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CPA PART III SECTION 6

ADVANCED FINANCIAL REPORTING

MONDAY: 30 November 2020. **Time Allowed: 3 hours.**

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings.

QUESTION ONE

(a) International Financial Reporting Standard (IFRS) 6 "Exploration for and Evaluation of Mineral Resources" requires entities to assess exploration and evaluation assets for impairment. The recognition criteria for impairment are different from those in International Accounting Standard (IAS) 36 "Impairment of Assets".

Required:
With reference to International Financial Reporting Standard (IFRS) 6, evaluate the circumstances under which impairment tests on exploration and evaluation assets are required. (6 marks)

(b) Professional accountants are expected to follow the guidance contained in the fundamental principles in the ethical code in all their courses of action. The ethical code sets out five fundamental principles of ethics comprising: Integrity, objectivity, professional competence and due care, confidentiality and professional behaviour; the spirit of which must be complied with.

Required:
With reference to the ethical code, discuss three circumstances that may potentially threaten the professional accountant's compliance with the fundamental principles of ethics. (6 marks)

(c) ABC Ltd. owns a machine which originally cost Sh.10,000,000. The accumulated depreciation associated with the machine was Sh.2,500,000 as at 31 December 2019. A mechanical engineer assessed the machine in early January 2020. The engineer's report stated that similar damaged machines had sold for Sh.1,000,000 in the recent past. In addition, due to the machine's unique nature, significant advertising costs of Sh.100,000 would be incurred to find a buyer. The machine was not covered by insurance.

A power surge during the year ended 31 December 2019 reduced the machine's production capacity and shortened its expected life. ABC Ltd.'s management accountants estimated that the damaged machine would generate cash flows of Sh.3,000,000 per annum over an expected remaining useful life of 3 years. ABC Ltd.'s cost of capital is 9%. No impairment of the machine had been recorded in the accounts.

Required:
In the context of IAS 36 (Impairment of Assets), outline the necessary accounting treatment of the machine given the above information.

Note: The present value interest factor of an annuity of Sh.1 per year at 9% for 3 years is 2.5313. (4 marks)

(d) Discuss two benefits that an organisation might derive from providing social and environmental reports. (4 marks)
(Total: 20 marks)

QUESTION TWO

(a) The objective of International Public Sector Accounting Standard (IPSAS) 18 "Segment Reporting" is to establish principles for reporting financial information by segments. The disclosure of this information will help users of the financial statements to better understand the entity's past performance, identify the resources allocated to support the major activities of the entity, enhance the transparency of financial reporting and enable the entity to better discharge its accountability duties.

Required:
In the context of International Public Sector Accounting Standard (IPSAS) 18 "Segment Reporting", explain how public sector entities identify segments that should be reported separately and indicate how this differs from reportable segments for commercial sector entities under International Financial Reporting Standard (IFRS) 8 "Operating Segments". (4 marks)

(b) H Limited is the parent entity of a group of companies with two subsidiaries, S Limited and R Limited. Both subsidiaries have been owned for a number of years.

The following statements of profit or loss and other comprehensive incomes relate to the group of companies:

Statement of profit or loss and other comprehensive incomes for the year ended 30 April 2020:

	H Limited Sh."million"	S Limited Sh."million"	R Limited Sh."million"
Revenue	4,275	2,515	1,730
Cost of sales	(2,735)	(1,445)	(1,010)
Gross profit	1,540	1,070	720
Distribution costs	(305)	(195)	(90)
Administrative expenses	(370)	(235)	(120)
Profit from operations	865	640	510
Finance costs	(45)	(40)	(30)
Profit before tax	820	600	480
Income tax expense	(160)	(120)	(100)
Profit after tax for the year	660	480	380
Other comprehensive income:			
Gain on property revaluation	150	80	-
Total comprehensive income	810	560	380

Additional information:

1. On 1 May 2017, H Limited acquired 75% of the ordinary shares of S Limited, a public limited entity. The purchase consideration was cash of Sh.560 million and the fair value of the identifiable net assets of S Limited was Sh.400 million as at that date. The fair value of non-controlling interest in S Limited as at the date of acquisition was Sh.240 million. H Limited wishes to use the "full goodwill" method for all acquisitions. The ordinary share capital and retained profit of S Limited as at the acquisition date were Sh.100 million and Sh.200 million respectively and there were no other reserves. The excess of the fair value of the identifiable net assets at acquisition is due to an increase in fair value of plant, which is depreciated on a straight-line basis and had a five-year remaining life as at the date of acquisition.
2. H Limited had acquired 80% of the ordinary shares of R Limited, on 1 May 2016. The purchase consideration was cash of Sh.600 million. R Limited's identifiable net assets had a fair value of Sh.550 million which was equal to their carrying amounts. The non-controlling interest in R Limited had a fair value of Sh.150 million at the date of acquisition.
3. On 1 November 2019, H Limited disposed of 30% of the ordinary shares of R Limited for a consideration of Sh.375 million. R Limited's identifiable net assets were Sh.675 million and the non-controlling interest of R Limited had a carrying value of Sh.175 million at the date of disposal. The remaining equity interest in R Limited held by H Limited had a fair value of Sh.575 million on 1 November 2019.

