tax	<u>(1,800)</u>
Profit after taxation	<u><u>1,920</u></u>

Extracts from Statements of Changes in Equity:	Shs million
Accumulated profits 1 June 2010	3,580
Net profit for the period	<u>1,920</u>
	5,500
Dividends paid (interim Shs 1.2 million; final Shs 0.6 million)	<u>(1,800)</u>
Accumulated profits 31 May 2011	<u><u>3,700</u></u>

Statement of Financial Position	Shs '000'	Shs '000'
Assets		
Current assets:		
Bank	-	
Accounts receivable	6,400	
Inventory	<u>5,500</u>	
		11,900
Non-current assets (note i)		<u>10,800</u>
Total Assets		<u><u>22,700</u></u>

Liabilities and Equity:

Current liabilities:		
Bank overdraft	1,300	
Trade accounts payable	7,000	
Taxation	<u>1,700</u>	
		10,000
Non-current liabilities		
8% loan notes		6,000
Share Capital and Reserves:		
Ordinary shares (Shs 5,000 per share)	3,000	
Accumulated profits	<u>3,700</u>	
		<u>6,700</u>
		<u><u>22,700</u></u>

Notes:

- (i) Details of the non-current assets at 31 May 2011:

	Shs '000'
Cost	72,000
Accumulated depreciation	<u>(61,200)</u>
Net book value	<u>10,800</u>

Required:

- (a) Explain the problems that are inherent when ratios are used to assess a company's financial performance. Your answer should consider any additional problems that may be encountered when using interfirm comparison services such as that used by Clay Merchandise Ltd.

(7 marks)

- (b) As the Finance Manager of Clay Merchandise Ltd, write a report to the Managing Director analysing the financial performance of the company based on a comparison with the sector averages.

(13 marks)**(Total 20 marks)****Question 3**

- (a) Earnings per Share is perhaps the single most important topic you should understand before investing money in the market. In fact, because of the importance of earnings to shareholders, a great deal of time is spent developing and evaluating earnings per share estimates. One should carefully examine the earnings information for a company. The reason earnings are so important to stockholders is because they tell you about the relative profitability of a company.

Required:

Explain why the trend of earnings per share may be different from the trend of the reported profits, and which is the more useful measure of performance.

(4 marks)

- (b) Alpha Limited has 85 million shares. On 1 June 2010 it issued Shs 200 million 8% convertible loan stock at par. The terms of conversion (on 1 June 2013) are that, 50 ordinary shares will be issued for every Shs 1,000 of loan stock at the option of loan stockholders. Alternatively the loan stock will be redeemed at par for cash. Also on 1 June 2010, the directors of Alpha Limited were awarded share options of 12 million ordinary shares exercisable from 1 June 2013 at Shs 15 per share. The income tax rate is 30%. Earnings attributable to ordinary shareholders for the year ended 31 May 2011 were Shs 255 million. The average market value of Alpha Limited's ordinary shares for the year ended 31 May 2011 is Shs 25 per share. The share options have been correctly

recorded in the income statement. It is assumed that both the convertible loan stock and the directors' options are dilutive.

Required:

Calculate Alpha Limited's basic and diluted earnings per share for the year ended 31 May 2011 (comparative figures are not required).

(7 marks)

- (c) Related party relationships are a common feature of commercial life that are not sometimes disclosed separately. The objective of IAS 24: Related Party Disclosures is to ensure that financial statements contain the necessary disclosures to make users aware of the possibility that financial statements may have been affected by the existence of related parties.

Required:

- (i) Describe 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.

(5 marks)

(Total 20 marks)

Question 4

- (a) Odravu Town Council has several sources of revenue among which are as follows:

Date	Source	Arrears b/f	Amount due	Amount received
		Shs	Shs	Shs
21 July 2010	Market 1 (for the year)	926,300	8,000,000	7,245,700
22 July 2010	Market 2 (for the year)	786,000	6,500,000	4,980,000
3 Aug. 2010	Land use (for the year)	950,000	6,000,000	5,601,000

The revenue received was collected by the Town Clerk and includes the previous outstanding balance.

Required:

Draw up a Revenue Register (Form RE 11) for the above revenue.

(10 marks)

- (b) The following information relates to central government grants to Odravu Town Council:

Grants Received 31 July 2010

	Shs '000'
District unconditional grant	100,000
Conditional transfers for PHC salaries	46,000
Conditional transfers to agricultural extensions	<u>34,500</u>
	<u>180,500</u>

Grants Accounted For 10 May 2011

District unconditional grant	100,000
Conditional transfers for PHC salaries	42,500
Conditional transfers to agricultural extensions	<u>33,000</u>
	<u>175,500</u>

The grants received were transferred to the relevant expenditure accounts on 4 August 2010. All unconditional grants received were used for payment of salaries.

Required:

Show all the necessary journal accounting entries to be made concerning the above grants.

(10 marks)

(Total 20 marks)

Question 5

- (a) IAS 12: Income Taxes was issued in 1996 and revised in 2000. It details the requirements relating to the accounting treatment of deferred tax.

Required:

- Explain why it is considered necessary to provide for deferred tax.
- Briefly outline the principles of accounting for deferred tax contained in IAS 12: Income Taxes.

(5 marks)

- (b) Bow Holdings Limited purchased an item of plant for Shs 46 million on 1 June 2008. It had an estimated life of eight years and an estimated residual value of Shs 9.2 million. The plant is depreciated on a straight-line basis. Depreciation is not an allowable expense. Instead initial allowance of 50% of the cost of this type of asset can be claimed against income tax in the year of purchase and 20% per annum (on a reducing balance basis) of its tax base thereafter. The rate of income tax is 30%.

Required:

In respect of the above item of plant, calculate the:

- (i) deferred tax charge/credit in Bow Holding Limited's statement of comprehensive income for the year to 31 May 2011.
(3 marks)
- (ii) deferred tax balance in the statement of financial position at that date.
(2 marks)
- (c) In accordance with IAS 38: Intangible Assets, discuss whether intangible assets should be recognised, and if so, how they should be initially recorded and subsequently amortised in circumstances when; they are purchased separately from other assets, they are obtained as part of acquiring the whole of a business and when they are developed internally.
(10 marks)

(Total 20 marks)

SECTION C

Question 6

- (a) The IASB's Framework for the Preparation and Presentation of Financial Statements requires financial statements to be prepared on the basis that they comply with certain accounting concepts, underlying assumptions and qualitative characteristics that include: Matching / accruals, Prudence and Materiality.

Required:

Explain the above concepts / assumptions, and illustrate with examples how each of these concepts / assumptions may be applied to accounting for trade and other receivables.

(6 marks)

- (b) Explain why events occurring after the reporting date may be relevant to the financial statements of the previous period.

(4 marks)

(Total 10 marks)

Question 7

Explain the functions and powers of the Auditor General.

(10 marks)