"Investing in Africa's Future"

COLLEGE OF BUSINESS PEACE, LEADERSHIP & GOVERNANCE

NMAC 404: ADVANCED ACCOUNTING & FINANCIAL THEORY

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

QUESTION ONE [100 MARKS]

A). Shinga Shinga Ltd is a manufacturer of electrical equipment. The company's year-end is 31 December 2020 and the following came to your attention before the financial statements were finalised on 16 February 2021:

1. The market value of a listed investment decreased in January 2021 to $500 000. Investments are stated at market value. Assume that the company does not speculate with shares.

2. A debtor with an outstanding balance of $51 700 on 31 December 20.4, was declared insolvent and placed under liquidation on 16 January 2021. The liquidator indicated that creditors will receive 30 cents in the rand. No allowance for credit losses was made at reporting date.

3. On 5 January 2021 the directors declared a dividend of 10 cents per share for the year ended 31 December 20.4. There is 100 000 issued ordinary shares.

4. During January 2021 inventory with a value of $16 000 was destroyed when a store was burnt down during a political uproar. Assume a tax rate of 28%, that all amounts are material and that the company is a going concern.

REQUIRED:

(a) Define events occurring after the reporting period according to IAS 10. **(6 marks)**

(b) In each of the above events:

Discuss in brief how the event will affect assets and liabilities in the financial statements i.e. must the assets and/or liabilities be adjusted or not. **(8 marks)**

B).The Avocado Ltd is preparing its consolidated financial statements for the year ended 31st December, 2019. Avocado Ltd has a number of investments in other entities. Details of these investments are as follows;

Investment in Apple Productions

Avocado acquired 12% of the issued ordinary share capital of Apple Productions on 1st January 2014 for $10,000,000. On 1st October, 2019 Avocado acquired a further 45% of the issued ordinary share capital for $45,000,000. The fair value of the net assets at 1st October 2019 was $120,000,000 and on 1st January 2014 was $80,000,000.

The previously held interest had a fair value on 1st October 2019 of $17,000,000.

Investment in Pine Apple Ventures Ltd (PAV)
Avocado Ltd acquired 90% of the issued ordinary share capital of Pine Apple Ventures Ltd on 1st March 2019 for $6,000,000 when the book value of the net assets was $5,800,000. The fair value of these net assets was estimated at $6,800,000 at the date of acquisition. The difference between fair value and the book value of the net assets related to depreciable property with a remaining useful life at the date of acquisition of 40 years.

Investment in Water Melon Ltd
At the date of acquisition of Pine Apple Ventures Ltd, Pine Apple Ventures Ltd held 65% of the issued ordinary share capital of Water Melon Ltd. The operations of Water Melon Ltd do not fit within the strategic plans of Avocado Ltd and so the directors plan to sell this investment. The investment is currently being marketed with a view to selling it within 4 months.

Investment in Good Brothers Ltd
Avocado Ltd acquired 40% of the issued ordinary share capital of Good brothers on 1st January 2018 for $2,000,000 when the book value of the net assets was $5,500,000. The fair value of these net assets was estimated at $6,000,000 at the date of acquisition.

Required:
a) Discuss the appropriate treatment of each investment in the consolidated financial statements of the Avocado Group Ltd as at 31st December 2019. **(25 marks)**

(Note: Calculations are not required)

C). The directors of Money Ltd are 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 have entered into the following transactions after the year end and wish to know how to deal with them in a cash flow statement, as they are unsure of the meaning of the definition of cash and cash equivalents.

Money had decided after the year end to deposit the funds with the bank in two term deposit accounts as follows:

(i) $3 million into a 12-month term account, earning 3.5% interest. The cash can be withdrawn by giving 14 days' notice but Money will incur a penalty, being the loss of all interest earned.

(ii) $7 million into a 12-month term account earning 3% interest. The cash can be withdrawn by giving 21 days' notice. Interest will be paid for the period of the deposit but if money is withdrawn, the interest will be at the rate of 2%, which is equivalent to the bank's stated rate for short-term deposits.

Money is confident that it will not need to withdraw the cash from the higher-rate deposit within the term, but wants to keep easy access to the remaining $7 million to cover any working capital shortfalls which might arise.

