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CPA PART III SECTION 6

ADVANCED FINANCIAL REPORTING

FRIDAY: 3 September 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

On 1 October 2019, H Limited acquired 80% of the ordinary shares in S Limited when the retained earnings of S Limited were Sh.5,335 million. On the same date, H Limited acquired 40% of the ordinary shares in A Limited paying Sh.16 per share.

The acquisition of the ordinary shares in S Limited was through a share exchange of one ordinary share in H Limited for every two shares in S Limited. The market prices of H Limited's and S Limited's shares as at the date of acquisition were Sh.30 and Sh.18 per share respectively.

In addition, H Limited agreed to pay a further amount of Sh.25 per acquired share in S Limited on 1 October 2021. H Limited's cost of capital is 10% per annum and one shilling receivable in two years' time has a present value of 83 cents. H Limited has not yet recorded the consideration on acquisition of the ordinary shares in S Limited.

The draft financial statements of the group companies are as follows:

Statement of profit or loss for the year ended 31 March 2020:

	H Limited Sh. "million"	S Limited Sh. "million"	A Limited Sh. "million"
Revenue	25,200	18,000	6,000
Cost of sales	(15,120)	(12,000)	(4,800)
Gross profit	10,080	6,000	1,200
Distribution costs	(1,344)	(840)	(600)
Administrative expenses	(2,196)	(1,080)	(1,320)
Investment income (interest and dividend)	330	-	-
Finance costs	(220)	(150)	-
Profit/loss before tax	6,650	3,930	(720)
Income tax expense/relief	(1,800)	(1,200)	120
Profit/loss for the year	4,850	2,730	(600)

Statement of financial position as at 31 March 2020:

Assets:	H Limited Sh."million"	S Limited Sh."million"	A Limited Sh."million"
Non-current assets:			
Property, plant and equipment	25,000	16,300	6,000
Investment in A Ltd.	1,920	-	-
Financial asset	250	-	-
	27,170	16,300	6,000
Current assets:			
Inventory	6,700	6,000	3,300
Trade receivables	4,150	1,000	2,000
Cash and cash equivalents	1,980	400	100
	12,830	7,400	5,400
Total assets	40,000	23,700	11,400

Equity and liabilities:	Sh."million"	Sh."million"	Sh."million"
Equity:			
Ordinary shares of Sh.10 each	8,000	5,000	3,000
Share premium	4,000	2,500	-
Retained earnings	12,100	6,700	3,600
	24,100	14,200	6,600
Non-current liabilities:			
8% loan notes	7,600	2,000	-
Current liabilities:			
Trade payables	5,500	5,200	3,100
Current tax payable	2,800	2,300	1,700
	8,300	7,500	4,800
Total equity and liabilities	40,000	23,700	11,400

Additional information:

1. At the date of acquisition, the fair values of S Limited's identifiable net assets approximated their book values with the exception of an item of plant which had a fair value of Sh.200 million above its carrying value. The plant had a remaining useful life of 10 years (straight-line depreciation) at the date of acquisition. Depreciation on plant is classified as part of cost of sales. The fair value of the plant has not been reflected in S Limited's financial statements. No fair value adjustments were required on the acquisition of A Limited. In addition, at the date of acquisition, S Limited had an internally generated brand which the directors of H Limited believed to have a fair value of Sh.300 million. The brand had an estimated useful life of 6 years. Amortisation charge is classified as an administrative expense.
2. Immediately after acquisition of S Limited, H Limited invested Sh.250 million in an 8% loan note of S Limited. All interest accruing to 31 March 2020 had been accounted for by both entities. S Limited also had other loans in issue as at 31 March 2020.
3. After the acquisition, S Limited sold goods to H Limited for Sh.500 million. S Limited had marked up these goods at 25% above their cost. H Limited had 30% of these goods in its inventory as at 31 March 2020.
4. H Limited's policy is to value the non-controlling interest of S Limited at its fair value at the date of acquisition. For this purpose, the market price of S Limited's shares at the date of acquisition is considered to be representative of the fair value.
5. Impairment tests were carried out on 31 March 2020 which concluded that due to poor trading performance, the investment in A Limited had been impaired to the extent of Sh.80 million.
6. S Limited paid dividends amounting to Sh.400 million before the year-end.
7. All incomes and expenses of the three companies are deemed to accrue evenly over the year unless as otherwise specified.
8. Other than the share exchange in the acquisition of the ordinary shares in S Limited, there was no other issue of ordinary shares by the group companies.

