CERTIFIED PUBLIC ACCOUNTANT (CPA)

ADVANCED LEVEL 1 EXAMINATIONS

A1.3: ADVANCED FINANCIAL REPORTING

WEDNESDAY: 6 JUNE 2018

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

QUESTION ONE

Zirungu Ltd (Zirungu) operates in the manufacturing sector. The following relates to the Zirungu Group:

Consolidated statement of financial position as at 31 May:

	2018	2017
	Frw'million'	Frw'million'
Assets:		
Non-current assets:		
Property, plant & equipment	1,056	1,158
Goodwill	12	57
Other intangible assets	111	81
Investment in associate	306	-
	1,485	1,296
Current assets:		
Inventories	324	495
Trade & other receivables	318	312
Cash & cash equivalents	117	129
	759	936
Total assets	2,244	2,232
Equity & liabilities:		
Share capital (Frw 100 nominal)	300	300
Retained earnings	1,131	810
Other components of equity	72	63
	1,503	1,173
Non-controlling interests	192	255
Total equity	1,695	1,428
Non-current liabilities:		
Long-term borrowings	78	144
Retirement benefit liability	180	216
Net deferred tax liability	42	45
Total non-current liabilities	300	405
Current liabilities:		
Trade & other payables	108	123
Current tax payable	141	276
Total current liabilities	249	399
Total liabilities	549	804
Total equity &liabilities	2,244	2,232

Consolidated statement of profit or loss and other comprehensive income for the year ended 31 May, 2018

	2018	2017
	Frw'million'	Frw'million'
Continuing operations:		
Revenue	3,306	1102
Cost of sales	(2,454)	(818)
Gross profit	852	284
Other income	42	14
Distribution costs	(135)	(70)
Administrative expenses	(189)	(63)
Finance costs	(69)	(23)
Share of profit of associate	48	16
Profit before tax	549	158
Income tax expense	(120)	(40)
Profit for the year from continuing operations	429	118
Discontinued operations:		
Loss for the year from discontinued operations	75	-
Profit for the year	354	118
Other comprehensive income for the year (after tax) which will not be reclassified to profit or loss in future years:		
Re-measurement gains on defined benefit plan	9	3
Total comprehensive income for the year	363	121
Profit/loss attributable to:		
(a) Owners of the parent	321	107
(b) Non-controlling interests	33	11
	354	118
Total comprehensive income for the year attributable to:		
(a) Owners of the parent	330	110
(b) Non-controlling interests	33	11
	363	121

Other information:

1. Zirungu acquired 80% shares in Saro Ltd on 31 November, 2013 for a consideration of Frw 396 million when the fair value of the identifiable net assets of SaroLtd was Frw 372 million. The consideration included a fair value uplift of Frw 48 million in relation to plant with a remaining useful life of eight years. Deferred tax at 25% on the fair value adjustment was also correctly provided for in the group accounts and is included within the fair value of net assets. The fair value of the non-controlling interest at acquisition was Frw 84 million. Goodwill, calculated under the full fair value method, was tested annually for impairment. At 31 May, 2017 goodwill relating to Saro Ltd had been impaired by 75%.

   A goodwill impairment charge has been included within administration expenses for the current year but does not relate to Saro Ltd.However, on 30 November, 2017 Zirungu disposed of their entire 80% equity holding in Saro Ltd for cash. The carrying values in the individual accounts of Saro Ltd at disposal are listed below. The fair value adjustment and subsequent deferred tax were not incorporated into the individual accounts of Saro Ltd.

	Frw'million'
Property, plant and equipment	240
Inventory	114
Trade receivables	69
Trade and other payables	(30)
Deferred tax liability	(18)

Bank overdraft	(6)

2. The loss for the period from discontinued operations in the consolidated statement of profit or loss and other comprehensive income relates to Saro Ltd and can be analysed as follows:

	Frw'million'
Profit before tax	18
Income tax expense	(6)
Loss on disposal	(87)
	(75)

3. Zirungu purchased a 40% interest in an associate for cash on 1 June, 2017. The associate paid a dividend of Frw 30 million in the year ended 31 May, 2018.
4. The retirement benefit liability relates to Zirunguas other companies in the group operate defined contribution schemes. The latest actuarial valuation is as follows:

	Frw'million'
Net obligation at 1 June, 2017	216
Service cost component	33
Contributions to scheme	(57)
Re-measurements - actuarial gains	(12)
Net obligation at 31 May, 2018	180

The benefits paid in the period by the trustees of the scheme were Frw 21 million. Tax reliefs are only allowed when contributions are paid into the scheme. The tax base was therefore zero at 31 May, 2017 and 31 May, 2018. The tax rate paid by Zirunguis 25%. The defined benefit expense is included within administrative expenses.
5. There were no disposals of property, plant and equipment during the year except on the sale of Saro Ltd. Depreciation for the year was Frw 60 million and is included within the cost of sales.
6. On 1 June, 2017 Zirungu commenced development expenditure on a new product. The new product is expected to be launched during 2019.
7. Amortisation of intangible assets for the year of Frw 21 million was also included in the cost of sales.
8. Advice was provided by a government department on the export markets available for Zirungu's products. The advice was free of charge, but Zirungu's marketing director estimates that similar advice from a firm of consultants would be Frw 40 million. The advice is likely to be useful to Zirungufor at least three years.
9. Zirungudid not pay a dividend to its shareholders during the year ended 31 January, 2016.

