THE INSTITUTE OF CHARTERED ACCOUNTANTS (GHANA)

NOVEMBER 2006 EXAMINATIONS
(PROFESSIONAL)

PART 3

CORPORATE REPORTING STRATEGY
(Paper 3.1)

Attempt ALL Questions

TIME ALLOWED: 3 HOURS

QUESTION 1

(a) The importance of income measurement in financial reporting cannot be over emphasized.

Required:

i) Outline any five (5) reasons why income measurement is considered to be important for business.

(***5 Marks)***

ii) Explain capital maintenance and the transaction approach to income measurement and outline any three (3) advantages of the transaction approach.

(7 ***Marks)***

iii) Draw a distinction between economic income and accounting income.

(3 ***Marks)***

(b) Agyeiwaa Group owns two companies, East Restaurant Limited and South Restaurant Limited. The summarized balance sheets of the two companies as at 31st March 2004 are given below:

	East Restaurant Ltd.	South Restaurant Ltd.
	¢'million	¢'million
Property, Plant & Equipment	3,600	3,612
Current Assets	900	288
Current Liabilities	(360)	(360)
12% Debentures	(2,400)	(2,400)
	1,740	1,140
Stated Capital	1,200	1,000
Income Surplus	540	140
	1,740	1,140

The profit and loss accounts of the two companies for the year ended 31st March 2004 are as follows:

	East Restaurant Ltd.	South Restaurant Ltd.
	¢'million	¢'million
Turnover	5,000	4,200
Cost of Sales	(2,800)	(2,900)
Gross Profit	2,200	1,300
Depreciation	540	542
Interest on debentures	288	288
Other expenses	872	170
Total Operating Expenses	1,700	1,000
Profit before tax	500	300
Taxation	163	98
Profit after tax	337	202

The debentures of the South Restaurant Ltd. were issued to raise funds to construct an ultra-modern office building at a cost of ¢2,400 million. The building was completed and was ready for occupancy by March 31st 2004. The accumulated weighted average expenditure on the project is ¢1,600 million.

Some pieces of equipment of East Restaurant Ltd are financed through a lease arrangement. Lease rental of ¢260 million paid in 2004 is included in other expenses of East Restaurant. The discounted present value of future lease payments is ¢3,800 million, of which ¢1,200 million is due for payment between April 1st 2004 and March 31st 2005.

At a recent Accountants Conference, the Chairman of Agyeiwa Group learnt that borrowing costs could be capitalized and that lease transactions could be brought onto the balance sheet through capitalization. Consequently the Board has directed that the accounts should be re-prepared by capitalizing borrowing costs and lease rentals.

All property, plant and equipment are depreciated at a rate of 15% per annum. Corporate tax rate is 32.5%.

Required:

Re-draft the balance sheet of the two companies after the lease rentals and borrowing costs have been capitalized.

(***10 Marks***)

(**Total 25 Marks**)

QUESTION 2

Happy Limited, a manufacturing company, has 80% holding in Lucky Limited, a company in the Gambia. The functional currency of Lucky Limited is Dalasi.

The profit and loss accounts of Happy Limited and its subsidiary for the year ended June 30, 2005 are as follows:

	Happy Ltd ¢'million	Lucky Ltd D'000
Turnover	40,000	65,000
Cost of Sales	(15,500)	(16,000)
Gross Profit	24,500	49,000
Selling, general & admin. expenses	(11,800)	(33,000)
Net operating profit	12,700	16,000
Dividend from Lucky Ltd.	2,137	0
Profit before Tax	14,837	16,000
Tax	(3,858)	(4,000
Profit after Tax	10,979	12,000
Income Surplus – July 1, 2004	12,500	8,900
	23,479	20,900
Less Proposed Dividend	6,200	8,400
Income Surplus – June 30, 2005	17,279	12,500

The balance sheets of Happy Limited and Lucky Limited as at June 30, 2005 are:

