



CHARTERED ACCOUNTANTS EXAMINATIONS

PROFESSIONAL LEVEL

P1: ADVANCED FINANCIAL REPORTING

SERIES: JUNE 2013

TOTAL MARKS – 100 TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.
2. This paper is divided into TWO sections:
Section A: Attempt this ONE compulsory question.
Section B: Attempt any THREE questions.
3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must NOT appear anywhere on your answer booklet.
4. Do NOT write in pencil (except for graphs and diagrams).
5. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.
6. All workings must be done in the answer booklet.
7. Present legible and tidy work.
8. Graph paper (if required) is provided at the end of the answer booklet.
9. Present Value and Annuity tables are attached at the end of this question paper.

SECTION A

QUESTION ONE

This question is compulsory and MUST be attempted.

Mfungwe Group: Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year ended 30 April 2012.

| | K'm |
|---|---------------------|
| Revenue | 46,125 |
| Cost of sales | <u>(39,671)</u> |
| Gross profit | 6,454 |
| Distribution costs | (785) |
| Administrative expenses | (1,064) |
| Finance cost (Note 4, 6) | (772) |
| Share of profit of associate (Note 3) | 20 |
| Profit on disposal of associate | <u>45</u> |
| Profit before tax | 3,898 |
| Income tax | <u>(1,086)</u> |
| Profit for the period | 2,812 |
| Other comprehensive income | |
| Remeasurement (actuarial) losses on defined benefit plan (Note 2) | <u>(90)</u> |
| Total comprehensive income | <u><u>2,722</u></u> |
| Profit attributable to: | |
| Equity holders of the parent | 2,471 |
| Non-controlling interests | <u>341</u> |
| | <u><u>2,812</u></u> |
| Total comprehensive income attributable to: | |
| Equity holders of the parent | 2,381 |
| Non-controlling interests | <u>341</u> |
| | <u><u>2,722</u></u> |

Mfungwe Group: Consolidated Statement of Financial Position as at 30 April:

| | 2012 K' m | 2011 K' m |
|---------------------------------------|----------------------|----------------------|
| ASSETS | | |
| Non-current assets | | |
| Property, plant and equipment | 33,443 | 28,999 |
| Goodwill (Note 4) | 2,514 | 2,798 |
| Intangible assets (Note 7) | 460 | 559 |
| Investment in associate | <u>-</u> | <u>210</u> |
| | <u>36,417</u> | <u>32,566</u> |
| Current assets | | |
| Inventories | 7,961 | 7,322 |
| Trade receivables | 6,950 | 7,005 |
| Investments (note 10) | <u>-</u> | <u>282</u> |
| | <u>14,911</u> | <u>14,609</u> |
| TOTAL ASSETS | <u><u>51,328</u></u> | <u><u>47,175</u></u> |
| EQUITY AND LIABILITIES | | |
| Equity | | |
| Share capital | 6,450 | 5,400 |
| Retained earnings | <u>22,062</u> | <u>19,676</u> |
| | 28,512 | 25,076 |
| Non-controlling interest | <u>3,088</u> | <u>2,806</u> |
| TOTAL EQUITY | <u><u>31,600</u></u> | <u><u>27,882</u></u> |
| Non-current liabilities | | |
| Long-term borrowings | 9,201 | 9,020 |
| Retirement benefit liability (Note 2) | <u>380</u> | <u>330</u> |
| | <u>9,581</u> | <u>9,350</u> |

Current liabilities

| | | |
|------------------------------|-----------------------------|-----------------------------|
| Trade payables | 8,039 | 7,704 |
| Bank overdraft | 898 | 912 |
| Income tax | 1,166 | 1,327 |
| Deferred consideration | <u>44</u> | <u>-</u> |
| | <u>10,147</u> | <u>9,943</u> |
| | <u> </u> | <u> </u> |
| TOTAL EQUITY AND LIABILITIES | <u><u>51,328</u></u> | <u><u>47,175</u></u> |

Notes

1. Depreciation of K3,037 million was charged in respect of property, plant and equipment in the year ended 30 April 2012.
2. Mfungwe group operates a defined benefit scheme. The current service cost and past service costs for the year ended 30 April 2012 were K150 million and K30 million respectively. Both the current service cost and the past service cost were charged to profit or loss (within administrative expenses). The net interest on the defined benefit assets was K120 million and this was also included in the defined benefit expense in administrative expenses. Mfungwe group recognises remeasurement (actuarial) gains and losses in other comprehensive income as required by IAS 19.
3. On 1 January 2012 Mfungwe disposed of the investment in an associate for K270 million. The share of profit in the income statement relates to the period from 1 May 2011 to 31 December 2011. A dividend was received from the associate on 1 June 2011.
4. Mfungwe acquired a seventy per cent holding in Luchazi, a public limited company, on 1 May 2011. The fair values of the net assets acquired were as follows:

| | |
|----------------------------------|-----|
| | K'm |
| Property plant and equipment | 105 |
| Inventories and work in progress | 135 |
| Total | 240 |

The purchase consideration was K150 million in cash and K38 million (discounted value) deferred consideration which is payable on 1 May 2012. The difference between the discounted value of the deferred consideration (K38 million) and the actual amount payable on 1 May 2012 (K44 million) is included in 'finance costs'.

5. Goodwill in one of the group's subsidiaries suffered an impairment during the year. The amount of the impairment was included in cost of sales.
6. The long-term borrowings are measured at amortised cost. The borrowing was taken out on 1 May 2010, and proceeds of K9, 000 million less issue costs of K150m were received on that date. Interest of 5% of the principal is paid in arrears each year,

and the borrowings will be redeemed on 30 April 2015 for K9, 825 million. All interest obligations have been met on the due dates. The effective interest rate applicable to the borrowings is 7%. The finance cost in the income statement also includes interest in respect of the long-term borrowings and interest on overdrafts repayable on demand.

7. Amortisation of 25% of the opening balance of intangibles was charged to cost of sales. A manufacturing patent was acquired for a cash payment on 30 April 2012.
8. An issue of share capital at par was made for cash during the year.
9. Dividends were paid to non-controlling interests during the year, but no dividend was paid to the equity holders of the parent entity.
10. The current asset investments represent treasury bills with three months to maturity.
11. It is the group policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Required:

Prepare the Consolidated Statement of Cash Flows of the Mfungwe Group for the financial year ended 30 April 2012. The statement of cash flows should be presented in accordance with the requirements of IAS 7 Statements of Cash Flows, and using the indirect method. Notes to the financial statement are NOT required, but full workings should be shown.