   After disposal, H Limited would exercise joint control over R Limited. The profits and losses of R Limited are deemed to accrue evenly over the year.
4. H Limited sold inventory to both S Limited and R Limited at a price of Sh.150 million and Sh.45 million respectively, in the month of October 2019. H Limited sells goods at a gross profit margin of 20% to group companies and third parties. At the year end, half of the inventory sold to S Limited remained unsold but the entire inventory sold to R Limited had been transferred to third parties.
5. Goodwill arising on acquisitions has been tested for impairment annually and as at 30 April 2019, goodwill on acquisition of S Limited had reduced in value by 15% and as at 30 April 2020, had lost a further 5% of its original value.

   No impairment had occurred in respect of goodwill on acquisition of R Limited and the interest in R Limited.

Required:

(i) Gain or loss arising on disposal of R Limited to be presented on the consolidated statement of profit or loss and other comprehensive incomes. (4 marks)

(ii) Consolidated statement of profit or loss and other comprehensive incomes for H Group for the year ended 30 April 2020. (12 marks)

(Total: 20 marks)

QUESTION THREE

(a) Madini Ltd. issued share options to its directors on 1 January 2019. The options have a vesting period of 10 years and had a fair value of Sh.20,000,000 as at the date of issue. In order to be eligible to exercise the share options, the directors are required to remain in the employment of Madini Ltd. over the entire vesting period.

Actuaries have estimated that 20% of the directors who have received the share options will leave the employment of Madini Ltd. over the vesting period. The financial year end of Madini Ltd. is 31 December.

Required:

Advise the management of Madini Ltd. on how to account for the share options in the financial statements for the year ended 31 December 2019. (6 marks)

(b) Uzamatt Ltd. is a long-established retail entity which has been operating through a network of retail outlets and an online store. In recent years, the business has seen its revenue from the online store grow strongly, and that from retail outlets decline significantly. On 25 June 2019, the board of Uzamatt Ltd. decided to close the retail network at the financial year end of 31 December 2019 and put the buildings up for sale on that date.

The directors of Uzamatt Ltd. are seeking advice regarding the treatment of the buildings in the statement of financial position, as well as the treatment of the trading results of the retail division for the year ended 31 December 2019. The following figures have been provided as at 31 December 2019:

	Sh."million"
Carrying value of buildings	2,000
Fair value less costs to sell of the buildings	1,720
Other expected costs of closure	390

Trading results:

1. Year ended 31 December 2019:

	Online store Sh."million"	**Retail outlet Sh."million"**
Revenue	3,900	900
Cost of sales	(1,300)	(700)
Gross profit	2,600	200
Operating costs	(1,000)	(500)
Profit before tax	1,600	(300)

2. Year ended 31 December 2018:

	Online store Sh."million"	**Retail outlet Sh."million"**
Revenue	3,200	1,200
Cost of sales	(1,100)	(900)
Gross profit	2,100	300
Operating costs	(800)	(500)
Profit before tax	1,300	(200)

Required:

In the context of IFRS 5 (Non-current Assets Held for Sale and Discontinued Operations);

(i) Discuss the conditions which must be present in order to classify a non-current asset as being "held for sale". (6 marks)

(ii) Draft the statement of profit or loss for Uzamatt Ltd. for the year ended 31 December 2019, together with the comparatives for 2018, taking the above information into account. (8 marks)

(Total: 20 marks)

QUESTION FOUR

(a) Distinguish between the two types of joint arrangement described by IFRS 11 (Joint Arrangements). (4 marks)

(b) Dynamic Ltd. has been reporting losses for the past few years. The creditors and shareholders have come up with a capital re-organisation plan aimed at putting the company back on the path of profitability.