Required
Discuss the principles behind the classifications in the statements of cash flows whilst advising Money on how to treat the two transactions above. **(20 marks)**

D). Cash Ltd operates in the energy industry and undertakes complex natural gas trading arrangements, which involve exchanges in resources with other companies in the industry. Cash Ltd is entering into a long-term contract for the supply of gas and is raising a loan on the strength of this contract. The proceeds of the loan are to be received over the year to 30 November 20X3 and are to be repaid over four years to 30 November 20X7. Cash Ltd wishes to report the proceeds as operating cash flow because it is related to a long-term purchase contract. The directors of Cash receive extra income if the operating cash flow exceeds a predetermined target for the year and feel that the indirect method is more useful and informative to users of financial statements than the direct method.

(i) Comment on the directors' view that the indirect method of preparing statements of cash flow is more useful and informative to users than the direct method. **(15 marks)**

ii).Discuss the reasons why the directors may wish to report the loan proceeds as an operating cash flow rather than a financing cash flow. **(10 marks)**

E). Makore Storage Ltd (Makore) is a company that owns two self-storage unit complexes in Chipinge. These units are rented to individuals or companies as secure storage spaces to be used as needed. Makore has a 31 December year end Makore's storage complexes are unique in that the units are made up of individual shipping containers that are stacked in a specific manner. makore obtains its shipping containers from Chiredzi where the market for containers is highly liquid due to the large number of containers stored there.

During 2019 the average price for a container similar to the size and condition used by Makore in Chiredzi was $28 000. There is a small market for containers in Chipinge. The average price of a container in Chipinge was $29 000 during 2019. Makore purchased 10 new containers on 29 December 2019 from an insolvent estate at $24 000 each. The financial director decided to use a discounted cash flow method to determine the fair value of the containers. The financial director determined that the fair value of the containers was $30750 each.

During the year Makore became aware of a new alternative use for shipping containers. The metal used for the containers has excellent anti-corrosion qualities and is thus in demand in coastal areas for roof sheeting and other construction elements. Makore was offered $29 500 by three different steel merchants for disassembled containers in December 2019. The costs to disassemble each container are negligible. The managing director indicated that Makore is a family business and is not interested in selling the containers to the steel merchants.

Discuss, with reasons, the appropriate fair value in terms of IFRS 13 *Fair value* of each container for the year ended 31 December 2019.

Please note:
• Your discussion should make reference to all the possible amounts Makore Storage Ltd will consider in determining the appropriate fair value.
• Your answer must comply with International Financial Reporting Standards (IFRS). **(10 marks)**

F). You were computing the taxable income of the company and you were given the following list of items:

i). Depreciation on certain fixed assets
ii). Depreciation on certain non-industrial buildings
iii). Fines
iv). Prepaid income
v). Dividends received from a source within Zimbabwe
vi). Donations to political parties
vii). Provisions for bad debts
viii). Entertainment expenses
ix). Revaluation profit
x) Loss carry over

You were told that to compute the taxable income, you have to classify those items into two groups, those that cause permanent differences and those that cause temporary differences.

Required:
i) Group the above items into the two groups. **(4 marks)**
ii). What is the effect of the timing difference on tax payable? **(1 mark)**
iii).Explain the impact of asset disposal on deferred tax. **(1 marks)**

QUESTION TWO [100 MARKS]

A). i). An entity acquired a business in a business combination
The acquired business consisted of a computer software developed by the acquiree and has an integrated billing and inventory software program. The parent determined that the highest and best use of the intangible asset is its current use. It is determined that the fair value of the software in its current use is $611 000. Market participants that might buy such intangible assets include both strategic buyers and financial buyers. Strategic buyers might buy it for competitive reasons, while financial buyers might buy it for financial reasons, e.g. to develop the intangible asset for disposal at a later stage. The fair value of the intangible asset is $890 000 for strategic buyers and $670 000 for financial buyers.

The acquiree also has land that is developed for industrial use as a site for a factory. The current use of the land is presumed to be the highest and best use. Nearby sites have recently been developed for residential use. It is determined that the fair value of the land as it is currently used by the entity is $1.3 million (taking into account related factory operations in combination with other assets to generate cash flows). The value of the land as a vacant site for residential use, taking into account the cost of demolishing the factory, is $1.45 million.

Discuss the correct fair value in terms of IFRS 13 Fair Value Measurement of the software and the land that should be used in valuation. **(10 marks)**

b). Diva Diva Ltd has a specialised machine installed in its factory that is used in combination with other assets. The specialised machine has a revalued carrying amount of $9 050 000. The machine has an expected useful life of 10 years. At the end of its financial year the client revalues its machinery in terms of IAS 16 Property, Plant and Equipment. The remaining useful life at the end of the financial year is seven years. The client is using the cost approach in terms of IFRS 13 Fair Value Measurement to determine the fair value of the machine. The cost of a similar new machine (not installed or customised for use) at the end of the financial year is $13 240 000. The cost of transporting a new machine to the factory is $117 000 and the cost of installation and customisation is $103 000.