'Note: Work to the nearest million'

(Total 40 marks)

SECTION B

ANSWER ANY THREE QUESTIONS.

QUESTION TWO

Mutomolo plc. is a listed entity preparing financial statements to 31 March each year. The following transactions have occurred in recent periods:

- (a) On 1 April 2007 Mutomolo plc. purchased 200,000 5% bonds from Kwenje Ltd. The nominal value was K400 per bond. The bonds were issued at K360 per bond and were redeemable at a nominal value on 31 March 2012. Mutomolo intends to hold the investment to collect the contractual cash flows rather than to sell the instrument prior to its contractual maturity to realise its fair value changes.

Annual interest payments were due on 31 March in arrears. The effective annual rate of interest inherent in the bonds was 8.5%. Kwenje Ltd paid the interest due on 31 March 2008 and 31 March 2009 in full.

On 31 March 2009 it became apparent that Kwenje Ltd was in financial difficulty and would be unable to make all the repayments due on the loan. An agreement was reached whereby Kwenje Ltd would make reduced interest payments of K10 per bond on 31 March 2010, 2011 and 2012 and would then redeem the bonds at nominal value on 31 March 2012.

On 31 March 2009 Mutomolo plc. would have required an annual effective return of 7.5% on new investments of this nature.

The reduced interest of K10 per bond was received by Mutomolo on 31 March 2010. On that date there was every expectation that the revised future repayment terms would be adhered to by Kwenje Ltd.

Relevant discount factors are as follows

Present value of K1 receivable in:

| | 7.5% | 8.5% |
|---------|------------|------------|
| 1 year | 93.0 ngwee | 92.2 ngwee |
| 2 years | 86.5 ngwee | 84.9 ngwee |
| 3 years | 80.5 ngwee | 78.3 ngwee |

Required:

- (i) Based on relevant IFRS discuss, with relevant computations, how Mutomolo should account for its investment in the bonds over the five year period to 31 March 2012. (Your answer should specifically address the initial and subsequent measurement principles as well as impairment issues) **(12 marks)**
- (ii) Prepare extracts for the statement of profit or loss and statement of financial position for the five years ending 31st March 2012. **(4 marks)**

- (b) On 1 October 2011 Mutomolo plc. ordered a quantity of inventory from a supplier whose functional currency was the Euro. The agreed purchase price was €40,000. The inventory was delivered on 1 December 2011 and paid for on 31 January 2012. Half the inventory was sold prior to 31 March 2012. Relevant exchange rates are as follows: (ZMK to Euro).

1 October 2011 – K6,200 to €1
1 December 2011 – K6,300 to €1
31 January 2012– K6,400 to €1
31 March 2012 – K6,500 to €1

Mutomolo plc. made no attempt to hedge the exchange risk arising out of the purchase of inventory denominated in Euros.

Required:

Produce relevant extracts that show how this transaction would be reported in the Statement of financial position of Mutomolo plc. at 31 March 2012 and in the Statement of profit or loss and other comprehensive income for the year ended 31 March 2012. Provide any explanations you consider relevant. **(4 marks)**

(Total 20 marks)

QUESTION THREE

- (a) Tuwimba plc. is a well-known, publicly listed automobile dealership. The company issued 40 million convertible bonds on 1 January 2012. The bonds had a term of three years and were issued with a total fair value of K400 million which is also the par value. Interest is paid annually in arrears. Each bond can be converted into two ordinary shares. The company can settle the principal amount of the bonds in ordinary shares or in cash.

When the bonds were issued, the interest rate for a similar debt without the conversion rights was 10%. At the issue date the market price of an ordinary share was K4. The company is likely to settle the contract by issuing shares. The company had accounted for the bond as a compound financial instrument with the proceeds allocated between the *equity* and *liability* components as follows:

- Liability component: K300 million
- Equity component: K100 million

The profit attributable to ordinary shareholders to 31 December 2012 was K330 million and the ordinary shares outstanding at 31 December 2012 were 100 million. The company has no other interest bearing liabilities apart from the one arising from the convertible bond. Assume an income tax rate of 25%.

Required:

- (i) Calculate basic earnings per share and diluted earnings per share for the year to 31 December 2012. **(3 marks)**

- (ii) Outline the uses and limitations of the figure for earnings per share. **(5 marks)**

- (b) The CEO of Tuwimba Plc. who is based at the **corporate headquarters** has decided that the company will be managed and controlled through three divisions, namely, the **spare parts division, the workshop division,** and the **sales division**. Both the sales division and the workshop division deal with external customers and handle orders of both walk-in customers as well as long-term customers who have purchased cars through earlier sales through this dealership. The entity's spare parts division, however, only supplies spare parts to the workshop division and does not cater to the demands of any outside customers. In other words, if outside customers desire to purchase spare parts directly from the spare parts division of Tuwimba, they cannot do so unless their automobiles are serviced by the workshop division of Tuwimba and the workshop division (of Tuwimba) purchases spare parts from its spare parts division for the purposes of undertaking repairs of vehicles they have been contracted to undertake repair work for. The CEO of Tuwimba is responsible for allocating resources and assessing performance based on the results of the three divisions; for which Tuwimba's financial controller maintains separate and discrete financial information.

The CEO is seeking your advice on how to determine the number of operating segments applicable to Tuwimba. She specifically wants clarification on whether the corporate headquarters and the spare parts division can be identified as operating segments.

Required:

Identify the number of operating segments that are applicable to Tuwimba based on IFRS 8 *Operating Segments*. **(8 marks)**

- (c) Tuwimba plc. has a pension plan in which, the employer contributes 10% of the employees' salary per month and the employees contribute 5% of their salary per month. Tuwimba guarantees a payment to the employee equivalent to 103% of the amount of the contributions made.

Required:

Briefly discuss whether this is a defined contribution or a defined benefit scheme.