REQUIRED:

(a) Prepare a consolidated statement of cash flows using the indirect method for Zirungu for the year ended 31 May, 2018 in accordance with the requirements of the relevant international financial reporting standards.

(35 Marks)

(b) The directors of Zirunguare confused over several issues relating to IAS 7: Statement of Cash Flows. They wish to know the principles utilised by the International Accounting Standards Board in determining how cash flows are classified, including how entities determine the nature of the cash flows being analysed. They are also unsure whether the indirect method for preparing a statement of cash flows is more useful to users than the direct method.

REQUIRED:

Discuss the principles behind the classifications in the statement of cash flows whilst advising the directors of Zirungu whether the indirect method for preparing a statement of cash flows is more useful to users than the direct method.

(9 Marks)

(c) Three people own the shares of Zirungu. The managing director owns 60%, and the operations director owns 30%. The third owner is a passive investor who does not help manage the entity. All ordinary shares carry equal voting rights. The wife of the managing director is the sales director of Zirungu. Their son is currently undertaking an internship with Zirunguand receives a salary of Frw 3 million per annum, which is normal compensation. The managing director and sales director have set up an investment company, Bebe Ltd. They jointly own Bebe Ltd and their shares in Bebe Ltd will eventually be transferred to their son when he has finished the internship with Zirungu.

In addition on 1 April, 2017 Zirungu obtained a bank loan of Frw50 million at a fixed interest rate of 6% per annum. The loan is to be repaid on 31 May, 2018. Repayment of the principal and interest is secured by a guarantee registered in favour of the bank against the private home of the managing director.

REQUIRED:

Discuss the advice which should be given to the directors of Zirunguon the identification and disclosure in preparing its separate financial statements for the year ending 31 May, 2018.

(6 Marks)
(Total 50 Marks)

SECTION B

QUESTION TWO

(a) The committee of Professional Standards and Regulation of Gakenke Lt noted that changes in general price levels can lead to both profit and asset valuation figures being far from reality if the original historical cost figures are used for their balance sheet amounts. The greater the rate of change in price levels, the greater the distortion. The deficiencies of historical cost accounting are noticeably obvious when the inflation rate is high. And if there were a period of deflation, the historical cost financial statements would still be misleading.

You have been given the following information prepared on basis of historical cost accounting relating GakenkeLtd for the period ended 31 March 2018:
Extract of the statement of profit or loss and other comprehensive income:

	Frw '000'	Frw '000'
Revenue		425,000
Cost of sales:		
Opening inventory	50,000	
Purchases	343,950	
	393,950	
Less: closing inventory	(62,500)	(331,450)
Gross profit		93,550
Depreciation		(20,000)
Other expenses		(46,000)
Operating profit		27,550
Interest		(7,750)
Profit after interest		19,800

Statement of financial position as at 31 March, 2018

	2018	2017
Assets:	Frw ‘000’	Frw ‘000’
Noncurrent assets:		
Plant & machinerycost	200,000	200,000
Depreciation	(80,000)	(60,000)
Net book value	120,000	140,000
Current assets:		
Inventory	62,500	50,000
Trade receivables	45,000	27,500
Cash	26,250	18,750
	133,750	96,250
Total assets	253,750	236,250
Equity and liabilities:		
Equity:		
Ordinary share capital Frw 5,000 per share	50,000	50,000
Retained earnings	103,750	83,750
Total equity	153,750	133,750
Current liabilities:		
Trade payables	22,500	25,000
Non-current liabilities:		
10% loan notes	77,500	77,500
Total liabilities	100,000	102,500
Total equity and liabilities	253,750	236,250

Additional information:

1. The price indices for inventory at the end of each month were:

Month	Dec.	Jan.	Mar.	Sept.	Dec.	Jan.	Mar.
Year	2016	2017	2017	2017	2017	2018	2018
Index	109	112	114	116	122	126	130

The average index for the period ending 31 March, 2018 was 126.