There is no evidence to suggest that the current use of the machine is not its highest and best use. The income approach to determine the fair value is not used because the machine does not have a separately identifiable income stream. Due to the customisation of the machine there were not sufficient data available to apply the market approach to determine the fair value of the machine.

Required:
Discuss the correct fair value in terms of IFRS 13 Fair Value Measurement and IAS 16 Property, Plant and Equipment that Diva Diva Ltd should use in the revaluation of its specialised machine.

(20 marks)

B). Hamilton Ltd
Hamilton Ltd, a company registered in Zimbabwe, is at the early stages of producing group financial statements. The company' first audit committee meeting to discuss the financial statements is scheduled for a few weeks' time and you have been asked to prepare a paper for presentation at that meeting to discuss the appropriate basis for accounting for the entities mentioned below.

Waka Ltd
Waka Ltd's relevant activities are directed by ordinary shareholder votes. Hamilton owns a controlling 60% of the shares in Cresta Ltd. Cresta Ltd owns 45% of the shares in Waka Ltd and Hamilton Ltd owns a further 20% of Waka Ltd. The remaining shares in Waka Ltd are held by an empowerment group that also owns a golden share. The golden share entitles the empowerment group to veto any decision made by vote at shareholders meetings. The audit committee has specifically asked what the effect of the golden share is i.e. what the treatment would be both with the golden share and assuming that the golden share did not exist.

Space (Pty) Ltd
Hamilton Ltd has recently designed a very powerful telescope that it plans to target at the astronomy market. In order to launch, manufacture and sell the product, it incorporated Space (Pty) Ltd ("Space") with a capital injection of $10 million. Before being launched and sold, the right to sell the telescope is required to be registered under a licence so that only holders of the licence and those authorised to sell under the licence can sell these telescopes.

Registration of telescope licences is a very specialised area of law and, as such, Hamilton Ltd partnered with Dynamic Ltd that specialises in registering licences to sell newly developed telescopes. Although registering the licence is a formality for Dynamic Ltd given its highly experienced staff, Dynamic Ltd's directors negotiated that it should share in 60% of Space's after tax operational profits for the first 3 years of Space's operations with Hamilton Ltd sharing in the other 40% of profits for the first 3 years and 100% thereafter.

In terms of the agreement for the running of Space's operations:

• Dynamic Ltd's staff will register the licence in its own name. After 3 years, Space will have the option to buy the licence from Dynamic Ltd for a stipulated nominal amount.

• Space has an unconditional right to sell the telescopes under Dynamic Ltd's licence for the first 3 years of operations, unless Space does not pay Dynamic Ltd the 60% profits to which it is entitled, within 2 months of its year end or if Space's current debt equity ratio doubles within the 3 years.

• Hamilton Ltd's chief operations officer (COO) will coordinate the launch of the product, its manufacture and sales as soon as the licence is registered.

• Dynamic Ltd's staff will assist with on-going legal and compliance work in respect of the registration of the licence but will not be involved in the selling of the product. Profits are expected to be low for the first 3 years of operations and the 60% profit-sharing ratio for 3 years is likely to equate to the fees that Dynamic Ltd would normally charge for its services.

Required:
Draft a memorandum to the audit committee explaining how the two companies referred to above should be treated in the group financial statements. While it is not necessary to explain the processes involved in consolidating, equity accounting etc., it is necessary to indicate what percentage of the group profits will be included in the group financial statements.

Your memorandum should deal with the nature of the investment and the type of accounting for the investment that would be appropriate in the group financial statements. If you determine that an entity is a subsidiary, briefly state the extent to which any non-controlling interests would be attributed a share of total comprehensive income.
When companies should be equity accounted, the percentage of the investee's profits that would be equity accounted as well as the group's effective interest should be discussed. If consolidation is appropriate, calculation of the effective interest is required.

