"Investing in Africa's Future"

COLLEGE OF BUSINESS PEACE LEADERSHIP AND GOVERNANCE

NMAC 203: INTERMEDIATE ACCOUNTING 11

END OF SECOND SEMESTER EXAMINATIONS

MAY 2021

LECTURER MR I. RARAMI

DURATION: 7 HOURS

INSTRUCTIONS

Answer **ONE** question

The marks allocated to each question are shown at the end of the question

Show all your workings if required

Credit will be given for presentations that are neat, logical and grammatically well constructed.

QUESTION ONE [100 MARKS]

A). Timmie, Izzie and Aggie are blood brothers. Timmie is the owner of Timmie Computers (Pvt) Ltd. Izzie is the owner of Izzie Accounting Service and Aggie is the owner of Aggie Fuels and Oils. The Three brothers are directors and have shares in the three companies. The three directors feel that it is not necessary to disclose related party information as they feel that such transactions are a normal feature of business and are aware of those transactions, therefore there is no need to disclose them.

Timmie Computers (Pvt) Ltd is applying for a facility from TN Bank Ltd. The Bank is worried about the impact of related party transactions on the results of Timmie Computers, because related parties may often enter into transactions which unrelated parties would not normally enter into.

i). State and explain any five examples of related party transaction that may occur in the three companies above and their impact on the financial results of Timmie that TN is worried about. **[10 marks]**

ii). State the disclosure that are necessary in the above companies to reduce the worry of TN Bank. **[4 marks]**

B. Mr Batsirwai and Mr Batsirai are employees of Matanda Timbers based in Mutare. Recently their Human Resources Manager Mr Mudyandigere, addressed them on the issue of their pensions. Mr Mudyandigere mentioned Retirement benefit Plans and Defined Benefit Plans which Mr Batsirai and Batsirwai could not understand. They heard that you are a student at Africa University and that in your accounting course you did IAS19.

They approached you:
i). To explain the two terms and the difference between the two.
[3 marks]
ii). To explain to them, which one is good to them and why not the other. **[3 marks]**

C).Mask & Sanitiser Limited is a manufacture of masks and sunitisers. The entity enters into a three-year contract with Rais Wheels Limited, a supplier of Road transport vehicles, for the use of ten vehicles to deliver orders of customer's masks and hand sanitisers around Zimbabwe. The model and capacity of the vehicles are specified in the contract.

Road Runner Limited has a large pool of similar vehicles that could be used to fulfil the requirements of the contract. Rais Wheels Ltd's premises are in the same area as Mask & Sanitiser Ltd's mask & sanitiser factory and the vehicles are parked at Rais Wheel Ltd's premises when not in use. The cost associated with substituting the vehicles used by Mask & Sanitisers Ltd with other similar vehicles are minimal for Rais Wheels Limited.

Required
Discuss, with reference to IFRS 16 leases, whether the agreement contains a lease. **(10 marks)**

D). **Part A:** Hello Limited is a telecommunications company, providing internet and data services to its customers, its engineers are investigating ways to improve customer services and have taken a decision to obtain the right to use strandsof dark fibre to create their own privately owned optical fibre network. (Dark fibre refers to unused strands of a fibre optic cable).

Hello limited enters into a twenty-year contract with Interdata Limited, a telecommunications company for the right to use 100 physically distinct strands of dark fibre within the undersea cable connecting the United Kingdom and Europe with Zimbabwe.

Hello Limited has control of use of all 100mstrands of fibre within the cable and decides the type and quality of data that will be transported. It is also responsible for the technical connections to equipment.

Interdata is responsible for the repairs and maintenance to the undersea cable. It can substitute the strands only for purpose of repair and maintenance.

Required:
Discuss, with reference to IFRS 16 Lease, whether the arrangement contains a lease. **(10 marks)**

Part B: Lessee Limited a communications company, providing internet and data services to its customers, its engineers have been investigating ways to improve customer services and have taken a decision to obtain the right to use a specified amount of bandwidth capacity within an existing optical fibre network.

Lessee Limited makes decisions about which strands are used to transport Lessee Limited's data and is responsible for the technical connections to its equipment.

Required
Discuss, with reference to IFRS 16 Lease, whether the arrangement contain a lease. **(10 marks)**

E). **Part A:** Apple Limited is a producer of apples. It enters into a contract with Freight Limited, a shipping company, for the transport of apples from Harare to Blantyre on a specific 18 tonnes truck. Freight Limited does not have substitution rights.

The contract specifies the quantity, quantity, grade and packaging of apples to be transported as well as the dates of departure and arrival. The apples will occupy substantially all of the capacity of the truck.