(4 marks)

(Total 20 marks)

QUESTION FOUR

You are the financial controller of Nsenga-Luzi plc. Your assistant has a reasonable general accounting knowledge but is not familiar with the detailed requirements of all relevant financial reporting standards. Three issues on which he requires your advice are shown below:

Transaction (a)

On 1 October 2010 we bought a property, consisting of land and buildings, for K600 million (land element K360 million). I have the following information regarding this property:

- (i) The estimated market value of the property on 30 September 2011 was K660 million (land element K405 million) and on 30 September 2012 K720 million (land element K435 million).
- (ii) The estimated useful economic life of the buildings on 1 October 2010 was 40 years. This estimate remains valid.
- (iii) We make an annual transfer to retained earnings of the excess depreciation on revalued assets.

I know we use the revaluation model to measure our properties but I have no experience of computing the figures and I do not know what excess depreciation means. Please show me how to compute the figures in the statement of financial position for the property and the revaluation surplus at 30 September 2011 and 2012. Please also show me how to calculate the depreciation charge that will be included in the income statement for the years ended 30 September 2011 and 2012. **(8 marks)**

Transaction (b)

On 1 October 2008 we bought a machine for K150 million. We originally estimated a useful economic life of five years with no residual value. On 1 October 2010 we looked at these estimates again and now we think the original estimate was over optimistic. The machine is unlikely to generate economic benefits for us after 30 September 2012 but we could expect a scrap value of K6 million at today's prices. We haven't charged enough depreciation in the years ending 30 September 2009 and 2010 but I'm not sure how to reflect this – should I change my brought forward figures? **(6 marks)**

Transaction (c)

During the year ended 30 September 2011 we supplied a customer with a product that turned out to be faulty. This led to the customer suffering financial loss and the customer has taken out a legal claim against us for the loss suffered. The claim has not yet been settled but it looks like we will have to make a payment of K24 million to settle the claim sometime early in January 2012. We have investigated the cause of the fault and it turns out that it relates to a defective component supplied to us by one of our suppliers. Our legal department intends to make a counter claim for K24 million against this supplier so overall we should get compensation. We think this will take around four months. I assume nothing needs to be provided for here because we are covered but do I need any note disclosures? **(6 marks)**

Required:

Draft a reply to the questions raised by your assistant. Your reply should include any additional explanations you consider relevant. In all cases you should compute the impact on the reported earnings for the years ended 30 September 2011 and 2012.

(Total 20 marks)

QUESTION FIVE

- (a) The IASB has adopted a mixed measurement approach which allows entities to use various measurement bases for valuing assets and liabilities in financial statements.

Required:

Discuss the various measurement bases identified in the IASB framework for financial reporting.

(4 marks)

- (b) The IASB framework acknowledges that historical basis is the most commonly used measurement basis. Even in times of inflation, published financial statements continue to be prepared under the historical cost convention despite its alleged limitations.

Required:

Explain why historical cost accounting has been criticised and discuss some of the advantages associated with its use.

(8 Marks)

- (c) In the recent past, especially in the wake of the global financial crisis of 2008, there has been an increasing trend towards fair value accounting.

Required:

Explain the terms 'fair value' and 'fair value accounting' and briefly discuss the major advantages and disadvantages of fair value accounting.

(8 marks)

(Total 20 marks)

END OF PAPER

PRESENT VALUE TABLE

Present value of 1, i.e. $(1+r)^{-n}$

Where r = discount rate

n = number of periods until payment

| | | <i>Discount rate (r)</i> | | | | | | | | | | |
|----------------|--|--------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|----|
| <i>Periods</i> | | | | | | | | | | | | |
| <i>(n)</i> | | 1% | 2% | 3% | 4% | 5% | 6% | 7% | 8% | 9% | 10% | |
| 1 | | 0.990 | 0.980 | 0.971 | 0.962 | 0.952 | 0.943 | 0.935 | 0.926 | 0.917 | 0.909 | 1 |
| 2 | | 0.980 | 0.961 | 0.943 | 0.925 | 0.907 | 0.890 | 0.873 | 0.857 | 0.842 | 0.826 | 2 |
| 3 | | 0.971 | 0.942 | 0.915 | 0.889 | 0.864 | 0.840 | 0.816 | 0.794 | 0.772 | 0.751 | 3 |
| 4 | | 0.961 | 0.924 | 0.888 | 0.855 | 0.823 | 0.792 | 0.763 | 0.735 | 0.708 | 0.683 | 4 |
| 5 | | 0.951 | 0.906 | 0.863 | 0.822 | 0.784 | 0.747 | 0.713 | 0.681 | 0.650 | 0.621 | 5 |
| 6 | | 0.942 | 0.888 | 0.837 | 0.790 | 0.746 | 0.705 | 0.666 | 0.630 | 0.596 | 0.564 | 6 |
| 7 | | 0.933 | 0.871 | 0.813 | 0.760 | 0.711 | 0.665 | 0.623 | 0.583 | 0.547 | 0.513 | 7 |
| 8 | | 0.923 | 0.853 | 0.789 | 0.731 | 0.677 | 0.627 | 0.582 | 0.540 | 0.502 | 0.467 | 8 |
| 9 | | 0.914 | 0.837 | 0.766 | 0.703 | 0.645 | 0.592 | 0.544 | 0.500 | 0.460 | 0.424 | 9 |
| 10 | | 0.905 | 0.820 | 0.744 | 0.676 | 0.614 | 0.558 | 0.508 | 0.463 | 0.422 | 0.386 | 10 |
| 11 | | 0.896 | 0.804 | 0.722 | 0.650 | 0.585 | 0.527 | 0.475 | 0.429 | 0.388 | 0.350 | 11 |
| 12 | | 0.887 | 0.788 | 0.701 | 0.625 | 0.557 | 0.497 | 0.444 | 0.397 | 0.356 | 0.319 | 12 |
| 13 | | 0.879 | 0.773 | 0.681 | 0.601 | 0.530 | 0.469 | 0.415 | 0.368 | 0.326 | 0.290 | 13 |
| 14 | | 0.870 | 0.758 | 0.661 | 0.577 | 0.505 | 0.442 | 0.388 | 0.340 | 0.299 | 0.263 | 14 |
| 15 | | 0.861 | 0.743 | 0.642 | 0.555 | 0.481 | 0.417 | 0.362 | 0.315 | 0.275 | 0.239 | 15 |
| | | | | | | | | | | | | |
| <i>(n)</i> | | 11% | 12% | 13% | 14% | 15% | 16% | 17% | 18% | 19% | 20% | |
| 1 | | 0.901 | 0.893 | 0.885 | 0.877 | 0.870 | 0.862 | 0.855 | 0.847 | 0.840 | 0.833 | 1 |
| 2 | | 0.812 | 0.797 | 0.783 | 0.769 | 0.756 | 0.743 | 0.731 | 0.718 | 0.706 | 0.694 | 2 |
| 3 | | 0.731 | 0.712 | 0.693 | 0.675 | 0.658 | 0.641 | 0.624 | 0.609 | 0.593 | 0.579 | 3 |
| 4 | | 0.659 | 0.636 | 0.613 | 0.592 | 0.572 | 0.552 | 0.534 | 0.516 | 0.499 | 0.482 | 4 |
| 5 | | 0.593 | 0.567 | 0.543 | 0.519 | 0.497 | 0.476 | 0.456 | 0.437 | 0.419 | 0.402 | 5 |
| 6 | | 0.535 | 0.507 | 0.480 | 0.456 | 0.432 | 0.410 | 0.390 | 0.370 | 0.352 | 0.335 | 6 |
| 7 | | 0.482 | 0.452 | 0.425 | 0.400 | 0.376 | 0.354 | 0.333 | 0.314 | 0.296 | 0.279 | 7 |
| 8 | | 0.434 | 0.404 | 0.376 | 0.351 | 0.327 | 0.305 | 0.285 | 0.266 | 0.249 | 0.233 | 8 |
| 9 | | 0.391 | 0.361 | 0.333 | 0.308 | 0.284 | 0.263 | 0.243 | 0.225 | 0.209 | 0.194 | 9 |
| 10 | | 0.352 | 0.322 | 0.295 | 0.270 | 0.247 | 0.227 | 0.208 | 0.191 | 0.176 | 0.162 | 10 |
| 11 | | 0.317 | 0.287 | 0.261 | 0.237 | 0.215 | 0.195 | 0.178 | 0.162 | 0.148 | 0.135 | 11 |
| 12 | | 0.286 | 0.257 | 0.231 | 0.208 | 0.187 | 0.168 | 0.152 | 0.137 | 0.124 | 0.112 | 12 |
| 13 | | 0.258 | 0.229 | 0.204 | 0.182 | 0.163 | 0.145 | 0.130 | 0.116 | 0.104 | 0.093 | 13 |
| 14 | | 0.232 | 0.205 | 0.181 | 0.160 | 0.141 | 0.125 | 0.111 | 0.099 | 0.088 | 0.078 | 14 |
| 15 | | 0.209 | 0.183 | 0.160 | 0.140 | 0.123 | 0.108 | 0.095 | 0.084 | 0.074 | 0.065 | 15 |

