CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 1 EXAMINATIONS

A1.3: ADVANCED FINANCIAL REPORTING

WEDNESDAY: 3 DECEMBER 2014

INSTRUCTIONS:

1. **Time Allowed: 3 hours 45 minutes** (15 minutes reading and 3 hours 30 minutes writing).
2. This examination has two sections; A & B.
3. Section A has one Compulsory Question while section B has three optional questions to choose any two.
4. In summary attempt three questions.
5. Marks allocated to each question are shown at the end of the question.
6. Show all your workings

SECTION A – compulsory

QUESTION ONE - CASE STUDY

Gisenyi Pride Investments Limited (GPIL) is a multinational company with its head office in Gisenyi, dealing in a diverse product range and operating in various geographical markets.

GPIL is finalising its financial statements for the year ended 30 June 2014 and numerous issues that need addressing to finalise the preparation of the financial statements have come up as outlined in parts (a) to (f) below:

(a) On 1 February 2014, as part of its financial risk mitigation options, GPIL entered into a foreign currency forward contract with a local bank to purchase USD 100,000 for Frw 50.7 million on 31 January 2015. At the time of entering the contract, the exchange rate was USD 1 = Frw 670. The auditors of GPIL have informed the company that this contract gave rise to a financial instrument, which is a derivative instrument. GPIL is of the view that since it had paid nothing for the instrument on 1 February 2014, there was no need of recognising this instrument in the financial statements on that date or on 30 June 2014, the reporting date.

The forward foreign exchange rate on 30 June 2014 for forward purchase of US Dollar is USD 1 = Frw 685.

Required:

Explain to the management of GPI Ltd:

(i) What is meant by the term 'derivative instrument', clearly discussing its characteristics. **(3 Marks)**

(ii) How a foreign currency forward contract works and the accounting requirements for the treatment of foreign currency contracts in the financial statements. **(2 Marks)**

(iii) The effect of the foreign currency forward contract in the financial statements of GPIL for the year ended 30 June 2014. **(3 Marks)**

(b) GPIL has a foreign subsidiary in USA, Parker Ltd, whose functional currency is USD. Parker Ltd owns a financial asset which is classified at fair value through profit or loss. Parker Ltd had acquired the financial asset at the cost of USD 150,000 on 1 April 2014 when the exchange rate was USD 1 = Frw 675.

On 30 June 2014, the fair value of financial asset was USD 180,000 and the exchange rate was USD 1 = Frw 685. The finance director of GPIL was concerned as to how this financial asset would be accounted for in the financial statements of Parker Ltd and in the consolidated financial statements. The average exchange rate for the period 1 April 2014 to 30 June 2014 was USD 1 = Frw 680.

Required:

Explain to GPIL:

(i) The meaning and characteristics of the term 'functional currency' in the case of Parker Ltd. **(2 Marks)**

(ii) How a financial asset owned by a foreign subsidiary and classified at fair value through profit or loss should be accounted for in the financial statements of the subsidiary and the consolidated financial statements. **(3 Marks)**

(iii) The effect of the above financial asset in the financial statements of Parker Ltd and consolidated financial statements of GPIL. **(3 Marks)**

(c) On 1 July 2013, GPIL acquired a Coltan mine at a cost of Frw. 7.7 billion together with the right to extract the mineral under a government licence. The terms of the licence are that in 10 years time when the mineral reserves have been exhausted, GPIL will have to refill the excavated area (which will then have no value) and restore the land to an environmentally satisfactory condition. The estimated cost of this exercise on 30 June 2020 will be Frw 3.85 billion. The present value of Frw 100 receivable in 10 years at the appropriate discount rate for GPIL of 8% is Frw 46.

Required:

(i) Explain and quantify how the Coltan mine should be treated in the financial statements of GPIL for the year ended 30 June 2014. **(5 Marks)**

(ii) Describe how your answer in (c) (i) above would change if the government licence did not require environmental cleanup. **(3 Marks)**

(d) GPIL is reviewing the accounting treatment of its buildings for which it uses the 'revaluation model'. The buildings had originally cost Frw 255 million on 1 July 2012 and had a useful economic life of 20 years. The buildings are being depreciated on a straight line basis to a nil residual value. The buildings were revalued downwards on 30 June 2013 to Frw 203 million, which was the buildings' recoverable amount. At 30 June 2014, the value of the buildings had risen to Frw 280 million, which is to be included in the financial statements.

