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CPA ADVANCED LEVEL

ADVANCED FINANCIAL REPORTING AND ANALYSIS

MONDAY: 24 April 2023. Afternoon Paper. Time Allowed: 3 hours.

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings. Do NOT write anything on this paper.

QUESTION ONE

Zura Limited, a private limited company which operates in the textile industry, has been in financial distress and has been reporting trading losses in recent years.

The company's latest statement of financial position as at 31 July 2022 was as shown below:

Sh."000" Sh."000"

Assets:

Non-current assets:

Freehold property 48,550 Plant and equipment 14,175 Motor vehicles 7,075 Fixtures and fittings 4,725 Goodwill 4,375 78,900

Current assets:

Inventories 11,825

Accounts receivable 3,175 15,000 Total assets 93,900

Equity and liabilities:

Equity:

Ordinary share capital (Sh.10 par value) 50,000

Share premium 10,500

Retained earnings (losses) (29,550)

Total equity 30,950

Non-current liability:

15% loan notes 40,000

Current liabilities:

Accounts payable 17,500

Bank overdraft 3,950

Accrued loan notes interest 1,500 22,950

Total equity and liabilities 93,900

The board of directors of Zura Limited, which also comprises the main shareholders, have proposed a scheme of internal financial reconstruction with effect from 1 August 2022, under the following terms:

1. The existing ordinary shares are to be reduced to Sh.2.5 per share.
   The current shareholders are to fully subscribe for a new issue of ordinary shares of Sh.2.5 each at par value, on the basis of four (4) new shares for every five (5) shares held.
2. The loan notes holders agreed to lower their interest rate to 12% per annum on condition that the accrued interest would be paid immediately.
3. The outstanding accounts payable accepted 6.4 million ordinary shares of Sh.2.5 each in full settlement of the amounts due.
4. The bank overdraft is to be repaid immediately.
5. The share premium account is to be utilised for the purpose of capital reduction.
6. The balances in the retained earnings (losses) and goodwill accounts are to be written off.

7. The following assets are to be adjusted to their fair values as follows:

	Sh.“000”
Freehold property	49,050
Plant and equipment	9,505
Motor vehicles	5,360
Fixtures and fittings	3,780
Inventories	10,050
Accounts receivable	2,925

8. Reconstruction costs of Sh.4 million are expected to be incurred and paid.

Required:

(a) Journal entries to effect the scheme of internal reconstruction. (8 marks)

(b) Capital reduction account as at 31 July 2022. (6 marks)

(c) Statement of financial position as at 1 August 2022 (immediately after the scheme of internal reconstruction). (6 marks)

(Total: 20 marks)

QUESTION TWO

The following are the summarised financial statements of P Limited and S Limited for the year ended 31 December 2022:

Statement of financial position as at 31 December 2022:

	P Limited Sh.“000”	S Limited Sh.“000”
Assets:		
Non-current assets:		
Property, plant and equipment	46,380	9,120
Investment in S Limited (cost)	7,464	-
	53,844	9,120
Current assets	15,240	2,640
Total assets	69,084	11,760
Equity and liabilities:		
Share capital (Sh.1 par value)	12,240	960
Revenue reserves	47,904	9,480
	60,144	10,440
Current liabilities	8,940	1,320
Total equity and liabilities	69,084	11,760

Statement of profit or loss and other comprehensive income for the year ended 31 December 2022:

	Sh.“000”	Sh.“000”
Revenue	12,240	4,800
Cost of sales and expenses	(10,800)	(4,320)
Profit before tax	1,440	480
Income tax expense	(432)	(96)
Profit for the year	1,008	384
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gain on property revaluation net of tax	288	96
Total comprehensive income	1,296	480

Additional information:

1. P Limited acquired 25% of S Limited on 1 January 2021 for Sh.2,424,000 and exercised significant influence over the financial and operating policy decisions of S Limited.

2. The fair value of S Limited’s identifiable assets and liabilities as at 1 January 2021 was equivalent to their book value. S Limited’s reserves stood at Sh.6,960,000.

3. A further 35% stake was acquired by P Limited in S Limited on 30 September 2022 for Sh.5,040,000. The fair value of S Limited’s identifiable assets and liabilities as at that date was Sh.11,040,000 and S Limited’s revenue reserves stood at Sh.9,360,000. As at 30 September 2022, S Limited’s share price was Sh.14.50.