2. The price indices for plant and machinery were:

Month	Mar.	Mar.	Mar.	Mar.	Mar.
Year	2014	2015	2016	2017	2018
Index	80	90	100	105	110

3. The price indices for accounts receivable and payable were:

March	2017	110
March	2018	200
Average for	2018	155

4. The directors of Gakenke Ltd are interested in preparing current cost financial statements to reflect changing prices.
5. Gakenke Ltd.'s plant and machinery was purchased for Frw 200 million on 1 April, 2015.
6. Assume that the trading activities occurred evenly throughout the year.

REQUIRED:

Make the necessary adjustments to the historical cost financial statements and derive the current cost statement of financial position for Gakenke Ltd as at 31 March, 2018.

(12 Marks)

(b) Gakenke Ltd has a sister company, Gatera Ltd, which is faced with financial distress and needs to do a reorganisation to reach a compromise withits creditors. As part of this reorganisation, Gatera Ltd is to reduce the original capital accordingly. The following isGateraLtd'strial balance for the year ended 30 April, 2018:

	Frw '000'	Frw '000'
Share capital 50,000 shares Frw 5,000 per share		250,000
Trade payables		132,500
Patent rights	22,500	
Trade receivable	50,000	
Inventory	69,250	
Retained earnings	750	-
	382,500	382,500

The shareholders and auditors have approved the following reorganisation scheme:

1. Gatera, is to go into voluntary liquidation and a new company, Ndabarinzi Ltd, with a nominal capital of Frw 500 million is to be formed to take over the assets and liabilities of Gatera Ltd.
2. The assets will be taken over at book value, with the exception of the patent rights which were to be subject to impairment adjustment.
3. The trade payable to be discharged by Ndabarinzi Ltd on the following basis:

	Frw '000'
Preferential creditors to be paid in full	2,500
Unsecured creditors to be discharged by paying them 50% of the obligation	67,000
Unsecured creditors to be discharged by issue of 6% debentures fully paid at a bonus of 10%	63,000
	132,500

4. 50,000 shares Frw 5,000 per share, Frw 2,500 paid up, to be issued to the shareholders in Gatera Ltd, payable as follows: Frw 1,250 on application and Frw 1,250 on allotment.
5. The costs of liquidation of Frw 1,250,000 will be paid by Ndabarinzi Ltd

REQUIRED:

(i) Demonstrate the accounting entries to close the books of Gatera Ltd.

(8 Marks)

(ii) Prepare the opening statement of financial position of Ndabarinzi Ltd (assuming all the shares and debentures have been allotted, and all the cash for the shares has been received).

(5 Marks)
(Total 25 Marks)

QUESTION THREE

(a) One of the Rwanda Government's medium term objectives in the Vision 2020 is to prioritise private sector development and encompass improved forms of financing as instruments of poverty reduction. In Rwanda, the private sector comprising of mainly small and medium-sized enterprises, lacks access to finance and this is a major obstacle to economic growth and expansion. Most private enterprises lack the required collateral to secure traditional loan financing from banks. As an alternative to traditional bank loans, leasing offers a more flexible form of financing that is better suited to the needs of private businesses with limited capital, or to new companies with limited credit history. The Rwanda Revenue Authority shows commitment to embrace and push leasing forward. This business-friendly alternative has presented a number of investment opportunities and has seen companies like Hakizimana Ltd (HzL), a company established under the Rwanda Companies Act (Law relating to companies) 2009, make investments in the necessary equipment required for the printing industry. You are the newly recruited finance controller of HzL and you have been presented with the following lease arrangement taken by HzL:

HzL, a lessor, leased an asset on a 5 year non-cancellable finance lease from 1 January, 2013 at a rental of Frw 26 million, payable annually in advance. The cost of the asset was Frw 100 million. HzL's corporation tax rate is 30% and payment of corporation tax takes place three months after the year end on 31 December.Assume that the leased asset is eligible for writing down allowance at the rate of 25% and the government of Rwanda paid HzL Frw 1,752,000 on behalf of the lessee as commitment to their Vision2020 during the year ended 2017.

The constant annual rate of return (after tax) on the net cash investment is assumed to be 3.75% per annum. Interest of 10% per annum is calculated on the net cash investment in each year.

REQUIRED:

Determine the net cash investments and gross earnings for each of the years of the lease by Hakizimana Ltd, together with the net investment as at 31 December, 2017.

(12 Marks)

(b) The board of HzL opted to adopt IFRS 15: Revenue from Contracts with Customers for the year ended 31 March, 2018.The treasurer indicated that the core principle is that a vendor should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the vendor expects to be entitled in exchange for those goods or services. As a financial controller, the board chairman has asked for your help in clarifying IFRS 15.

REQUIRED:

Discuss to the board the process in which the core principle in IFRS15 is assessed.