Required:

(a) Consolidated statement of profit or loss for the year ended 31 March 2020. (10 marks)

(b) Consolidated statement of financial position as at 31 March 2020. (10 marks)

(Total: 20 marks)

QUESTION TWO

(a) The following capital structure relates to Shela Ltd. as at 31 December 2020:

	Sh."000"
Ordinary shares of Sh.10 each	60,000
10% cumulative preference shares of Sh.20 each	40,000
12% convertible loan notes of Sh.10 each	50,000
Profit after tax for the year	171,200

Additional information:

1. On 1 February 2020, the company issued 1.5 million ordinary shares at full market price.
2. On 30 June 2020, the company made a rights issue of 1 ordinary share for every 4 ordinary shares held on that date. The exercise price was Sh.36 per share and the market price on the last quotation was Sh.48 per share.
3. The convertible loan notes were issued in the year 2018. Ten convertible loan notes are convertible into one new ordinary share.

4. On 1 October 2020, the employees of the company were granted share options to purchase 1 million ordinary shares at Sh.30 each. The average market price was Sh.48 per share. As at 31 December 2020, none of the employees had exercised their options.
5. The corporation tax rate is 30%.

Required:

(i) Basic earnings per share (EPS) for the year ended 31 December 2020 in conformity with IAS 33 (Earnings per share). (6 marks)

(ii) Diluted earnings per share (EPS) for the year ended 31 December 2020 in conformity with IAS 33 (Earnings per share). (4 marks)

(b) Tandaza Ltd. is a conglomerate whose equity shares are quoted on the National Securities Exchange. The group manufactures, distributes and retails food products. The group also operates a hotel chain for purposes of diversifying its revenues. The group's Financial Controller wishes to know if IFRS 8 (Operating Segments) applies to the entity and if so, what segments should be reported on. He informs you that the operating results of each of the divisions presented below are internally reported separately to the chief operating decision maker.

The following information is available:

Business	**Revenue (External) Sh."million"**	**Revenue (Internal) Sh."million"**	**Profit (loss) Sh."million"**	**Assets Sh."million"**
Manufacturing	460	250	32	1,450
Distribution	5	42	3	250
Retailing	750	15	75	375
Hotel chain	150	3	(14)	100

Required:

By applying the requirements of IFRS 8 to the above information, explain which of the above businesses of Tandaza Ltd. are reportable segments. (10 marks)

(Total: 20 marks)

QUESTION THREE

(a) (i) With reference to deferred tax, differentiate between "permanent differences" and "temporary differences". (4 marks)

(ii) Huruma Limited, a public limited company, has a portfolio of investments including various subsidiaries and also undertakes various projects varying from debt factoring to investing in property and commodities.

The following information was extracted from the group financial statements relating to the deferred tax provision for the year ended 31 March 2021:

1. Huruma Limited acquired a controlling interest in a subsidiary, Sukari Limited, on 1 July 2020. The fair values of the assets and liabilities acquired were considered to be equal to their carrying amounts, with the exception of freehold property which had a fair value of Sh.256 million and a tax base of Sh.248 million.
   The directors of Huruma Limited have no intention of selling the property.
2. During the year ended 31 March 2021, Huruma Limited sold goods at a price of Sh.48 million to another subsidiary, Wingu Limited, and made a profit of Sh.16 million on the transaction. 40% of these goods were held in inventories of Wingu Limited as at 31 March 2021.
3. Huruma Limited has a portfolio of financial assets comprising readily marketable government securities which are held as current assets for financial trading purposes. These investments are stated at fair value in the statement of financial position, with any gain or loss taken to profit or loss. These gains or losses are taxed when investments are sold. Currently, the investments have a market value of Sh.412 million and accumulated unrealised gains are Sh.64 million.
4. Huruma Limited's loan assets had carrying amounts of Sh.168 million after an allowance for credit losses of Sh.32 million based on a twelve-month expected credit loss. Tax relief is only available when the specific loan is written off.
5. Huruma Limited has unrelieved trading losses of Sh.20 million as at 31 March 2021. These unused tax losses arose from a one-off restructuring exercise carried out during the financial year and it is highly expected that taxable profits will be available in the future.
6. On 1 April 2020, Huruma Limited's deferred tax account had a nil balance. Assume a corporation tax rate of 30%.

Required:
Determine the deferred tax asset or liability for Huruma Group as at 31 March 2021 in conformity with IAS 12 (Income Taxes). (8 marks)

(b) Peponi Ltd. decided to grant its 500 employees 200 share options each from 1 July 2021 on condition that the employees still be in employment as at 30 June 2025.

The company has provided the following details regarding the share option scheme:

Year ended	Number of employees expected to leave employment	Fair value of each option
30 June 2022	40	40
30 June 2023	30	35
30 June 2024	25	30
30 June 2025	25	30

The fair value of the option was Sh.40 as at 1 July 2021. The exercise price of the option was Sh.15 and the par value of the company's share was Sh.10. The average market price of the share over the four-year period is expected to be Sh.50.