ANNUITY TABLE

$$\frac{1 - (1 + r)^{-n}}{r}$$

Present value of an annuity of 1, i.e.

Where r = discount rate

n = number of periods

| | | <i>Discount rate (r)</i> | | | | | | | | | | |
|----------------|--|--------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|----|
| <i>Periods</i> | | | | | | | | | | | | |
| <i>(n)</i> | | 1% | 2% | 3% | 4% | 5% | 6% | 7% | 8% | 9% | 10% | |
| 1 | | 0.990 | 0.980 | 0.971 | 0.962 | 0.952 | 0.943 | 0.935 | 0.926 | 0.917 | 0.909 | 1 |
| 2 | | 1.970 | 1.942 | 1.913 | 1.886 | 1.859 | 1.833 | 1.808 | 1.783 | 1.759 | 1.736 | 2 |
| 3 | | 2.941 | 2.884 | 2.829 | 2.775 | 2.723 | 2.673 | 2.624 | 2.577 | 2.531 | 2.487 | 3 |
| 4 | | 3.902 | 3.808 | 3.717 | 3.630 | 3.546 | 3.465 | 3.387 | 3.312 | 3.240 | 3.170 | 4 |
| 5 | | 4.853 | 4.713 | 4.580 | 4.452 | 4.329 | 4.212 | 4.100 | 3.993 | 3.890 | 3.791 | 5 |
| 6 | | 5.795 | 5.601 | 5.417 | 5.242 | 5.076 | 4.917 | 4.767 | 4.623 | 4.486 | 4.355 | 6 |
| 7 | | 6.728 | 6.472 | 6.230 | 6.002 | 5.786 | 5.582 | 5.389 | 5.206 | 5.033 | 4.868 | 7 |
| 8 | | 7.652 | 7.325 | 7.020 | 6.733 | 6.463 | 6.210 | 5.971 | 5.747 | 5.535 | 5.335 | 8 |
| 9 | | 8.566 | 8.162 | 7.786 | 7.435 | 7.108 | 6.802 | 6.515 | 6.247 | 5.995 | 5.759 | 9 |
| 10 | | 9.471 | 8.983 | 8.530 | 8.111 | 7.722 | 7.360 | 7.024 | 6.710 | 6.418 | 6.145 | 10 |
| 11 | | 10.37 | 9.787 | 9.253 | 8.760 | 8.306 | 7.887 | 7.499 | 7.139 | 6.805 | 6.495 | 11 |
| 12 | | 11.26 | 10.58 | 9.954 | 9.385 | 8.863 | 8.384 | 7.943 | 7.536 | 7.161 | 6.814 | 12 |
| 13 | | 12.13 | 11.35 | 10.63 | 9.986 | 9.394 | 8.853 | 8.358 | 7.904 | 7.487 | 7.103 | 13 |
| 14 | | 13.00 | 12.11 | 11.30 | 10.56 | 9.899 | 9.295 | 8.745 | 8.244 | 7.786 | 7.367 | 14 |
| 15 | | 13.87 | 12.85 | 11.94 | 11.12 | 10.38 | 9.712 | 9.108 | 8.559 | 8.061 | 7.606 | 15 |
| 11 | | 10.37 | 9.787 | 9.253 | 8.760 | 8.306 | 7.887 | 7.499 | 7.139 | 6.805 | 6.495 | 11 |
| 12 | | 11.26 | 10.58 | 9.954 | 9.385 | 8.863 | 8.384 | 7.943 | 7.536 | 7.161 | 6.814 | 12 |
| 13 | | 12.13 | 11.35 | 10.63 | 9.986 | 9.394 | 8.853 | 8.358 | 7.904 | 7.487 | 7.103 | 13 |
| 14 | | 13.00 | 12.11 | 11.30 | 10.56 | 9.899 | 9.295 | 8.745 | 8.244 | 7.786 | 7.367 | 14 |
| 15 | | 13.87 | 12.85 | 11.94 | 11.12 | 10.38 | 9.712 | 9.108 | 8.559 | 8.061 | 7.606 | 15 |
| <i>(n)</i> | | 11% | 12% | 13% | 14% | 15% | 16% | 17% | 18% | 19% | 20% | |
| 1 | | 0.901 | 0.893 | 0.885 | 0.877 | 0.870 | 0.862 | 0.855 | 0.847 | 0.840 | 0.833 | 1 |
| 2 | | 1.713 | 1.690 | 1.668 | 1.647 | 1.626 | 1.605 | 1.585 | 1.566 | 1.547 | 1.528 | 2 |
| 3 | | 2.444 | 2.402 | 2.361 | 2.322 | 2.283 | 2.246 | 2.210 | 2.174 | 2.140 | 2.106 | 3 |
| 4 | | 3.102 | 3.037 | 2.974 | 2.914 | 2.855 | 2.798 | 2.743 | 2.690 | 2.639 | 2.589 | 4 |
| 5 | | 3.696 | 3.605 | 3.517 | 3.433 | 3.352 | 3.274 | 3.199 | 3.127 | 3.058 | 2.991 | 5 |
| 6 | | 4.231 | 4.111 | 3.998 | 3.889 | 3.784 | 3.685 | 3.589 | 3.498 | 3.410 | 3.326 | 6 |
| 7 | | 4.712 | 4.564 | 4.423 | 4.288 | 4.160 | 4.039 | 3.922 | 3.812 | 3.706 | 3.605 | 7 |
| 8 | | 5.146 | 4.968 | 4.799 | 4.639 | 4.487 | 4.344 | 4.207 | 4.078 | 3.954 | 3.837 | 8 |
| 9 | | 5.537 | 5.328 | 5.132 | 4.946 | 4.772 | 4.607 | 4.451 | 4.303 | 4.163 | 4.031 | 9 |
| 10 | | 5.889 | 5.650 | 5.426 | 5.216 | 5.019 | 4.833 | 4.659 | 4.494 | 4.339 | 4.192 | 10 |
| 11 | | 6.207 | 5.938 | 5.687 | 5.453 | 5.234 | 5.029 | 4.836 | 4.656 | 4.486 | 4.327 | 11 |
| 12 | | 6.492 | 6.194 | 5.918 | 5.660 | 5.421 | 5.197 | 4.988 | 4.793 | 4.611 | 4.439 | 12 |
| 13 | | 6.750 | 6.424 | 6.122 | 5.842 | 5.583 | 5.342 | 5.118 | 4.910 | 4.715 | 4.533 | 13 |
| 14 | | 6.982 | 6.628 | 6.302 | 6.002 | 5.724 | 5.468 | 5.229 | 5.008 | 4.802 | 4.611 | 14 |
| 15 | | 7.191 | 6.811 | 6.462 | 6.142 | 5.847 | 5.575 | 5.324 | 5.092 | 4.876 | 4.675 | 15 |