(6 Marks)

(c) The committee of corporate governance of HzL was discussing the issues faced by the company. In particular, the issues were diversity, remuneration, accountability, conflict of interest and transparency. They noted that these issues were core to the way the business of HzL is overseen and directed. They also indicated that these issues have an ethical imperative and involves the discretion of the board. As the financial controller, the chairman of the board has asked you to throw sufficient light on the issues stated.

REQUIRED

Write a detailed report to the board chairman of HzL demonstrating appropriate professional and ethical judgmentwith regard to the above issues.

(7 Marks)
(Total 25 Marks)

QUESTION FOUR

Shyaka Ltd, a Rwandese registered company prepares financial statements in accordance with International Financial Reporting Standards (IFRS). The Company's financial year is 31 March each year. You are a qualified accountant at Shyaka Ltd reporting directly to the managing director (MD). The MD is scheduled to present some financial information at a board meeting soon and has presented to you the following briefing notes for your input.

1. As you are aware, our company has built up cash reserves and the directors have made a decision to concentrate on growth through acquisition of other companies in Rwanda. MpakaLtd a private company is one of the target companies being considered for acquisition. A review of Mpaka Ltd. by our financial analyst indicates that for the last eight years, it has been manufacturing and selling its own brands. Over the last fifteen months, Mpaka Ltd.has invested in developing an online presence. The sales director of Mpaka Ltd.has also used his extensive contacts to secure a deal with a chain of wholesale traders for Mpaka Ltd.'s products. The contract was set up on 1 October, 2017, and has generated revenues of Frw850 million and a strong gross profit margin. The managing director of Mpaka Ltd now wishes to build on the work of the sales director to develop further sales opportunities. However, the financial institution that currently provides the long-term loan and overdraft facility (secured on Mpaka Ltd.'s property, plant and equipment) has rejected Mpaka Ltd.'s application for additional funding on the grounds that there are insufficient assets to offer security.

   My own view is that this would be a good investment, but I would really value your opinion on Mpaka Ltd.'s financial performance and position, together with a recommendation as to whether we should consider an investment in this company.

   Attached are the most recent financial statements of Mpaka Ltd. for the year ended 31 March, 2018.

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

	2018	2017
	Frw 'million'	Frw 'million'
Revenue	3,200	1,850
Cost of sales	(2,050)	(1,300)
Gross profit	1,150	550
Other income	50	20
Distribution costs	(230)	(200)
Administration costs	(460)	(250)
Finance costs	(40)	(20)
Profit before tax	470	100
Income tax	(50)	(10)
Profit for the year	420	90

Statement of Financial Position as at 31 March:

	2018	2017
	Frw 'million'	Frw 'million'
Assets:		
Non-current assets:		
Property, plant & equipment	200	180
Intangible assets - development costs	20	10
	220	190
Current assets:		
Inventories	650	600
Trade receivables	230	160
Cash & cash equivalents	-	20
	880	780
Total assets	1,100	970
Equity:		
Issued capital (100 Frw ordinary shares)	280	280
Retained earnings	370	300
Total equity	650	580
Non-current liabilities:		
Long-term borrowings	220	200
Current liabilities:		
Trade & other payables	180	190
Overdraft	50	-
	230	190
Total equity &liabilities	1,100	970

2. I recently attended a CPA continuing professional development course in Kigali. One of the main topical areas covered was on how to improve the quality of information that we report at the year end. The key speaker made the argument, which I fully support, that the annual report and relevant disclosure notes (prepared in accordance with IFRSs) do not satisfy the information needs of the users. She suggested that we should look at producing a more integrated annual report which brings together both financial and non-financial information. I think we should give this some serious consideration, particularly in light of the pressure we are under to demonstrate how we contribute to sustainable development in relation to our impact on society and the environment.

   I am really not convinced that traditional financial reporting, and its preoccupation with economic profit, is sufficient to address the diverse requirements of our users. Moreover, and I think you will agree, the Conceptual Framework for Financial Reporting does not really address this issue.

3. On 1 April, 2017, Shyaka Ltd. issued 3% loan notes with a nominal value of Frw750 million. They were issued at a 5% discount and issue costs of Frw13 million were incurred. The loan notes will be repayable at a premium of 10% after four years. The effective rate of interest is 7.25%.

REQUIRED

Prepare a report for the managing director that:

(a) Critically analyses the financial performance and position of Mpaka Ltd. Your report should outline any matters that require further investigation.

(10 Marks)

(b) Discusses, with reference to the points raised by the managing director regarding the quality of accounting information reported, the limitations of financial reporting and the extent to which integrated reporting might improve the usefulness of the information provided in the annual report.

(8 Marks)

(c) Discusses the required IFRS accounting treatment for the issued loan notes, preparing relevant calculations for inclusion in the statement of profit or loss and other comprehensive income and the statement of financial position for the year end March, 2018.

(7 Marks)
(Total 25 Marks)

END OF QUESTION PAPER