4. The difference between the fair value of the identifiable assets and liabilities of S Limited and their book value was due to brands. The brands were estimated to have an average remaining useful life of 5 years from 30 September 2022.
5. Incomes and expenses are assumed to accrue evenly over the year. Neither company paid dividends during the year and neither issued any shares.
6. P Limited elected to measure non-controlling interests as at the date of acquisition at fair value.
7. There is no impairment loss on goodwill as at 31 December 2022 while amortisation of brands is classified in cost of sales.

Required:

(a) Consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 2022. (10 marks)

(b) Consolidated statement of financial position as at 31 December 2022. (10 marks)
(Total: 20 marks)

QUESTION THREE

(a) International Accounting Standard (IAS) 12 "Income Taxes", allows entities to recognise a deferred tax asset where they have unused tax losses, only to the extent that it is probable that future taxable profits will be available against which the unused tax losses can be utilised.

Required:

In view of the above statement, explain FOUR key considerations for recognition of deferred tax assets on unused tax losses. (8 marks)

(b) The following statement of financial position relates to ABC Ltd., a public limited company, as at 31 March 2022:

	Sh."000"
Assets:	
Non-current assets:	
Property, plant and equipment	10,000
Goodwill	6,000
Other intangible assets	5,000
Financial assets (cost)	9,000
	30,000
Current assets:	
Trade receivables 7,000	
Other receivables 4,600	
Cash and cash equivalents 6,700	
	18,300
Total assets 48,300	
Equity and liabilities:	
Equity:	
Share capital 9,000 Other reserves 4,500 Retained earnings 9,130	22,630
Non-current liabilities:	
Long term borrowings 10,000 Deferred tax liability 3,600 Employee benefit liability 4,000	17,600
Current tax liabilities:	
Current tax 3,070 Trade and other payables 5,000	
	8,070
Total liabilities 25,670 Total equity and liabilities 48,300	

The following information is relevant to the above statement of financial position:

1. The financial assets are classified as fair value through other comprehensive income as shown in the above statement of financial position at their cost on 1 April 2021, including transaction costs of Sh.0.5 million. The market value of the assets is Sh.10.5 million on 31 March 2022. Taxation is payable on the sale of the assets.
2. The stated interest rate for the long term borrowing is 8%. The loan of Sh.10 million represents a convertible bond which has a liability component of Sh.9.6 million and an equity component of Sh.0.4 million. The bond was issued on 31 March 2022.
3. The defined benefit plan had a rule change on 1 April 2021. ABC Ltd. estimates that of the past service cost of Sh.1 million, 40% relates to vested benefits and 60% relates to benefits that will vest over the next five years from that date. The past service costs have not been accounted for.
4. The tax bases of the assets and liabilities are the same as their carrying amounts in the statement of financial position as at 31 March 2022 except for the following:

Sh."000"

- Property, plant and equipment 2,400
  Trade receivables 7,500
  Other receivables 5,000
  Employee benefits 5,200
- Other intangible assets are development costs which were allowed for tax purposes when the costs were incurred in 2021.
- Trade and other payables include an accrual for compensation to be paid to employees. This amounts to Sh.1 million and is allowed for tax purposes when paid.

5. Goodwill is not allowable for tax purposes in the jurisdiction of ABC Limited.
6. Assume taxation is payable at the rate of 30%.

Required:

By applying the requirements of IAS 12 (Income Taxes):

(i) Calculate the temporary differences after the necessary adjustments. (ii) (10 marks)

Determine the deferred tax charge for the year ended 31 March 2022. (2 marks)

(Total: 20 marks)

QUESTION FOUR

(a) The objective of International Accounting Standard (IAS) 29 "Financial Reporting in Hyperinflationary Economies" is to establish specific standards for entities reporting in the currency of a hyperinflationary economy so that the financial information provided is meaningful.

Required:

Discuss THREE limitations of historical cost accounting when used for assessing entity performance during periods of inflation. (6 marks)

(b) The objective of International Financial Reporting Standard (IFRS) 13 "Fair Value Measurement" is to provide a single source of guidance for fair value measurement where it is required by a reporting standard, rather than it being spread throughout several reporting standards.