	Happy Ltd ¢'million	Lucky Ltd D'000
Fixed Assets	52,000	45,000
Less Accumulated Depreciation	22,500	18,500
	29,500	26,500
Investment in Lucky Limited	10,000	0
Stocks	4,600	8,800
Debtors	5,805	0
Bank	65,400	28,000
Dividend Receivable	2,137	
Creditors	(3,400)	0
Tax	(2,500)	(2,400)
Proposed Dividends	(6,200)	(8,400)
	105,342	52,500
Stated Capital	88,063	40,000
Income Surplus	17,279	12,500
	105,342	52,500

Additional information:

i. The balance on the income surplus account of Lucky Limited at the time of the acquisition was D7,200,000.

ii. Details of exchange rates were:

On acquisition of subsidiary	¢256 to D1
June 30, 2004	¢300 to D1
Average (July 2004 to June 2005)	¢309 to D1
June 30, 2005	¢318 to D1
On acquisition of fixed assets	¢280 to D1

iii. In May 2005, Lucky Ltd bought goods worth D2,800,000 on credit from one of its major suppliers. The goods were supplied in May 2005 but the invoice was received on June 29, 2005. No entry was passed for this transaction in the books. Proceeds amounting to D1,800,000 realized from sale of 60% of these goods was however recorded in the books. The rest of the goods remained unsold at the end of the year and have not been included in the stocks of Lucky Ltd shown in the financial statements.

iv. The effect of this transaction on the tax of Lucky Ltd is overstatement of tax charge by D420,000.

v. The group's policy is to use the closing rate method but to translate profit and loss items at the average rate. It is also the group's policy to transfer any goodwill on acquisition to profit and loss account immediately.

Prepare:

a. Consolidated profit and loss account for the year ended June 30, 2005;

b. Consolidated income surplus account for the year ended June 30, 2005; and

c. Consolidated Balance Sheet as at June 30, 2005.

(**20 Marks)**

QUESTION 3

Apple Ltd and Beans Ltd have been competitors in the tomato industry for the past ten years.

The following financial statements relate to the three years ended 31st December 2003, 2004 and 2005.

	Apple Ltd			Beans Ltd		
	2003	2004	2005	2003	2004	2005
Gross profit margin (%)	28.9	26.5	27.6	31.2	33.8	34.8
Return on capital surplus (%)	23.2	18.5	15.7	22.5	24.6	28.0
Profit margin (%)	4.5	5.5	5.8	7.7	11.8	14.8
Asset turnover (times)	1.5	1.6	1.7	1.79	1.91	2.03
Gearing (%)	20.5	24.6	26.5	19.9	25.3	24.7
Debt/Equity (%)	22.5	25.6	29.8	24.8	33.9	32.8
Interest cover (times)	6.1	6.5	7.2	12.6	8.5	9.2
Current ratio	1.5:1	1.2:1	1.3:1	2.98:1	3.1:1	3.2:1
Quick ratio	1.2:1	0.9:1	0.6:1	1.35:1	1.27:1	1.23:1
Debtors payment period (days)	52	54	53	42.3	36.3	39.1
Creditors payment period (days)	27	24	23	34.4	33.0	34.9
Inventory turnover (times)	80.6	78.5	82.6	112.3	127.5	131.9

Required:

a) Comment and compare the performances of Apple Ltd and Beans Ltd using the ratios provided.

(***12 Marks)***

b) State any three reasons why a company should be interested in the performance of its competitors.

(***3 Marks)***

(Total: 15 Marks)

QUESTION 4

The shareholders of Atea Ltd., a successful family business, are planning to offer 2,000,000 of their shares for sale to the public.

The summarised balance sheet of Atea Ltd. as at 31st December, 2005 is as follows:

	¢'million
Long term assets	19,000
Net current assets	9,500
	28,500
Stated Capital	
5,000,000 ordinary shares of no par value	9,500
Income Surplus	11,000
18% Debenture Stock	8,000
	28,500

Extracts of income surplus accounts from 2001 to 2005 are:

Year	Net Profit After tax ¢'million	Dividend ¢'million	Retained profit ¢'million
2001	2,850	950	1,900
2002	3,325	950	2,375
2003	3,800	950	2,850
2004	3,800	1,900	1,900
2005	4,275	1,900	2,375

The following information is relevant:

(i) The shares were issued several years ago.

