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CPA PART II SECTION 3

FINANCIAL REPORTING

THURSDAY: 20 May 2021. **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

International Public Sector Accounting Standards (IPSAS) prescribe the accounting treatment of various items of revenue, expenditure, assets and liabilities in the books of public sector entities.

Required:

With reference to the above statement:

(a) Describe three constraints that affect the relevance and reliability of financial information presented by public entities. (6 marks)

(b) Summarise the key provisions of IPSAS 3 – Accounting Policies, Changes in Accounting Estimates and Errors with regard to changes in accounting policies. (6 marks)

(c) Discuss four challenges facing the adoption of IPSAS in your country. (8 marks)

(Total: 20 marks)

QUESTION TWO

(a) In the context of International Financial Reporting Standard (IFRS) 9 "Financial Instruments: Recognition and Measurement", explain the accounting treatment of financial instruments that are equity instruments, both on initial recognition and subsequent measurement. (8 marks)

(b) The following balances were extracted from the financial records of Savanna Commercial Bank PLC for the year ended 31 December 2020:

	Sh."000"
Intangible assets	857,140
Property, plant and equipment	1,494,190
Interest on loans and advances	1,329,750
Interest on customers' deposits	750,135
Loan loss reserve	578,345
Customers' deposits	3,444,990
Deposits and placements due from other banks	389,190
Interest received on deposits and placements with other banks	19,780
Interest paid on deposits and placements from other banks	26,320
Income tax credit	28,720
Ordinary share capital	1,900,000
Revaluation surplus	300,000
Depreciation on property, plant and equipment	62,355
Other interest income	7,760
Equity investments	225,000
Loans and advances	3,675,230
Retained earnings (1 January 2020)	193,200
Deposits and placements due to other banks	484,490
Long-term borrowings	1,720,000
Other interest expenses	33,700

	Sh."000"
Fees and commission income	13,150
Dividend income	2,250
Share premium	270,000
Staff remuneration expenses	478,710
Pension costs	85,930
Directors' salaries	38,260
Printing and stationery	52,500
Deferred tax asset	37,500
Tax refundable	27,750
Cash in hand and with central bank	2,055,125
Miscellaneous expenses	3,400

Required:
Prepare for Savanna Commercial Bank PLC:

(i) Statement of profit or loss for the year ended 31 December 2020. (6 marks)

(ii) Statement of financial position as at 31 December 2020. (6 marks)
(Total: 20 marks)

QUESTION THREE

The following trial balance relates to Baraka Ltd. as at 30 September 2020:

	Sh."000"	Sh."000"
Revenue		380,000
Cost of sales	246,800	
Distribution cost	17,400	
Administrative expenses	50,500	
Interest on loan paid	1,000	
Investment income		1,300
Profit on sale of investments		2,200
Current tax	2,100	
Freehold property at cost (1 October 2019)	63,000	
Plant and equipment at cost	42,200	
Brand at cost (1 October 2016)	30,000	
Accumulated depreciation (1 October 2019):		
Building		8,000
Plant and equipment		19,700
Accumulated amortisation (1 October 2019)		9,000
Investment in equity instruments	26,500	
Inventory (30 September 2020)	38,000	
Trade receivables	44,500	
Bank	8,000	
Trade payables		42,900
Ordinary share capital		52,000
Retained earnings (1 October 2019)		26,060
Other reserves (1 October 2019)		5,000
5% convertible loan notes 2022		18,440
Deferred tax		5,400
	570,000	570,000

Additional information:

1. Baraka Ltd. revenue include Sh.16 million for goods sold to Chaka Ltd. on 1 October 2019 on sale or return basis. Baraka Ltd. normally makes a profit margin of 40% on such sales. Chaka Ltd. is yet to confirm the sales.
2. Administrative expenses include an equity dividend of Sh.1,200,000 paid during the year.
3. The 5% convertible loan note was issued for proceeds of Sh.20 million on 1 October 2018. It has an effective interest rate of 8% due to the value of its conversion option.
4. During the year, Baraka Ltd. sold an equity investment for Sh.11 million. At the date of sale, it had a carrying value of Sh.8 million and had originally cost Sh.7 million. Baraka Ltd. has recorded the disposal of the investment. The remaining equity investment (the Sh.26.5 million in the trial balance) have a fair value of Sh.29 million as at 30 September 2020. The other reserve in the trial balance represents the net increase in the value of the equity investments as at 1 October 2019. Baraka Ltd. made an irrevocable decision at initial recognition of these

instruments to recognise all changes in fair value through other comprehensive income and makes a transfer of realised profit from the other reserves to income surplus on disposal of the investments.
Ignore deferred tax on these transactions.

5. The balance on the current tax represents the under/over provision of the tax liability for the year ended 30 September 2019. The income tax expense for the year ended 30 September 2020 is estimated at Sh.16.2 million. As at 30 September 2020, the carrying amount of Baraka Ltd. net assets were Sh.13 million in excess of their tax base. The income tax rate of Baraka Ltd. is 30%.

6. Non current assets:
The freehold property has a land element of Sh.13 million. The building element is being depreciated on a straight line basis. Plant and equipment is depreciated at a rate of 40% per annum on reducing balance method. Baraka Ltd.'s brand in the trial balance relates to a product line that received bad publicity during the year which led to falling sales revenues. An impairment review was conducted on 1 April 2020 which concluded that based on estimated future sales, the brand had a value in use of Sh.12 million and a remaining useful life of only three years. However, on the same date as the impairment review, Baraka Ltd. received an offer to purchase the brand for Sh.15 million.

Prior to the impairment review of the brand, it was being depreciated using the straight line method over a 10 year life. No depreciation/amortisation has yet been charged on any non current asset for the year ended 30 September 2020. Depreciation, amortisation and impairment charges are all charged to cost of sales.