**SUGGESTED SOLUTIONS
FOR P1
JUNE 2013 EXAMINATIONS**

Important note:

The model answers may be considerably longer and more detailed than would be expected from any candidate in the examination. They should therefore be used as a guide to the form, style and technical standard (but not in length) of answers that candidates should aim to achieve.

However, these answers, particularly the discursive answers, may not include all valid points mentioned by a candidate. Credit should be given to candidates mentioning other relevant points.

SOLUTION ONE**Mfungwe Group: Consolidated statement of cash flows for the financial year ended 30 April 2012.**

| Cash flows from operating activities | K'm | K'm |
|---|----------------|------------|
| Profit before taxation | 3,898 | |
| Adjustments for: | | - |
| Depreciation | 3,037 | |
| Impairment of goodwill (w1) | 304 | |
| Amortisation of intangibles (w3) | 140 | |
| Interest expense | 772 | |
| Profit on disposal of associate | (45) | |
| Share of profit of associate | (20) | |
| Retirement benefit expense (w4) | 60 | |
| Cash paid to defined benefit plan(w4) | <u>(100)</u> | |
| Operating profit before working capital changes | 8,046 | |
| Increase in inventories (7961-7322-135) | (504) | |
| Decrease in receivables (6950-7005) | 55 | |
| Increase in payables (8039-7704) | <u>335</u> | |
| Cash generated from operations | 7,932 | |
| Interest paid (w5) | (585) | |
| Income taxes (w6) | <u>(1,247)</u> | |

| | | |
|--|--------------|---------------------|
| Net cash from operating activities | | 6,100 |
| Cash flows from investing activities | | |
| Purchase of property, plant & equipment (w7) | (7,376) | |
| Purchase of intangibles (w3) | (41) | |
| Proceeds from sale of associate (w8) | 270 | |
| Cash paid to acquire subsidiary | (150) | |
| Dividend received from associate (w8) | <u>10</u> | |
| Net cash used in investing activities | | (7,287) |
| Cash flows from financing activities | | |
| Proceeds from issue of share capital (6450 - 5400) | 1,050 | |
| Dividends paid to non controlling interests(w9) | <u>(131)</u> | |
| Net cash from financing activities | | <u>919</u> |
| Net decrease in cash and cash equivalents | | (268) |
| Cash and cash equivalents at the beginning of the period (282-912) | | <u>(630)</u> |
| Cash and cash equivalents at the end of the period | | <u><u>(898)</u></u> |

WORKINGS

| | |
|--|---------------------|
| 1. Goodwill impairment | K'm |
| Balance b/fwd | 2,798 |
| On Acquisition (w2) | 20 |
| Impairment (balancing figure) | <u>(304)</u> |
| Balance c/fwd | <u><u>2,514</u></u> |
| 2. Goodwill on acquisition of Luchazi | |
| Consideration | K'm |
| Cash | 150 |
| Deferred cash | <u>38</u> |

| | |
|--|------------------|
| Total consideration | 188 |
| Share of fair value of net assets acquired (70% x 240) | <u>(168)</u> |
| Goodwill | <u><u>20</u></u> |

3. Intangibles

| | |
|---------------------------------------|-------------------|
| Balance b/fwd | K'm 559 |
| Amortisation (559 x 25%) | (140) |
| Purchase of patent (balancing figure) | <u>41</u> |
| Balance c/fwd | <u><u>460</u></u> |