Required:

In light of the above statement and citing examples, briefly describe THREE hierarchical level inputs required by IFRS 13 "Fair Value Measurement". (6 marks)

(c) The sole mandate and responsibility for issuing International Financial Reporting Standards (IFRSs) lies with the International Accounting Standards Board IASB (The Board) which in conjunction with other regulatory bodies such as IFRS Foundation, the IFRS Advisory Council and IFRIC ensure the development of global accounting standards of high quality.

Required:

In view of the above statement, briefly describe the procedure for the development of an IFRS standard. (4 marks)

(d) With reference to International Public Sector Accounting Standard (IPSAS) 7 "Investment in Associates", briefly explain the accounting treatment of investment in associates in the financial statements of a public sector entity, and indicate how the requirements of IPSAS 7 compare with those of International Accounting Standard (IAS) 28 "Investment in Associates" for commercial sector entities. (4 marks)

(Total: 20 marks)

QUESTION FIVE

The following draft consolidated financial statements were extracted from the financial records of G Group for the year ended 30 September 2022:

G Group

Consolidated statement of profit or loss for the year ended 30 September 2022:

	Sh."million"
Revenue	18,590
Cost of sales	(11,250)
Gross profit	7,340
Distribution costs	(1,330)
Administration expenses	(2,460)
Profit from operations	3,550
Fair value gain on short term investments	170
Finance costs	(280)
Profit before tax	3,440
Income tax expense	(880)
Profit for the year	2,560
Attributable to the group owners	2,040
Attributable to the non-controlling interests	520
	2,560

G Group

Consolidated statements of financial position as at 30 September:

	2022 Sh."million"	2021 Sh."million"
Assets:		
Non-current assets:		
Property, plant and equipment	23,500	14,750
Goodwill	4,200	4,140
	27,700	18,890
Current assets:		
Inventory	8,900	7,660
Trade receivables	7,420	7,010
Investments at fair value through profit or loss	2,570	2,400
Cash at bank	310	240
	19,200	17,310
Total assets	46,900	36,200
Equity and liabilities:		
Equity:		
Ordinary share capital (Sh.10 par value)	20,000	15,000
Share premium	4,500	3,000
Retained earnings	6,010	4,340
Equity attributable to group owners	30,510	22,340
Non-controlling interests	1,840	1,080
Total equity	32,350	23,420
Non-current liabilities:		
Deferred consideration	795	-
Bank loans	2,600	3,000
Deferred tax	620	450
	4,015	3,450
Current liabilities:		
Trade payables	9,790	8,750
Current tax	745	580
	10,535	9,330
Total equity and liabilities	46,900	36,200

Additional information:
1.The property, plant and equipment comprised the following:
30 September 2022 30 September 2021
Sh.“million” Sh.“million”
Cost 43,000 30,000
Provision for depreciation (19,500) (15,250)
Carrying amount 23,500 14,750
During the year ended 30 September 2022, G Limited disposed of an item of equipment for cash proceeds of Sh.260 million. The equipment had cost Sh.750 million and had an accumulated depreciation of Sh.370 million. Any gain/loss on disposal and depreciation on property, plant and equipment is included in cost of sales.
2. On 1 January 2022, G Limited acquired 75% of the 100 million ordinary shares of Sh.10 each in S Limited. The acquisition consideration comprised a share exchange on the basis of two (2) shares in G Limited for every three (3) acquired shares in S Limited. G Limited was also to pay Sh.810 million to the owners of S Limited on 1 January 2023. G Limited’s cost of capital is 8% per annum.

The market values of ordinary shares at 1 January 2022 were Sh.30 and Sh.20 for G Limited and S Limited respectively. The fair values of assets and liabilities of S Limited at the date of acquisition were as follows:
Sh.“million”
Property, plant and equipment: - Cost 5,000
- Provision for depreciation (2,900)
Inventory 820
Trade receivables 650
Current tax (refundable) 20
Deferred tax asset 110
Trade payables (1,200)
2,500
3. The group policy is to measure the non-controlling interest in subsidiaries at fair value at acquisition dates. The market values of the subsidiaries’ ordinary shares are considered to be representative of the fair values of shares held by the non-controlling interests.
4. Investments at fair value through profit or loss consist of highly marketable and risk-free securities held by G Limited.
5. Any impairment loss on goodwill is included in administration expenses.

Required:

Consolidated statement of cash flows for G Group for the year ended 30 September 2022 using the indirect method in line with International Accounting Standard (IAS) 7 “Statements of Cash Flows”.
(Total: 20 marks)
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