(ii) Included in long term assets is a piece of land which cost ¢950 million. It has recently been valued professionally at ¢2,950 million in its current use and at ¢3,750 million as residential land. The valuation has not been incorporated in the accounts.

(iii) The directors have applied to the Metropolitan Assembly for a permit for a change of use of the land. In addition they are arranging alternative premises at a rental of ¢285 million per year.

(iv) ¢100 million of trade debtors is considered irrecoverable.

(v) The directors have decided that Abeh Ltd, a quoted company which manufactures similar products as those of Atea Ltd, provides a relevant comparison to Atea Ltd.

The following information relate to Abeh Ltd.

	2005	Average 2001 to 2005
	¢	¢
Dividend per share	285	228
Price per share	4,560	4,750
Earnings per share	570	380
Book value of net assets per share	3,800	-

Required:

(a) Suggest a price range for the sale of 2,000,000 of the shares of Atea Ltd to the public using each of the following methods:

- Earnings
- Dividend
- Net assets

(***14 Marks)***

(b) In any takeover bid, both buyers and sellers have a price that they realistically hope to achieve. Outline any **four** factors that shareholders of Atea Limited may consider in fixing the final price.

(***6 Marks)***

(Total 20 Marks)

QUESTION 5

Paya Limited has been trading at a loss for a number of years. The board of directors of the company is now considering the options of liquidating the company or undertaking a capital reduction. The following is the balance sheet of Paya Limited as at 30th June, 2006.

Balance Sheet of Paya Ltd. as at 30th June, 2006

	¢'million	¢'million
Long Term Assets		
Freehold Building		8,000
Equipment, Furniture & Fittings		3,571
Motor Vehicles		639
Intellectual Property		1,682
		13,892
Current Assets		
Stocks	5,375	
Debtors	14,222	
Investments	9,664	
	29,261	
Current Liabilities		
Bank Loan (secured on investments)	10,462	
Trade Creditors	14,525	
Other Creditors	20	
	25,007	
Net Current Assets		4,254
		18,146
20% Debentures (secured on freehold building)		(10,000)
		8,146
Financed by:		
Stated Capital		35,000
Capital Surplus		2,600
Income Surplus		(29,454)
		8,146

Additional information:

(i) The stated capital of the company is made up of 20,000,000 ordinary shares, issued and fully paid at ¢25,000 million and 16% 10,000,000 preference shares issued for ¢10,000 million.

(ii) Preference dividend is in arrears for 2 years.

(iii) The costs of the reconstruction scheme are estimated at ¢50 million while the liquidation expenses are estimated at ¢80 million.

(iv) The freehold building was revalued on 30th June, 2006 and included in the financial statements as such. If it is sold at 30th September, 2006 the net proceeds will be ¢8,200 million.

(v) The present value of the future cash flows from the intellectual property as at 30th September, 2006 is estimated at ¢800 million. However, if it is sold on that date the net sale proceeds will be ¢500 million.

(vi) The break up values of the other assets as at 30th September, 2006 are as follows: Stocks ¢3,000 million; Debtors ¢8,500 million; Investments ¢8,000 million; Motor Vehicles ¢600 million; and Equipment, Furniture and Fittings ¢1,400 million.

(vii) Stocks and debtors in the financial statements have been overstated by ¢500 million and ¢650 million respectively.

(viii) The ordinary shareholders have promised to introduce cash totaling ¢5,000 million for new ordinary shares in the company.

(ix) Other creditors represent tax on employees' salaries for the month of June 2006.

(x) Paya Limited will require a working capital ratio of 2:1 to ensure efficient operation after reconstruction. Any deficiency will be made good by the ordinary shareholders by introducing additional cash for more shares.

Required:

(a) Design a capital reconstruction scheme as at 30th September 2006 which is likely to be accepted by the ordinary shareholders, preference shareholders and creditors. Provide reasons for your proposals.

(***14 Marks)***

(b) Prepare a balance sheet of Paya Limited after the reconstruction.

(***4 Marks)***

(c) Comment on any two additional information you require to supplement your answer.

(***2 Marks)***

(**Total 20 Marks)**

Show relevant workings