Freight Limited operates and maintain the truck and is responsible for the safe transport of the apples and other cargo on board. Apple limited is not permitted to hire another operator for the truck or to operate the truck itself.

Required:
Discuss, with reference to IFRS 16 Lease, whether the arrangement contain a lease. **(10 marks)**

Part B: Apple Limited is a producer of apples. It enters into a contract with Freight Limited, a shipping company, for the transport of apples for a three-year period on a specific truck. Freight Limited does not have substation rights.

Apple Limited decides on the quantity, grade and packaging of apples to be transported, the date of travel and also the departure and arrival depots. It is also permitted to use space capacity to transport produce from neighbouring farms.

Freight Limited operates and maintains the truck and is responsible for its safe passage. It can restrict the truck from travelling on roads deemed unsafe due to civil wars and piracy, and can restrict the carrying of unsuitable cargo.

Required
Discuss, with reference to IFRS 16 Lease, whether the arrangement contain a lease. **(10 marks)**

F). Africa University is a private educational institution. It enters into a contact with Copy Limited for the lease of twenty-one printers for a period of three years.

One of the printers is a high specification printer that can cope with high volumes and can email scanned documents to recipients. It has current retail price of $20 000. The other 20 printers are desk models for use in individual offices and each has a current price of $2 000.

The make and model of the printer is specified in the contract and although Copy Limited has substitution rights, it is not economically viable to do so.

Required
Discuss, with reference to IFRS 16 Lease, how Africa University should account for this lease contract. **(20 marks)**

G) Discuss the reasons why the previous lease accounting standards (IAS 17) failed to meet the needs of users and was said to be conceptually flawed. **(10 marks)**

QUESTION TWO [100 MARKS]

A.In-order to comply with the Zimbabwean Indigenisation Act, Mbada Mbada diamond mine in Marange granted Chiyadzwa $10 million. This would allow the Chiyadzwa community to benefit from the activities of the mine. The amount would be used to build schools, hospitals and other public amenities and in return Mbada Mbada would have complied with the Act and its licence to mine would be safe. You graduated from Africa University with 1st Class Honours Degree in Accounting and you are a first year audit trainee at Rais Auditors.

i).You have been asked by the partner to determine how to account for the $10 million in the 31 December 2019 financial Statements of Mbada Mbada. **(20 marks)**

ii) Discuss why the current treatment of prior period errors could lead to earnings management by companies, together with any further arguments against the current treatment. **(10 marks)**

B. You are the Chief Accountant of Rais Ltd a Transport and Tyre manufacturing company in Mutare. You were represented by your Junior Accountant, recently graduated from Africa University in the Directors meeting. The Directors meeting was held on the 24th of December 2019. The following are some of the decisions which were made:

A: A decision was made by the directors to pay a bonus to an employee.
B: A decision was made by the directors to purchase a new truck in 3 year time.
C: Legislation recently passed means that one of the plants has to be dismantled in a year's time.
D: Future losses are expected from a branch in Botswana.

Also discussed in the meeting was a road tanker that overturned in early December 2019 during a bad rain storm. The tanker spilled its contents, thus contaminating a local river. Rais Ltd has never before contaminated a river. Rais Ltd has no legal obligation to clean the river, has no published policies as to its views on the rehabilitation of the environment and has not made any public statement that it will clean the river. It intends to clean-up the river and has been able to calculate a reliable estimate of the cost thereof.

Required:
i).Your junior accountant is not sure whether or not any of the above A to D decisions result in present obligations at 31 December 2019. Explain to your junior accountant. **(20 marks)**

Required:
ii).Explain to the junior accountant whether Rais Ltd should recognise a liability or a provision at 31 December 2019. **(15 marks)**

C. Discuss the guidance in IAS 37 *Provisions, contingent liabilities and contingent assets* as regards the recognition and measurement of provisions and why it might be felt necessary to replace this guidance. **(20 marks)**

D. Royanai, a public limited company, extracts oil and has a present obligation to dismantle an oil platform at the end of the platform's life, which is ten years. Royanai cannot cancel this obligation or transfer it. Royanai intends to carry out the dismantling work itself and estimates the cost of the work to be $150 million in ten years' time. The present value of the work is $105 million.

A market exists for the dismantling of an oil platform and Royanai could hire a third party contractor to carry out the work. The entity feels that if no risk or probability adjustment were needed then the cost of the external contractor would be $180 million in ten years' time. The present value of this cost is $129 million. If risk and probability are taken into account, then there is a probability of 40% that the present value will be $129 million and 60% probability that it would be $140 million, and there is a risk that the costs may increase by $5 million.

