ZIMBABWE EZEKIEL GUTI UNIVERSITY

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING AND FINANCE

EXAMINATION

FINANCIAL REPORTING FOR COMPANIES CAC 203

DURATION: 3 HOURS 5 DECEMBER 2018

INSTRUCTIONS TO CANDIDATES

1. No cell phones are allowed in the examination venue.
2. Answer **ALL FOUR** questions
3. Begin each question on a new page.
4. The number of marks allocated to each question or part question is shown in brackets
5. Hand-held, self-powered, non-programmeable, silent calculators are allowed into the examination.

QUESTION 1

Taylor is another company about which Mrs Hanna has obtained the following information from its published
financial statements:

Earnings per share:

Year to 30 September	2017	2016
Basic earnings per share	25 cents	20 cents

The earnings per share is based on attributable earnings of $50 million ($30 million in 2016) and 200 million ordinary shares in issue throughout the year (150 million weighted average number of ordinary shares in 2016).

Balance sheet extracts:	$ million	$ million
8% Convertible loan stock	200	200

The loan stock is convertible to ordinary shares in 2019 on the basis of 70 new shares for each $100 of loan stock.

Note to the financial statements:

There are directors' share options (in issue since 2014) that allow Taylor's directors to subscribe for a total of 50 million new ordinary shares at a price of $1·50 each.

(Assume the current rate of income tax for Taylor is 25% and the market price of its ordinary shares throughout the year has been $2·50)

Mrs Hanna has read that the trend of the earnings per share is a reliable measure of a company's profit trend.

She cannot understand why the increase in profits is 67% ($30 million to $50 million), but the increase in the earnings per share is only 25% (20 cents to 25 cents). She is also confused by the company also quoting a diluted earnings per share figure, which is lower than the basic earnings per share.

Required:

(i) Explain why the trend of earnings per share may be different from the trend of the reported profit, and which is the more useful measure of performance; (4 marks)

(ii) Calculate the diluted earnings per share for Taylor based on the effect of the convertible loan stock and the directors' share options for the year to 30 September 2017 (ignore comparatives); and (5 marks)

(iii) Explain the relevance of the diluted earnings per share measure. (5 marks)

(c) Mrs Hanna has noticed that the tax charge for a company called Stepper is $5 million on profits before tax of $35 million. This is an effective rate of tax of 14·3%. Another company Jenni has an income tax charge of $10 million on profit before tax of $30 million. This is an effective rate of tax of 33·3% yet both companies state the rate of income tax applicable to them is 25%. Mrs Hanna has also noticed that in the cash flow statements each company has paid the same amount of tax of $8 million.

Required:
Advise Mrs Hanna of the possible reasons why the income tax charge in the financial statements as a percentage of the profit before tax may not be the same as the applicable income tax rate, and why the tax paid in the cash flow statement may not be the same as the tax charge in the income statement. (6 marks)

(20 Marks)

QUESTION 2

The following trial balance was extracted from the books of Newton Ltd on 31 July 2017.

	Note	Dr	Cr
		$000	$000
Cost of sales		76.8	
Distribution costs		24.4	
Administration expenses		12.0	
Provision for warranty claim	(i)		12.0
Land and buildings at cost (including land $24,000)	(ii)	160.0	
Accumulated depreciation 1 August 2016 – land & buildings	(ii)		8.0
Revaluation surplus 1 August 2016	(ii)		24.0
Plant and equipment at cost	(iii)	260.0	
Accumulated depreciation 1 August 2016 - plant and equip	(iii)		124.0
Revenue	(iii)		240.8
Investment property	(iv)	128.0	
Equity investments	(v)	33.6	
Trade receivables		27.6	

Inventory at 31 July 2017		24.8	
Cash and bank		35.2	
Trade payables			18.4
Corporation tax	(vi)	1.6	
Equity shares of 10c each	(vii)		80.0
Share premium account	(viii		140.0
Equity investment reserve	(v)		5.6
6% Debenture (issued on 1 March 2017)	(vii)		80.0
Equity dividend paid		9.4	
Retained earnings reserve 1 August 2016			60.6
		793.4	793.4

The following notes are relevant to your answer:

(i) Newton Ltd maintains a provision for warranty claims expected to arise in the future on goods sold. At the reporting date this provision was carried at $12,000. It has been agreed that this provision should be increased to $17,500.

(ii) Land and buildings are carried under the revaluation model, as permitted by IAS 16. The most recent valuation took place on 31 July 2015, resulting in the values included in the trial balance above. The revaluation surplus of $24,000 resulted solely from these land and buildings. The buildings were estimated to have a useful economic life of 17 years as at that date and zero residual value. On 31 July 2017, the land was revalued to $20,000 and the buildings to $90,000. There was no change to the useful life estimates of the buildings. Depreciation is recognised on a straight-line basis through cost of sales, and no depreciation has yet been charged for the year ended 31 July 2017.

(iii) Plant & equipment is being depreciated through cost of sales at 20% per annum reducing balance. On 31 July 2017, a piece of plant which cost $40,000 on 1 August 2015 was sold for $22,000. The only entries made to record this transaction were to debit cash and credit sales revenue with $22,000.