Required:
Extracts from the financial statements of Peponi Ltd. for each of the years ended 30 June 2022, 2023, 2024 and 2025 to reflect the above transactions. (8 marks)
(Total: 20 marks)

QUESTION FOUR

(a) (i) International Financial Reporting Standard (IFRS) 9: "Financial Instruments: Recognition and Measurement", provides guidance relating to hedging and allows hedge accounting where there is a designated hedging relationship between a hedging instrument and a hedged item.

Required:
Citing relevant examples, explain the two main types of hedge and describe their accounting treatment in the financial statements of an entity. (6 marks)

(ii) Bahati Limited entered into a hedge in order to protect its future cash inflows relating to a recognised financial asset held at amortised cost. The cash flow hedge was formally documented on 1 July 2020 and was considered to be highly effective. At the inception of the hedge, the value of the hedging instrument was nil, but by the year end of 30 June 2021, a gain of Sh.22,750,000 had been made when measured at fair value.

The corresponding loss in respect of the future cash flows (hedged item) amounted to Sh.22,000,000 in fair value terms.

Required:
Show the relevant journal entry to account for the above transaction for the year ended 30 June 2021 and explain whether the cash flow hedge is effective or not. (6 marks)

(b) In the context of International Public Sector Accounting Standard (IPSAS) 22: "Disclosure of Financial Information about the General Government sector":

(i) Explain the term "general government sector (GGS)". (2 marks)

(ii) Identify the disclosures that should be made in respect of the general government sector (GGS). (6 marks)
(Total: 20 marks)

QUESTION FIVE

(a) Explain four limitations of the IASB's Conceptual Framework for Financial Reporting. (4 marks)

(b) International Financial Reporting Standard (IFRS) 13 "Fair Value Measurement" provides extensive guidance on how the fair values of assets and liabilities should be established.

Required:
With regard to International Financial Reporting Standard (IFRS) 13, briefly describe the fair value hierarchy of inputs for arriving at fair value. (6 marks)

(c) Paka Ltd. acquired 100% of Angaza Ltd. on 1 October 2017. Angaza Ltd. exports electrical materials across the world. As at the date of acquisition, goodwill of Sh.12 million was calculated. The entire amount of this goodwill has been outstanding since then because Angaza Ltd.'s recoverable value has remained higher than its carrying amount. For the year ended 30 September 2020 however, there were indications that Angaza Ltd. may be impaired. No adjustment to the group financial statements relating to this matter has been made yet.

Angaza Ltd.'s business is divided into two Cash Generating Units (CGUs); the Industrial Division and the Domestic Division.

When Angaza Ltd. was originally acquired, Sh.8 million of the goodwill was attributable to the Industrial Division and Sh.4 million to the Domestic Division.

The carrying values of Angaza Ltd.'s CGUs as at 30 September 2020 were as follows:

	Industrial Division	**Domestic Division**
	Sh."000"	**Sh."000"**
Property, plant and equipment	3,800	2,900
Inventory	5,320	1,125
Receivables	5,500	3,500
Cash	450	450
Payables	(1,200)	(1,000)
	13,870	6,975

In relation to the recoverable value of the divisions, it has not been possible to establish the net selling price for either division but an estimate was received of the future cash flows for each of the CGUs for the next five financial years. These were as follows:

Industrial Division:

	2021	**2022**	**2023**	**2024**	**2025**
	Sh."000"	**Sh."000"**	**Sh."000"**	**Sh."000"**	**Sh."000"**
Operating cash	1,500	1,500	1,000	1,000	1,000
Interest	(200)	(200)	(200)	(250)	(250)
Taxation	(100)	(100)	(110)	(160)	(160)
	1,200	1,200	690	590	590

Domestic Division:

	2021	**2022**	**2023**	**2024**	**2025**
	Sh."000"	**Sh."000"**	**Sh."000"**	**Sh."000"**	**Sh."000"**
Operating cash	2,000	2,000	1,800	1,850	1,850
Interest	(200)	(200)	(200)	(250)	(250)
Taxation	(80)	(80)	(80)	(70)	(70)
	1,720	1,720	1,520	1,530	1,530

Additional information:
1. The industrial division could be sold at the end of year 2025 for an estimated Sh.6,000,000.
2. The domestic division would be held indefinitely generating cash flows of Sh.1,500,000 per annum in perpetuity.
3. The pre-tax cost of capital of Angaza Ltd.'s divisions is 8% per annum and the rate of tax is 30% per annum.
4. The following discount factors are relevant:

Year	**1**	**2**	**3**	**4**	**5**
Discount factor	0.926	0.857	0.794	0.735	0.681

Required:
Calculate the impairment (in conformity with IAS 36 – impairment of Assets) that should be recognised in the group financial statements for the year ended 30 September 2020 in relation to Angaza Ltd. (10 marks)
(Total: 20 marks)

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