Required:

Explain the effect of the revaluation on 30 June 2014 in the financial statements of GPIL for the year ended 30 June 2014. **(6 Marks)**

(e) GPIL, being partly in the mining business, has to consider the impact of its operations on the environment in which it operates. In April 2014, the chief executive officer (CEO) of GPIL, Mr. Dominique Rutaisire, a chemist by profession, attended a workshop on 'Corporate Social Responsibility and Sustainability Reporting in Rwanda', organized by the Institute of Certified Public Accountants of Rwanda. At the workshop, Mr. Rutaisire was introduced to new concepts such as 'sustainability reporting' and learned that businesses should embrace sustainability reports either as part of the annual report or published as a distinct report to show the economic, environmental and social impacts caused by its day-to-day activities. Mr. Rutaisire would like to attempt to publish a section on this new and evolving concept in the annual report for the year ended 30 June 2014.

Required:

(i) Prepare a draft section in the annual report discussing the concept of sustainability reporting, including its internal and external benefits to GPI Ltd for Mr. Rutaisire's review before incorporation in the draft annual report. **(7 Marks)**

(ii) In the draft section in (e) (i) above, identify and discuss the key economic, environmental and social issues that impact on the day-to-day activities of GPIL that it would have to highlight in its sustainability report. **(8 Marks)**

(f) GPI Ltd operates a retail outlet (supermarket) in the outskirts of Gisenyi. You are a financial reporting supervisor to new accounts assistants recording transactions at the outlet.

Required:

Explain to the accounts assistants the criteria for recognizing revenue from sale of goods as per the requirements of IAS 18: Revenue. **(5 Marks)**

(Total 50 Marks)

SECTION B

Attempt two questions from this section

QUESTION TWO

The following is the list of account balances of General suppliers Ltd as at 30 June 2014:

		Dr		Cr
	Note	**"Frw" '000'**		**"Frw" '000'**
Share capital 100,000 shares of **Frw** 500 per share				26,300
Accumulated profits 1 June 2013				24,000
Suspense account	7			16,000
Revaluation reserves				12,000
Trade and other payables				19,000
Taxation	6			1,200
Land and building at valuation	3	78,000		
Plant and equipment at cost	4	44,000		
Plant on lease at cost	9	7,500		
Investment property at valuation 1 June 2013	5	5,200		
Accumulated depreciation:				
Land and Building				4,700
Plant and Equipment				12,500
Trade and other receivables		16,200		
Inventory 1 June 2013		14,000		
Cash and bank		2,600		
Sales revenue	2			164,000
Investment income				600
Purchases		83,000		
Distribution costs		14,800		
Administration costs		12,220		
Finance costs		480		
Ordinary dividend paid		2,300		
		280,300		**280,300**

Notes:

1. The inventory at 30 June 2014 was valued at **Frw** 15 million. This includes **Frw** 2.6 million of slow moving goods. Generous Suppliers 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 **Frw** 1.6 million.

2. Generous Suppliers Ltd's revenue includes **Frw** 4.2 million of revenue for credit sales made on a 'sale or return' basis. As at 30 June 2014, customers who had not paid for the goods had the right to return **Frw** 2.7 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. The accountant did not make any adjustment because his view was that the transaction complies with IFRS.

3. On 1 July 2013 Generous Suppliers Ltd had its land and buildings revalued by a firm of surveyors at **Frw** 78 million, with **Frw** 15 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. **Frw** 0.26 million of the revaluation reserve will be realized 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 July 2013 **Frw** 5.26 million
 30 June 2014 **Frw** 5.16 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 30 June 2014 at **Frw** 7.48 million.

7. The suspense account contains the credit entry relating to the issue on 1 July 2013 of **Frw** 15.8 million 6% loan stock. Interest is payable six months in arrears. The first payment of interest has been accrued and was due on 30 June 2014.