4. Defined benefit liability

| | |
|---|-------------------|
| | K'm |
| Defined benefit liability b/fwd | 330 |
| Service costs (current and past service costs) (150+30) | 180 |
| Net interest on defined benefit asset | <u>(120)</u> |
| Defined benefit expense in profit or loss | 60 |
| Remeasurement (actuarial) loss in OCI | 90 |
| Contributions paid(balancing figure) | <u>(100)</u> |
| Defined benefit liability c/fwd | <u><u>380</u></u> |

5. Interest

| Date | Balance b/fwd K'm | Interest at 7% K'm | Interest paid at 5% K'm | Balance c/fwd K'm |
|------------|-------------------------|--------------------------|-------------------------------|-------------------------|
| 01/05/2010 | 8,850 | 620 | (450) | 9,020 |
| 01/05/2011 | 9,020 | * 631 | (450) | 9,201 |
| 01/05/2012 | 9,201 | 644 | (450) | 9,395 |

| | | | | |
|------------|-------|-----|-------|-------|
| 01/05/2013 | 9,395 | 658 | (450) | 9,603 |
| 01/05/2014 | 9,603 | 672 | (450) | 9,825 |

| | |
|--|-------------------|
| | K'm |
| Total finance cost in income statement | 772 |
| Less: Interest (unwinding of discount) on long-term borrowings | *(631) |
| Less: Interest on deferred consideration (44-38) | <u>(6)</u> |
| Balance = Interest on overdrafts | <u>135</u> |
| Total cash outflow in respect of interest: (135 + 450)= | <u><u>585</u></u> |

6. Income taxes

| | |
|-----------------------------|---------------------|
| | K'm |
| Balance b/fwd | 1,327 |
| Income statement: provision | 1,086 |
| Paid (balancing figure) | <u>(1,247)</u> |
| Balance c/fwd | <u><u>1,166</u></u> |

7. Property plant equipment and depreciation

| | |
|------------------------------|----------------------|
| | K'm |
| Net book value b/fwd | 28,810 |
| Depreciation | (3,037) |
| Acquisition of subsidiary | 105 |
| Additions (balancing figure) | <u>7,565</u> |
| Net book value c/fwd | <u><u>33,443</u></u> |

8. Investment in associate

| | |
|-----------------------------|-----|
| | K'm |
| Balance b/fwd | 210 |
| Share of profit to 31.12.11 | 20 |

| | |
|---|------------------|
| Disposal proceeds | (270) |
| Dividend received 1.6.11 (balancing figure) | <u>(10)</u> |
| Profit on disposal | <u><u>50</u></u> |

9. Non controlling interests (NCI)

| | |
|---|---------------------|
| | K'm |
| Balance b/fwd | 2,806 |
| TCI attributable to NCI | 341 |
| On acquisition of subsidiary (30% x 240m) | 72 |
| Dividend paid (balancing figure) | <u>(131)</u> |
| Balance c/fwd | <u><u>3,088</u></u> |

SOLUTION TWO

- a) At initial recognition, all financial assets are measured at fair value, which is normally equal to the cash paid to acquire the asset. Mutomolo will therefore recognise the bonds at K72 million (K360 x 200,000 bonds).

For subsequent measurement, financial assets that are debt instruments are classified at amortised cost or fair value on the basis of both

1. The entity's business model for managing the financial assets.
2. The contractual cash flow characteristics of the financial asset.

According to IFRS 9 a debt instrument (such as Mutomolo's bond) that is held within a business model whose objective is to collect the contractual cash flows and has contractual cash flows that are solely payments of principal and interest generally must be measured at amortised cost. All other debt instruments must be measured at fair value through profit or loss (FVTPL).

IAS 39 requires that entities should at the end of each reporting period assess whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity should carry out an impairment review.

Significant financial difficulty of the issuer is an example of objective evidence that a financial asset or group of assets is impaired .

The impairment loss on financial assets carried at amortised cost is measured as the difference between the asset's carrying amount and the present value of estimated future

cash flows discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition).

The amount of the impairment loss should be recognised in profit or loss.

The table below shows how the investment would be measured for the years ended 31 March 2008 and 2009 and before the issue of Kwenje Ltd's financial difficulty is taken into account:

| Year ended | Financial Asset b/fwd K'm | Interest income @ 8.5% K'm | Cash received @5% of K80m K'm | Financial Asset c/fwd K'm |
|------------|---------------------------------|-------------------------------------|-------------------------------------|------------------------------------|
| 31/03/2008 | 72.00 | 6.12 | (4.00) | 74.12 |
| 31/03/2009 | 74.12 | 6.30 | (4.00) | 76.42 |

Following evidence of the financial difficulty of Kwenje Ltd the financial asset would be reviewed for impairment. The recoverable amount of the asset at 31 March 2009 would be the present value of the (revised) estimated future cash flows, discounted at the original effective rate of interest. This would be K67.75m, as calculated below:

| Year ended | Expected cashflows | Discount factor | Present Value K'm |
|------------|--------------------|-----------------|----------------------|
| 31/03/2010 | *2 | 0.922 | 1.84 |
| 31/03/2011 | 2 | 0.849 | 1.70 |
| 31/03/2012 | 2 | 0.783 | 1.57 |
| 31/03/2012 | **80 | 0.783 | 62.64 |
| | | | <u>67.75</u> |

Notes:

*Interest: K10 x 200,000 bonds = K2m

** Redemption amount (Par value) = K80m

An impairment loss of K8.67m (K76.42m – K67.75m) would be recognised in profit or loss for the year ended 31 March 2009.