You are not required to deal with disclosure

Waka Ltd **(10 marks)**
Space Ltd **(15 marks)**

C. Your two junior accountants were preparing a cash flow statement and were not sure on the main differences between the direct method and the indirect method. They were also not sure where to classify dividend and interest receipts and payments as well as taxation on income. They are not sure whether they are classified as Operating, Investing or Financing Activities

Required:
i). Explain the usefulness and limitations of cash flow statement **(10 marks)**
i). Explain clearly the differences between the direct and indirect method. **(4 marks)**

ii) Explain the treatment of dividend and interest receipts and payments and taxation under the three sections of the cash flow statement with reasons. **(9 marks)**

D).B Ltd, a real estate fund, was set up to invest in real estate companies and other real estate investment funds, which own, manage and lease out real estate assets. The fund was set up for the benefit of institutional and retail investors. The fund was set up and is managed by an investment manager that has extensive experience in the real estate business. The fund earns dividends and share of profits and it realises capital gains from its real estate investments.

Depending on the market conditions, B Ltd has a policy of disposing of its investments over a 5 to10 year period. B Ltd investment manager and its investors use fair value to assess performance and to make investment decisions. All the real estate companies of B Ltd report their investment properties at fair value in accordance with IAS 40 *Investment Property.* The fund issues units which are redeemable at a share of the fund's net asset value.
The above information is clearly set out in all publications distributed by the entity to potential investors.

Required:

Discuss, with reasons, whether B Ltd will be classified as an investment entity. **(15 marks)**

E). a)Earnings per share is now the subject of an international financial reporting standard. In the context of this standard, explain the following words:

i) Earnings per share
ii) Diluted earnings per share **(2 marks)**

b). what is the effect of the following on the formula of Earnings per share, that is on the earnings and number of shares.
i). Options
ii). Convertible Debentures
iii). Convertible Preference shares **(5 marks)**

QUESTION THREE (100 MARKS)

A). Mutsai Holdings (Pty) Ltd (Mutsai) owns an investment property (land and a building) situated in Trangle, Masvingo. The building is a warehouse that is leased to an unrelated third party who uses the building as a distribution facility. Recently, residential development has taken place in the area surrounding the property. This has led to substantial increases in the value of residential properties in the area. The most recent development is that the town council has in principle approved the rezoning of the Triangle property owned by Mutsai, for residential development.

Mutsai is seriously considering the possibility of developing the land into a residential estate, in which units will initially be leased out. Mutsai has already enlisted the services of an architect who drew up plans for the proposed development. The architect was paid for his services in December 2019.

Mutsai has been in negotiations with a contractor to develop the residential property. The contractor will commence work after the existing building has been demolished. The scope of the contractor's work will include all relevant earthworks, infrastructure development and construction of the residential units.

After doing extensive research into the planned residential property development, Mutsai determined that the fair value of the property would be $4 million if it were to pursue the opportunity. The valuation committee of Mutsai questioned the $4 million fair value of the residential development and its significant difference from the current fair value of the investment property of $2 518 000 as disclosed in the draft annual financial statements for the year ending 31 December 2019.

Discuss, with reasons, whether the fair value measurement of the Triangle investment property included in the draft annual financial statements for the year ending 31 December 2019 is appropriate in terms of IFRS 13 *Fair Value Measurement.* **(25 marks)**

B) a).IFRS 10 *Consolidated financial statements* was published in 2011. It retains control from its predecessor IAS 27 as the key concept underlying the parent/subsidiary relationship but it has broadened the definition and clarified its application.

Explain the circumstances in which an investor controls an investee according to IFRS 10 **(10 marks)**

(b) Hope holds 40% of the voting rights of Good and twelve other investors each hold 5% of the voting rights of Good. A shareholder agreement grants Hope the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities. To change the agreement, a two-thirds majority vote of the shareholders is required. To date, Hope has not exercised its rights with regard to the management or activities of Good.

Required
Explain whether Hope should consolidate Good in accordance with IFRS 10. **(6 marks)**

(c) Copperfield holds 45% of the voting rights of Spenlow. Murdstone and Steerforth each hold 26% of the voting rights of Spenlow. The remaining voting rights are held by three other shareholders, each holding 1%. There are no other arrangements that affect decision-making.

Required
Explain whether Copperfield should consolidate Spenlow in accordance with IFRS 10. **(6 marks)**

(d) Scrooge holds 70% of the voting rights of Cratchett. Marley has 30% of the voting rights of Cratchett. Marley also has an option to acquire half of Scrooge's voting rights, which is exercisable for the next two years, but at a fixed price that is deeply out of the money (and is expected to remain so for that two-year period).