(iv) Investment properties are accounted for under the fair value model of IAS 40. The figure included in the trial balance above represents the fair value of these properties at 1 August 2016. The fair value of these properties at 31 July 2017 was $140,000.

(v) The figure for equity investments represents the fair value of equities held at 1 August 2016 plus the cost of equities purchased during the year. As permitted by IFRS 9, an election was made at the date of purchase to account for any fair value gains and losses on all these equity investments through 'other comprehensive income'. Newton Ltd takes such gains and losses to a separate component of equity. The fair value of the equity investments at 31 July 2017 was $25,000.

(vi) Corporation tax for the year was estimated at $22,000. The balance in the trial balance is a residual amount following the payment of corporation tax for year ended 31 July 2016 and its offset against the provision made that year.

(vii) The debentures were issued during the year. Interest is payable annually in arrears. No interest has been provided for or paid as at 31 July 2017.

(viii) $40,000 was raised on 31 July 2017 through the issue of equity shares. This was correctly accounted for by crediting $16,000 to equity share capital and $24,000 to share premium.

REQUIRED:

Prepare, in a form suitable for publication to the shareholders of Newton Ltd:

(a) Statement of Profit or Loss and Other Comprehensive Income of Newton Ltd for the year to 31 July 2017;

(16 marks)

(b) Statement of Changes in Equity for year ended 31 July 2017; (6 marks)

(c) Statement of Financial Position as at 31 July 2017. (14 marks)

(d) Calculate basic earnings per share for the year. (4 **marks)**

[Total: 40 Marks]

Note: Notes to the financial statements are not required but all workings should be shown.

Question 3

Under the IASB's *Conceptual Framework for Financial Reporting* certain qualitative characteristics of useful financial information are identified. These are subdivided into characteristics considered fundamental and those considered to be enhancing. The two fundamental characteristics identified by the framework are 'relevance' and 'faithful representation'. In order for financial transactions to be represented faithfully in the financial statements, the principle of 'substance over form' should be applied. This means that wherever there is a difference between the legal form of a transaction and its economic substance, the financial statements should reflect the economic substance.

The following transactions were entered into by Hosho Ltd (Hosho) during the year ended 31 July 2016:

- On 1 August 2015, Hosho agreed to sell a plot of land to another entity for $5 million cash. The land had a carrying value and a fair value at that date of $4 million. On the same date Hosho entered into a binding agreement with the same counterparty to repurchase the land on 1 August 2016 for $5.5 million cash.
- On 1 July 2016, Hosho delivered goods with an invoice value of $400,000 to a customer. The agreement with the customer was that the goods would be paid for only if the customer sold them on. If they were not sold by 31 August 2016, the customer could pay for them, or return them without penalty. Hosho could request the return of the goods at any time until the customer paid for them. The goods had cost Hosho $340,000 to manufacture. On 31 July 2016, none of the goods had been paid for by the customer, and none returned.
- On 10 July 2016, Hosho delivered goods with an invoice value of $250,000 to another customer. The agreement with this customer was that the goods would be paid for on sale to a third party or on 31 August 2016. However, in this case there was no right of return once the customer accepted delivery and was satisfied the goods were as ordered and of good quality. The goods had cost Hosho $160,000 to manufacture. On 31 July 2016, none of the goods had been paid for by the customer.

REQUIRED:

(a) Why it is considered important that the economic substance of a transaction be reflected in the financial statements over its legal form? (4 marks)

(b) Describe in general terms the features of a transaction that suggest that its economic substance may differ from its legal form. (4 marks)

(c) In the case of (i) to (iii) above, explain using journals, how the transactions should be accounted for under IFRS, justifying for your answers. Assume no entries have already been made in respect of the above transactions.
(12 marks)

[Total: 20 MARKS]

QUESTION 4

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is an important standard regulating the recognition of liabilities and the use of provisions. It has been especially useful in controlling the abuse of provisions to manage reported earnings.

REQUIRED:

(a) Define a provision and discuss in detail the three conditions that must be satisfied in order for a provision to be recognised under IAS 37. Your answer should explain how the requirements of IAS 37 are consistent with the principles contained in the conceptual framework.
(10 marks)

(b) Discuss briefly how Mukanya Ltd should record each of the following transactions and events in compliance with the requirements of IAS 37.

(i) A decision was taken by the board of Mukanya Ltd shortly before the year-end to close down a division. The costs of the closure are estimated to total $30 million. The decision was announced in principle, but detailed implementation plans have not been made yet.
(2 marks)

(ii) Mukanya Ltd has traditionally repainted its premises every five years. The next painting is due in a year's time. The entity proposes to accrue as a provision the expected cost of repainting the premises. (2 marks)

(iii) Mukanya Ltd has sold 5,000 units of a product to customers during the past 12 months with a year's warranty attaching. Past experience has shown that 3% of goods sold require warranty repair at an average cost of $200 per unit.
(4 marks)

(iv) Mukanya Ltd has guaranteed the debts of its associate company up to a maximum amount of $3 million. The associate is in excellent financial health and the directors are of the opinion that it is unlikely the guarantee will ever be called in. (2 marks)

[Total: 20 MARKS]

END OF PAPER