Required:
Describe the accounting treatment of the above events under IAS 37. **(15 marks)**

QUESTION THREE [100 MARKS]

A. Electron, a public limited company, operates in the energy sector. The company has grown significantly over the last few years and is currently preparing its financial statements for the year ended 30 June 2018.

Electron buys and sells oil and currently has a number of oil trading contracts. The contracts to purchase oil are treated as non-current assets and amortised over the contracts' durations. On acceptance of a contract to sell oil, fifty per cent of the contract price is recognised immediately with the balance being recognised over the remaining life of the contract. The contracts always result in the delivery of the commodity. **(10 marks)**

Electron has recently constructed an ecologically efficient power station. A condition of being granted the operating licence by the government is that the power station be dismantled at the end of its life which is estimated to be 20 years. The power station cost $100 million and began production on 1 July 2017. Depreciation is charged on the power station using the straight line method. Electron has estimated at 30 June 2018 that it will cost $15 million (net present value) to restore the site to its original condition using a discount rate of five per cent. Ninety-five per cent of these costs relate to the removal of the power station and five per cent relates to the damage caused through generating energy. **(15 marks)**

Electron has leased another power station, which was relatively inefficient, to a rival company on 30 June 2018. The beneficial and legal ownership remains with Electron and in the event of one of Electron's power stations being unable to produce energy, Electron can terminate the agreement. The leased power station is being treated as an operating lease with the net present value of the income of $40 million being recognised in profit or loss. The fair value of the power station is $70 million at 30 June 2018. A deposit of $10 million was received on 30 June 2018 and it is included in the net present value calculation. **(12 marks)**

The company has a good relationship with its shareholders and employees. It has adopted a strategy of gradually increasing its dividend payments over the years. On 1 August 2018, the board proposed a dividend of 5c per share for the year ended 30 June 2018. The shareholders will approve the dividend along with the financial statements at the general meeting on 1 September 2018 and the dividend will be paid on 14 September 2018. The directors feel that the dividend should be accrued in the financial statements for the year ended 30 June 2018 as a 'valid expectation' has been created.
(8 marks)

The company granted share options to its employees on 1 July 2019. The fair value of the options at that date was $3 million. The options vest on 30 June 2020. The employees have to be employed at the end of the three year period for the options to vest and the following estimates have been made:

Estimated percentage of employees leaving during vesting period at:

Grant date 1 July 2017 5%
30 June 2018 6% **(10 marks)**

Required
Draft a report suitable for presentation to the directors of Electron which discusses the accounting treatment of the above transactions in the financial statements for the year ended 30 June 2018, including relevant calculations.

B) Leasing is important to Hombe, a public limited company as a method of financing the business. The Directors feel that it is important that they provide users of financial statements with a complete and understandable picture of the entity's leasing activities. They believe that the current accounting model is inadequate and does not meet the needs of users of financial statements.

Hombe has leased plant for a fixed term of six years and the useful life of the plant is 12 years. The lease is non-cancellable, and there are no rights to extend the lease term or purchase the machine at the end of the term. There are no guarantees of its value at that point. The lessor does not have the right of access to the plant until the end of the contract or unless permission is granted by Hombe.

Fixed lease payments are due annually over the lease term after delivery of the plant, which is maintained by Hombe. Hombe accounts for the lease as an operating lease but the directors are unsure as to whether the accounting treatment of an operating lease is conceptually correct.

Required
Discuss whether the plant operating lease in the financial statements of Hombe meets the definition of an asset and liability as set out in Conceptual Framework for Financial Reporting. **(20 marks)**

C) Due to the complexity of International Financial Reporting Standards (IFRS), often judgements used at the time of transition to IFRS have resulted in prior period adjustments and changes in estimates being disclosed in financial statements. The selection of accounting policy and estimation techniques is intended to aid comparability and consistency in financial statements. However, IFRS also place particular emphasis on the need to take into account qualitative characteristics and the use of professional judgement when preparing the financial statements. Although IFRS may appear prescriptive, the achievement of all the objectives for a set of financial statements will rely on the skills of the preparer. Entities should follow the requirements of IAS 8 *Accounting policies, changes in accounting estimates and errors* when selecting or changing accounting policies, changing estimation techniques, and correcting errors.

However, the application of IAS 8 is additionally often dependent upon the application of materiality analysis to identify issues and guide reporting. Entities also often consider the acceptability of the use of hindsight in their reporting.

Required

(i) Discuss how judgement and materiality play a significant part in the selection of an entity's accounting policies. **(15 marks)**

(ii) Discuss the circumstances where an entity may change its accounting policies, setting out how a change of accounting policy is applied and the difficulties faced by entities where a change in 'accounting policy is made. **(10 marks)**

END OF PAPER