The following is the summarised statement of financial position of the company as at 30 June 2019:

	Sh."million"	Sh."million"
Assets:		
Non-current assets:		
Tangible assets		3,040
Intangible assets		1,872
		4,912
Current assets:		
Inventory	2,720	
Accounts receivable	3,104	
Investment (market value Sh.896 million)	352	6,176
Total assets		11,088
Capital and liabilities:		
Share capital:		
240 million ordinary shares of Sh.20 each		4,800
6%, 128 million cumulative preference shares of Sh.20 each		2,560
		7,360
Revenue reserve:		
Accumulated losses		(2,624)
Non-current liabilities:		
6% debentures		2,400
		7,136
Current liabilities:		
Accounts payable	1,600	
Bank overdraft	1,248	
Debenture interest payable	144	
Accruals	320	
Directors' loans	640	
		3,952
Total capital and liabilities		11,088

The court approved the scheme of reorganisation and it was to take effect on 1 July 2019. Details of the approved scheme were as follows:

1. Tangible assets comprised freehold property and plant valued at Sh.2,720 million and Sh.320 million respectively while the intangible assets comprised patents and goodwill valued at Sh.976 million and Sh.896 million respectively.

   Patents and goodwill are to be written off. An amount of Sh.480 million is to be written off inventory and Sh.374.4 million is to be provided for bad debts. The remaining freehold property is to be revalued at Sh.2,480 million. The investment was sold at the prevailing market value.
2. The 6% preference dividends are four years in arrears of which three-quarters are to be waived and ordinary shares are to be allocated at par for the balance.
3. The 6% preference shares are to be written down to Sh.15 each and the existing ordinary shares to Sh.4 each.

   All the ordinary shares are to be consolidated into shares of Sh.20 each. The rate of dividend on preference shares is to be increased to 10%.
4. There are capital commitments amounting to Sh.2,400 million which are to be cancelled, on payment of 3⅓% of the contract price as a penalty.
5. The 6% debenture holders were to have their interest paid in cash and to take over part of the freehold property (book value Sh.640 million) at a valuation of Sh.768 million in part payment of their holding. The 6% debenture holders are also to provide additional cash of Sh.832 million secured by a floating charge on the company's assets at an interest rate of 12% per annum.
6. The directors were to accept settlement of their loans as to 90% thereof by allotment of ordinary shares at par and as to 5% in cash. The balance of 5% was to be waived.

7. The trade payables were to be paid Sh.0.40 in every shilling to maintain and obtain an extension of the credit period.
8. The bank has sanctioned an overdraft limit of Sh.40 million to provide working capital.

Required:

(i) The capital reduction account to record the scheme of capital re-organisation. (8 marks)

(ii) The statement of financial position of Dynamic Ltd. as at 1 July 2019 immediately after effecting the scheme of reorganisation. (8 marks)

(Total: 20 marks)

QUESTION FIVE

(a) On 1 January 2019, Dodoma Ltd. issued 1,000,000 bond instruments with a face value of Sh.100, at a market price of Sh.95. Bond brokers charged fees totalling Sh.1,800,000 in relation to the bond issue. The bonds carry a coupon rate of 5% and are redeemable in 3 years at face value. Dodoma Ltd. wishes to account for the bonds using the amortised cost method as per IFRS 9 (Financial Instruments).

However, there is some confusion about how the bonds should be accounted for. The cash received from the bond issue of Sh.95,000,000 has been recognised as a non-current liability. The broker fees of Sh.1,800,000 were deducted from the carrying amount of the non-current liability. The coupon payment of Sh.5,000,000 has been expensed in arriving at the profit before tax.

The effective rate of interest is 7.62%. The coupon interest payments are made at the end of the year.

Required:

Demonstrate how the bond issue should be accounted for in the books of Dodoma Ltd. for the year ended 31 December 2019. (10 marks)

(b) On 1 January 2019, Kamili Ltd. commenced a defined benefit pension plan for its employees. Under the pension plan, Kamili Ltd. has an obligation to provide staff with agreed post-employment benefits. Kamili Ltd. carries the actuarial and investment risk associated with the pension scheme.

The following information has been compiled for the financial year ended 31 December 2019:

	Sh."000"
Interest income on plan assets	16,500
Employer contributions to plan	550,000
Current service cost	600,000
Interest on plan liability	18,000
Fair value of plan assets (31 December 2019)	580,000
Present value of plan obligations (31 December 2019)	620,000

Kamili Ltd's accountant was not sure which accounting standard to apply when accounting for the pension scheme. The only adjustment made to account for the scheme was to expense the company's contribution of Sh.55,000,000 for the financial year ended 31 December 2019 in the statement of profit or loss and other comprehensive incomes and to credit the cash account.

Required:

Evaluate the treatment Kamili Ltd.'s accountant has given the above issues and offer any correction, if and where necessary. Use journal entries. (10 marks)

(Total: 20 marks)

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