Required
Explain whether either of Scrooge or Marley should consolidate Cratchett in accordance with IFRS 10. **(5 marks)**

C).a) IAS 12 *Income taxes* focuses on the statement of financial position in accounting for deferred taxation, which is calculated on the basis of temporary differences. The methods used in IAS 12 can lead to accumulation of large tax assets or liabilities over a prolonged period and this could be remedied by discounting these assets or liabilities. There is currently international disagreement over the discounting of deferred tax balances.

Required
(i) Explain what the terms 'focus on the statement of financial position' and 'temporary differences' mean in relation to deferred taxation. **(6 marks)**

(ii) Discuss the arguments for and against discounting long-term deferred tax balances. **(6 marks)**

D).a) (i) In November 20X0, Alexandra defaulted on an interest payment on an issued bond loan of $100 million repayable in 20X5. The loan agreement stipulates that such default leads to an obligation to repay the whole of the loan immediately, including accrued interest and expenses. The bondholders, however, issued a waiver postponing the interest payment until 31 May 20X1.

On 17 May 20X1, Alexandra felt that a further waiver was required, so requested a meeting of the bondholders and agreed a further waiver of the interest payment to 5 July 20X1, when Alexandra was confident it could make the payments. Alexandra classified the loan as long-term debt in its statement of financial position at 30 April 20X1 on the basis that the loan was not in default at the end of the reporting period as the bondholders had issued waivers and had not sought redemption. **(5 marks)**

(ii) In the year to 30 April 20X1, Alexandra acquired a major subsidiary. The inventory acquired in this business combination was valued at its fair value at the acquisition date in accordance with IFRS 3 *Business Combinations*. The inventory increased in value as a result of the fair value exercise. A significant part of the acquired inventory was sold in the post-acquisition period but before 30 April 20X1.

In the consolidated statement of profit or loss and other comprehensive income, the cost of inventories acquired in the business combination and sold by the acquirer after the business combination was disclosed on two different lines. The inventory was partly shown as cost of goods sold and partly as a 'non-recurring item' within operating income. The part presented under cost of goods sold corresponded to the inventory's carrying amount in the subsidiary's financial statements. The part presented as a 'non-recurring item' corresponded to the fair value increase recognised on the business combination. The 'non-recurring item' amounted to 25% of Alexandra's earnings before interest and tax (EBIT).

Alexandra disclosed the accounting policy and explained in the notes to the financial statements that showing the inventory at fair value would result in a fall in the gross margin due to the fair value increase. Further, Alexandra argued that isolating this part of the margin in the 'non-recurring items', whose nature is transparently presented in the notes, enabled the user to evaluate the structural evolution of its gross margin. **(6 marks)**

(iii) Alexandra acquired another subsidiary, Chrissy, on 30 April 20X1. At the time of the acquisition, Chrissy was being sued as there is an alleged mis-selling case potentially implicating the entity. The claimants are suing for damages of $10 million. Alexandra estimates that the fair value of any contingent liability is $4 million and feels that it is more likely than not that no outflow of funds will occur. Alexandra wishes to know how to account for this potential liability in Chrissy's entity financial statements and whether the treatment would be the same in the consolidated financial statements. **(4 marks)**

Required:
Discuss how the above transactions should be dealt with in the year ended 30 April 20X1.

E) Developing a framework for disclosure is at the forefront of current debate and there are many bodies around the world attempting to establish an overarching framework to make financial statement disclosures more effective, coordinated and less redundant. The belief is that excessive disclosure is burdensome and can overwhelm users. However, it could be argued that there is no such thing as too much 'useful' information for users.

Required:
Discuss why it is important to ensure the optimal level of disclosure in annual reports, describing the reasons why users of annual reports may have found disclosure to be excessive in recent years. **(10 mark)**

F) Lucky Dairy's directors have been reviewing the International Integrated Reporting Council's *Framework for Integrated Reporting.* The directors believe that International Financial Reporting Standards are already extensive and provide stakeholders with a comprehensive understanding of an entity's financial position and performance for the year. In particular, statements of cash flow enable stakeholders to assess the liquidity, solvency and financial adaptability of a business.

They are concerned that any additional disclosures could be excessive and obscurethe most useful information within a set of financial statements. They are therefore unsure as to the rationale for the implementation of a separate, or combined, integrated report.

Required:

Discuss the extent to which statements of cash flow provide stakeholders with useful information about an entity and whether this information would be improved by the entity introducing an Integrated Report. **(11 marks)**

END OF EXAMINATION