In the three years ended 31 March 2012 the financial asset would continue to be measured on an amortised cost basis using the original effective interest rate. Therefore the carrying values and the amount taken to the finance income for the remaining 3 years would be as follows:

| Year ended | Financial Asset b/fwd K'm | Interest income at 8.5% K'm | Cash received K'm | Financial Asset c/fwd K'm |
|------------|---------------------------------|--------------------------------------|----------------------|------------------------------------|
| 31/03/2010 | 67.75 | 5.76 | (2.00) | 71.51 |
| 31/03/2011 | 71.51 | 6.08 | (2.00) | 75.59 |
| 31/03/2012 | 75.59 | 6.42 | (82.00) | 0.0 |

b) Based on the above explanations and computations the financial statement extracts will be as follows:

Mutomolo: Statement Profit or loss (extracts) for the years ended:

| | 31/03/2008 | 31/03/2009 | 31/03/2010 | 31/03/2011 | 31/03/2012 |
|-----------------|------------|------------|------------|------------|------------|
| Interest | 6.12 | 6.30 | 5.76 | 6.08 | 6.42 |
| Impairment loss | | 8.67 | | | |

Mutomolo: Statement of financial position (extracts) as at:

| | 31/03/2008 | 31/03/2009 | 31/03/2010 | 31/03/2011 | 31/03/2012 |
|------------------------|------------|------------|------------|------------|------------|
| Financial Asset (bond) | 74.12 | 67.75 | 71.51 | 75.59 | 0 |

(b) Statement of profit or loss for the year ended 31 March 2012 (Extracts)

| | |
|--|------------|
| Cost of sales (K252m x 50%) | K'm 126 |
| Exchange loss on settlement of trade payable | 4 |

Statement of financial position as at 31 March 2012 (Extracts)

| | |
|-----------|------------|
| Inventory | K'm 126 |
|-----------|------------|

A liability to pay for the goods arises on 1 December 2011 when they are delivered. On this date K252m (40,000 x 6,300) is debited to inventory and credited to trade payables.

When the liability was settled 40,000 Euros cost K256m (40,000 x 6,400) so an exchange loss of K4m (K256m – K252m) is recognised in the statement of profit or loss.

The inventory is a non monetary asset and so is measured using the rate of exchange in force when purchased. No exchange difference arises. (1 mark)

SOLUTION THREE

a)

i) Basic EPS= $K330m/100$ million shares = K3.3 per share

ii) Diluted EPS = $K330m + 10\% \times K300million \times 75\%$ (interest saving net of tax) / $100m$ shares+80m shares on conversion

= $K352.50m/180m$ shares = K1.958 per share

Uses and limitations of the figure for earnings per share.

Shareholders use the reported EPS to estimate future growth which will, in turn, affect future share price. It is therefore a useful indicator of growth over time. It is also important as one element in the calculation of the price/earnings ratio (P/E ratio), which is the multiple of the last reported EPS. The higher the ratio, the higher the market rates of the company and the cheaper the cost of equity capital.

The following are limitations of the EPS calculation:

- The EPS is based on past earnings and must, by definition, be a weak indicator of future profitability.
- The EPS, as with earnings, is affected by the accounting policies used to measure profit, assets and liabilities. This undermines comparability with the figures for EPS reported by other companies.
- The EPS is affected by the capital structure, for example, the relationship between share capital and retained profits, and this also undermines its usefulness for inter-company comparisons.

b) An operating segment is a component of an entity:

(i) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),

(ii) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

(iii) for which discrete financial information is available.

IFRS 8 clearly specifies that although some operating segments may derive their revenue solely or primarily from other segments of the same entity, these segments cannot be precluded from qualifying as operating segments for the purposes of reporting under this standard on the grounds that they do not derive their revenues from external sources.

However, this is subject to the above segments meeting all the other qualifying requirements. In other words, for the purposes of IFRS 8, a segment is not required to have external customers or revenues in order to be classified as an operating segment for financial reporting purposes. Therefore, all three divisions of Tuwimba , i.e. the **spare parts division, the workshop division,** and the **sales division,** qualify as operating segments.

IFRS 8 states that not every part of an entity is necessarily an operating segment or part of an operating segment. The **corporate headquarters** (or some functional departments) may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments.

c) Post employment benefits are employee benefits (other than termination benefits) that are payable after completion of employment. Examples of such benefits include lump sum payments on completion of employment and ongoing cash sums payable on a monthly basis in the form of a pension. Such benefits are often payable via post employment benefit plans.

Post-employment benefit plans are classified as either **defined contribution** plans or **defined benefit plans,** depending on the economic substance of the plan as derived from its principal terms and conditions.

Under defined contribution plans, the entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions. In consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall, in substance, on the employee.

Under defined benefit plans:

(a) the entity's obligation is to provide the agreed benefits to current and former employees; and

(b) actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the entity. If actuarial or investment experience are worse than expected, the entity's obligation may be increased.

A guarantee, either indirectly through a plan or directly, of a specified return on contributions is an example of a case where an entity's obligation is not limited to the amount that it agrees to contribute implying that the entity has a legal or constructive obligation.

Tuwimba's pension scheme will therefore be a **defined benefit plan** since the employer has guaranteed a fixed rate of return and therefore assumes the risk.

SOLUTION FOUR

(a) Properties are treated as 'component assets' for depreciation purposes. The two components are a land component and a buildings component. The buildings component is depreciated and the land component is not. In this case the buildings component is K240m (K600m – K360m) on 1 October 2010 so the depreciation charge for the year ended 30 September 2011 is K6m (K240m x 1/40).

Since the property is carried under the revaluation model its carrying value at 30 September 2011 will be K660m. The difference between its market value of K660m and its carrying value immediately before the revaluation of K594m (K600m – K6m) will be reported in other comprehensive income (i.e. credited to a revaluation surplus and shown as a component of equity). The balance on this reserve at 30 September 2011 will be K66m (K660m – K594m).

Following revaluation the depreciable component of the asset is K255m (K660m – K405m). Since the remaining estimated useful life of the buildings at 1 October 2011 is 39 years the annual depreciation for the year ended 30 September 2012 will be K6,538,462m (K255m/39yrs).

The excess depreciation is K538,462, which is the difference between the depreciation actually charged on a revalued asset (K6,538,462) and the depreciation that would have been charged if the asset had never been revalued (K6m). IAS 16 Property, plant and equipment allows entities to transfer this amount from the revaluation surplus to retained earnings on an annual basis. This transfer does not affect profit or loss.

Following the revaluation at 30 September 2012 the property will have a carrying value of K720m. Its carrying value immediately prior to the revaluation will be K653,461,538 (K660m – K6,538,462). Therefore a further transfer to the revaluation reserve of K66,538,462 (K720m – K653,461,538) will be made. The closing balance on the revaluation surplus at 30 September 2012 will be K132,000,000 (K66m – K538,462 (the excess depreciation) + K66,538,462m).

(b) The calculation of depreciation of a non current asset involves the making of accounting estimates. In this case two of the estimates, the useful economic life of the asset and the expected residual value, have changed. IAS 8 – Accounting policies, changes in accounting estimates and errors states that when accounting estimates change, the change should be made prospectively. Brought forward values are not adjusted.

