"Investing in Africa's Future"

COLLEGE OF BUSINESS PEACE LEADERSHIP & GOVERNANCE

MAC 404 ADVANCED ACCOUNTING & FINANCIAL THEORY

END OF FIRST SEMESTER EXAMINATIONS

NOVEMEBR 2021

I. RARAMI

DURATION: 5 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 [50 MARKS]

A). You are a junior accountant at RAIS Consultant. 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. Your colleague is asking you whether it is necessary to do that, and what is their impact on the taxable income.

Required:
i) Explain to your colleague the difference between the items that causes permanent differences and those that cause temporary differences clearly. **(5 marks)**

ii). Group the above items into the two groups. **(5 marks)**

ii). One of the Motor Vehicles on which Special Initial Allowance and Accelerated Wear and Tear was disposed of at a profit in its third year of use. Your colleagues is asking you, how he should calculate the profit to include in the financial statements. Explain to him clearly how he should determine the figure to include and effect of asset disposal on the deferred tax **(5 marks)**

iii). In 2019 Zimbabwe changed its corporate tax from 25% to 24% to stimulate investments. This has an effect on the deferred tax provision. Deferred tax provisions are made at the tax rates ruling today and deferred tax caused by reversing timing differences are made at rates ruling at a future date. Explain to your colleague the limited Liability method and the advantages of this method.

(10 mark)

B). Financial statements have seen an increasing move towards the use of IFRS 13 fair values in accounting. Advocates of 'fair value accounting' believe that fair value is the most relevant measure for financial reporting whilst others believe that historical cost provides a more useful measure. Issues have been raised over the reliability and measurement of fair values, and over the nature of the current level of disclosure in financial statements in this area.

In 2011 the IASB published IFRS 13 Fair value measurement, which sets out to sets out to define fair value, set out in a single IFRS a framework for measuring fair value and require disclosure about fair value measurements.

Required

(a) Discuss the view that fair value is a more relevant measure to use in corporate reporting than historical cost. **(12 marks)**

(b) Discuss the main changes introduced by IFRS 13 Fair value measurement. **(9 marks)**

(c) Farai holds shares in Farisai, which it treats as an equity instrument (a financial asset). Sale of this financial asset is restricted by contract to qualifying investors.
How would the fair value of this instrument be measured? **(4 marks)**

QUESTION TWO [50 MARKS]

A). Harahwa Ltd

Harahwa 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.

Chembere Ltd

Chembere Ltd's relevant activities are directed by ordinary shareholder votes. Harahwa owns a controlling 60% of the shares in Jaha Ltd. Jaha Ltd owns 45% of the shares in Chembere Ltd and Harahwa Ltd owns a further 20% of Chembere Ltd. The remaining shares in Chemebere 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
Harahwa 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, Harahwa 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 Harahwa 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.

- Harahwa 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

Chembere Ltd **(10 marks)**
Space Ltd **(10 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)**

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 [50 MARKS]

A). Electrol Electrol 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 2020, 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 2020. 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. **(3 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. **(5 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. **(15 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. **(10 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 2016 and are to be repaid over four years to 30 November 2020. 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. **(9 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. **(8 marks)**

END OF PAPER