8. In the current accounting period, Generous Suppliers Ltd has spent **Frw** 2.6 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 staffs now need less supervision. This in turn has led to an increase in revenue and cost reductions. The directors of Generous Suppliers 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 July 2013 Generous Suppliers Ltd purchased an item of plant for **Frw** 7.4 million which it leased to a customer on the same date. The lease period is four years with annual rentals of **Frw** 2.1 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 Generous Suppliers Ltd for the year ended 30 June 2014:

(a) A statement of profit or loss account. **(10 Marks)**
(b) A statement of changes in equity. **(5 Marks)**
(c) A statement of financial position. **(10 Marks)**
(Total 25 Marks)

QUESTION THREE
Good Luck Services Ltd (GLS) 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 inter firm 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 inter firm comparison are shown below.
Ratios of companies reporting a full year's results for periods ending between 1 June 2013 and 31 May 2014:

Return on capital employed	22·1%
Net assets turnover	1·6 times
Gross profit margin	26%
Net profit (before tax) margin	10·5%
Current ratio	1·6:1
Quick ratio	0·9:1
Inventory holding period	47 days
Accounts receivable collection period	42 days
Accounts payable payment period	51 days
Debt to equity ratio	36%

Interest cover	5 times

Good Luck Services Ltd (GLS)	
Statement of profit or loss	
Year ended 31 May 2014	
	Frw
	"million"
Sales revenue	970,000
Cost of sales	(748,000)
Gross profit	222,000
Other operating expenses	(86,000)
Operating profit	136,000
Administration costs	(48,000)
Profit before interest and Tax	88,000
Interest payable	(13,600)
Profit before taxation	74,400
Income tax	(36,000)
Profit after taxation	38,400

Good Luck Services Ltd (GLS)	
Extracts from Statements of Changes in Equity	
	Frw "million"
Accumulated profits 1 June 2013	71,600
Net profit for the period	38,400
	110,000
Dividends paid (interim **Frw** 24 million; final **Frw** 12million)	(36,000)
Accumulated profits 31 May 2014	74,000

Good Luck Services Ltd (GLS)		
Statement of Financial Position As at 31 May 2014		
	Frw "000"	**Frw "000"**
Assets		
Current assets:		
Accounts receivable	128,000	
Inventory	110,000	
		238,000
Non-current assets (note i)		216,000
Total Assets		**454,000**
Liabilities and Equity:		
Current liabilities:		
Bank overdraft	26,000	
Trade accounts payable	140,000	
Taxation	34,000	
		200,000
Non-current liabilities		
8% loan notes		120,000
Share Capital and Reserves:		-
Ordinary shares (**Frw** 5,000 per share)	60,000	-
Accumulated profits	74,000	-
		134,000
		454,000

(i) Details of the non-current assets at 31 May2014	
	Frw "000"
Cost	1,440,000
Accumulated depreciation	(1,224,000)
Net book value	216,000

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 inter firm comparison services such as that used by Good Luck Services Ltd

(10 Marks)

(b) As the Finance Manager of Good Luck Services Ltd write a report to the Managing Director analyzing the financial performance of the company based on a comparison with the sector averages.

(15 Marks)

(Total 25 Marks)

QUESTION FOUR

(a) Earnings per Share is perhaps the single most important topic you should understand before investing money in the market. In fact many investors normally pay special attention to this because of the importance and a great deal of time is spent developing and evaluating **earnings per share on investments.** 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 the more useful measure of performance is. **(5 Marks)**

(b) Beto Limited has 20 million shares. On 1 June 2013 it issued **Frw** 50 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 **Frw** 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 2013, the directors of Beto Limited were awarded share options of 3 million ordinary shares exercisable from 1 June 2013 at **Frw** 15 per share. The income tax rate is 30%. Earnings attributable to ordinary shareholders for the year ended 31 May 2014 were **Frw** 64 million. The average market value of Beto Limited's ordinary shares for the year ended 31 May 2014 is **Frw** 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 Beto Limited's basic and diluted earnings per share for the year ended 31 May 2014 (comparative figures are not required).

(9 Marks)

(b) Related party relationships are a common feature of commercial life that is 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. **(6 Marks)**

(ii) Explain why the disclosure of related party relationships and transactions may be important.

(5 Marks)

(Total 25 Marks)

End of question paper

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