In this case the new depreciable amount from 1 October 2010 is K84m, i.e. carrying amount K90m (150 - 150/5 x 2yrs) less revised residual value of K6m. This should be charged to the income statement over the revised remaining expected useful life of the asset from 1 October 2010, i.e. 2 years. Therefore depreciation of K42m will be charged in 2011 and 2012, unless the accounting estimates change again next year.

(c) It is necessary to consider the two parts of this issue separately. The claim by our customer needs to be recognised as a liability (provision) in the financial statements for the year ended 30 September 2011. IAS 37 – provisions, contingent liabilities and contingent assets – states that a provision should be made when, at the reporting date:

- (i) An entity has a present obligation arising out of a past event
- (ii) There is a probable outflow of economic benefits

- (iii) A reliable estimate can be made of the outflow.

All three of those conditions are satisfied here and so a provision of K24m, with a corresponding charge to profit or loss (income statement) is appropriate.

The counter claim against our supplier is a contingent asset. IAS 37 states that contingent assets should not be recognised until their realisation is virtually certain, but should be disclosed where their realisation is probable. This appears to be the situation we are in here. Therefore the contingent asset would be disclosed by way of note in the 2011 financial statements and, assuming that realization occurs as expected, recognised as income in the 2012 financial statements.

SOLUTION FIVE

a) Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income. This involves the selection of the particular basis of measurement.

A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

(a) Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

(d) Present value. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value.

b)

Historical cost accounting (HCA) has been criticised on the following grounds.

(a) Reported results may be distorted as a result of the matching of current revenues with costs incurred at an earlier date. The full distribution of profits calculated on that basis may result in the distribution of sums needed to maintain capital. A distribution which appears well covered when measured against historical cost profit may appear much less well covered when compared with a measurement of profit that takes account of changing prices.

(b) The amounts reported in a statement of financial position in respect of assets may not be realistic, up-to-date measures of the resources employed in the business.

(c) As a result of (a) and (b), calculations to measure return on capital employed may be misleading.

(d) Because holding gains or losses attributable to price level changes are not identified, management's effectiveness in achieving operating results may be concealed.

(e) There is no recognition of the loss that arises through holding assets of fixed monetary value and the gain that arises through holding liabilities of fixed monetary value.

(f) A misleading impression of the trend of performance over time may be given because no account is taken of changes in the real value of money.

Criticism of HCA becomes most vocal in periods of high inflation, such as the late 1970s, since so many of the profits then reported are due to realised holding gains rather than true operating gains.

When inflation levels are low, such as in most of the world today, there is less pressure on standard setters to recommend new accounting methods that do not suffer from the limitations of HCA noted above.

HCA has remained the principal basis for preparing accounts in most countries for many years, so it must have some advantages. Among these strengths are the following:

(a) It is more objective than adjusted-price methods. The cost of a non-monetary asset is a fact established in the past, whereas the current value of such an asset is a subjective opinion, whether the basis for the value is replacement cost, net realisable value or economic value.

(b) HCA is well established with users aware of its limitations when they make decisions from accounts drawn up under this basis. For example, quoted companies are expected to maintain a dividend cover of 2 or more; they would be criticised for over distribution were they to pay out all the historical profits that the income statement indicated they could.

(c) In times of low inflation, such as the present, HCA's problems are less serious. If one believes that inflation has been permanently squeezed out of the world economy, then there is little advantage in shifting to methods of current value accounting.

(d) It is relatively inexpensive to operate. The historical cost convention has the advantage of familiarity. This probably makes it cheaper to apply, because procedures for its implementation are well established, and easier to use, because users too have established routines for interpreting it. This advantage may extend to any existing departures from historical cost: familiarity on the part of both preparers and users may be reduced costs and increased acceptability.

c)

Fair value

The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, other than in a liquidation. The fair value of a liability is the amount at which that liability could be incurred or settled in a current transaction between willing parties, other than in a liquidation.

With the issuance of IFRS 13 *Fair Value Measurement*, the definition of fair value has been revised as follows: *the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*

Fair value accounting

Fair value accounting is becoming increasingly common under generally accepted accounting principles (GAAP). Using fair value accounting, companies measure and report the value of certain assets and liabilities on the basis of their actual or estimated fair market prices. Changes in asset or liability values over time generate gains or losses for the assets held and liabilities outstanding, increasing or reducing profit or loss, as well as other comprehensive income.

Advantages of fair value accounting

1) Accurate asset and liability Valuation

A primary advantage of fair value accounting is that it provides ***accurate asset and liability valuation*** on an ongoing basis to users of a company's reported financial information. When the price of an asset or liability has increased or is expected to increase, the company marks up the value of the asset or liability to its current market price to reflect what it would receive if it sold the asset or would have to pay to relieve itself from the liability. Conversely, the company marks down the value of an asset or liability to reflect any decrease in the market price. Fair value measurements therefore provide more transparency than historical cost based measurements.

2) True Income

Fair value accounting limits a company's ability to potentially manipulate its reported net income (profit or loss and other comprehensive income). Sometimes management may purposely arrange certain asset sales, for example, to use gains or losses from the sales to increase or decrease net income as reported at its desired time. Using fair value accounting, gains or losses from any price change for an asset or liability are reported in the period in which they occur. While an increase in asset value or a decrease in liability value adds to net income, a decrease in asset value or an increase in liability value reduces net income.

Disadvantages of fair value accounting

Subjectivity

Determination of fair values depends on market conditions . If available, a quoted market price in an active market is the best evidence of fair value and should be used as the basis for the measurement. If a quoted market price is not available, preparers should make an estimate of fair value using the best information available in the circumstances. This may include discounting future cash flows or using pricing models such as Black-Scholes. However these methods all use an *element of estimation which in itself can create discrepancies in the values that result*. In many circumstances, quoted market prices are not available. As a result, difficulties occur when making estimates of fair value.

Reliability in volatile markets

Fair value information can provide value at the point in time that it is measured but its relevance will depend on the volatility of the market inputs. Conditions of the markets in which certain assets and liabilities are traded may fluctuate often and even become volatile at times. Applying fair value accounting, companies reevaluate the current value of certain assets and liabilities even in volatile market conditions, potentially creating large swings in the value of those assets and liabilities. However, as markets stabilise, such value changes likely reverse back to their previous normal levels, making any reported losses or gains temporary, which means fair value accounting may have provided misleading information at the time.