Required:

(a) Statement of comprehensive income for the year ended 30 September 2020. (10 marks)

(b) Statement of financial position as at 30 September 2020. (10 marks)

(Total: 20 marks)

QUESTION FOUR

Abel, Benta and Chale have been trading in a partnership business under the name ABC Enterprises. They decided to convert the partnership into a limited company, Abele Ltd. as at 30 November 2019. The partnership's financial year ends on 31 May and the company will continue using the same year end date.

The trial balance below showed the financial position of the partnership as at 31 May 2020 before making adjustment for the conversion to the company:

		Sh."000"	Sh."000"
Capital:	Abel		32,000
	Benta		16,000
	Chale		10,000
Current account:	Abel		2,000
	Benta		2,000
	Chale	1,000	
Drawings in cash:	Abel	2,000	
	Benta	1,200	
	Chale	1,200	
Freehold property at cost		51,600	
Motor vehicles at cost		24,000	
Furniture and fittings at cost		12,000	
Accumulated depreciation	- Motor vehicle		7,200
	- Furniture and fittings		7,200
Inventory (31 May 2020)		28,800	
Cost of sales		60,800	
Sales			120,000
Administrative expenses		12,000	
Selling and distribution expenses		6,000	
Accounting and audit expenses		2,400	
Incorporation expenses		1,200	
Trade receivables and trade payables		18,000	12,200
Prepayments and accruals		1,000	600
Loan from Benta (10% interest per annum)			12,000
Bank balance			2,000
		223,200	223,200

Additional information:

1. The partners were sharing profits and losses equally after allowing for annual salaries of Sh.3 million for Abel and Sh.2.2 million each for Benta and Chale.
2. The partners agreed on the following conditions for conversion to a company:
   - Assets to be revalued as follows:

	Sh."million"
Freehold property	54
Furniture and fittings	4.8
Motor vehicles	24

   - Goodwill to be valued at Sh.27 million.
   - Each partner to become a director of the company at the same salary as that previously allowed in the partnership.
   - Benta's loan is to be converted into share capital at par.
   - Shares are to be issued to each partner at par in respect of the amounts of their equity holding as at 30 November 2019.
3. The sales during the second half of the year after conversion were 50% above that of first half. However, the gross profit percentage remained the same throughout the year.
4. The selling and distribution expenses were proportional to the sales for each period. All the expenses were incurred evenly throughout the year.
5. Salary drawings were made evenly. Drawings made after incorporation were to be treated as directors' salaries.
6. There were no purchases or sales of non-current assets during the year.
   Depreciation is to be provided on cost per annum as follows:

Motor vehicles	-	20%
Furniture and fittings	-	10%

7. No dividends are paid or proposed but it is decided to write off the incorporation expenses and also Sh.7 million of goodwill. Goodwill is treated as having arisen from purchase of a business.

Required:

(a) Statement of profit or loss in columnar form showing separately for ABC Enterprises and Abele Ltd. for the year ended 31 May 2020. (8 marks)

(b) Calculations showing the value of shares to be issued to each partner. (4 marks)

(c) Statement of financial position for Abele Ltd. as at 31 May 2020. (8 marks)

(Total: 20 marks)

QUESTION FIVE

On 1 April 2018, Ambaza Ltd. acquired the following investments:

- 1,320,000 equity shares in Rudisha Ltd. at a cost of Sh.27,300,000 when the retained earnings of Rudisha Ltd. were Sh.12,500,000.
- 50% of Rudisha Ltd's 12% debentures at par.

The statement of financial position of the two companies as at 31 March 2020 were as follows:

	Ambaza Sh."000"	Rudisha Sh."000"
Non-current assets:		
Property, plant and equipment	37,300	24,060
Investments	52,600	4,800
	89,900	28,860
Current assets:		
Inventories	6,350	5,200
Accounts receivable	4,360	1,950
Bank	1,390	-
	12,100	7,150
Total assets	102,000	36,010
Equity and liabilities:		
Equity and reserves:		
Ordinary share capital (Sh.10 each)	43,000	16,500
Retained earnings	34,560	8,190
	77,560	24,690

	Ambaza Sh."000"	Rudisha Sh."000"
Non current liabilities:		
12% debentures	8,200	2,800
Deferred tax	3,900	1,200
	12,100	4,000
Current liabilities:		
Accounts payable	5,710	1,760
Taxation	5,330	2,410
Dividends	1,300	1,200
Bank overdraft	-	1,950
	12,340	7,320
	102,000	36,010

Additional information:

1. The fair value of Rudisha Ltd.'s assets at the date of acquisition was equal to their carrying value except for an item of plant which had a fair value of Sh.1,600,000 in excess of its carrying value. The plant had a remaining useful life of 4 years.
2. On 15 March 2020, Rudisha Ltd. sold goods to Ambaza Ltd for Sh.700,000, all on credit terms. The goods had not been received by the company as at 31 March 2020 and were not included in closing inventory. No entry had been made in the books of Ambaza Ltd. in respect of this transaction. Rudisha Ltd. sells goods to all customers at a standard mark up of 16⅔%.
3. As at 31 March 2020, the account payable of Ambaza Ltd. included Sh.750,000 due to Rudisha Ltd. before taking into account the above transaction.
4. Ambaza Ltd. had not accounted for dividend receivable from Rudisha Ltd.
5. Goodwill arising on acquisition of Rudisha Ltd. was considered impaired by 20% as at 31 March 2020.
6. The fair value attributable to non controlling interest amounted to Sh.6,800,000.

Required:

Consolidated statement of financial position as at 31 March 2020. **(Total: 20 marks)**

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