

**CMA DECEMBER-2020 EXAMINATION
PROFESSIONAL LEVEL-III
SUBJECT: 301: ADVANCED FINANCIAL ACCOUNTING-II**

MODEL SOLUTION

Solution of the Q. No. 1

a)

Yes, if warrants or options are present, an increase in the market price of the ordinary shares can increase the number of potentially dilutive ordinary shares by decreasing the number of shares repurchasable.

In addition, an increase in the market price of ordinary shares can increase the compensation expense reported in a share appreciation rights plan. This would decrease net income and, consequently, earnings per share.

b)

Methods of Valuation of Human Assets:

There are a number of methods suggested for the valuation of human assets. Many of these methods are based on the valuation of physical and financial assets while others take into account human consideration. Major methods of valuation of human assets are historical cost, replacement cost, standard cost, present value of future earnings, and expected realizable value.

1. Historical Cost:
2. Replacement Cost:
3. Standard Cost:
4. Present value of future earnings:
5. *Expected realizable value:*

(c)

Share of net assets acquired ($60\% * (400 + 120 + (3/12 * 60))$)	321
Less: Discount arising on acquisition	<u>(3)</u>
Cost of investment	318

(d)

i. Consolidated balance sheet journal

DR P's share of A's post acquisition retained earnings ($35\% * (50,000 * 40\%)$) 7,000

CR P's inventories 7,000

The effect on retained earnings can best be dealt with by adjusting A's net assets in the net assets working by 100% of the PURP (so CU20,000 ($50,000 * 40\%$)) before calculating P's 35% share of A's post acquisition retained earnings.

ii. Share of profit of associates for consolidated income statement

Associate's PAT 75,000
Less: Unrealised profit (20,000)
<u>55,000</u>
Group share *35% 19,250

Solution of the Q. No. 2

a)

89.1 pence

Weighted average number of shares:

TERP: 2 shares @ £2.00 = £4.00

1 share @ £1.40 = £1.40

3 £5.40 therefore £5.40/3 = £1.80

Adjustment factor: Market value of share=£2.00

TERP £1.80

1 Jan X7 – 31 March X7 2,400,000 x 2.00 x 3/12 666,667
1.80

Rights issue 1,200,000

1 April X7 – 31 Dec X7 3,600,000 x 9/12 2,700,000
3,366,667

Basic EPS

= £3,000,000

3,366,667 shares

= 89.1p

b)

Basic EPS

2016

Trading results £

Profit before interest and tax 1,050,000

Interest on 7% convertible loan stock (105,000)

Profit before tax 945,000

Taxation(283,500)

Profit after tax 661,500

Number of shares outstanding 2,000,000

Basic EPS (£661,500 / 2,000,000 shares) **£0.33**

Testing for dilutive impact

Increase in earnings = interest saved (£1,500,000 x 7% x (1-30%)) £73,500

Increase in number of shares (£1,500,000/£100 x 140) 2,100,000

EPS (£73,500 / 2,100,000) **3.5p**

This is less than basic EPS and therefore the convertible loan stock is dilutive.

(c)

The computation of Fitzgerald Pharmaceutical Industries' basic earnings per share and the diluted earnings per share for the fiscal year ended June 30, 2015, are shown below.

$$\begin{aligned} \text{Diluted earnings per share} &= \frac{\text{Net income} - \text{Preference dividends} + \text{Interest (net of tax)}}{\text{Average ordinary shares} + \text{Potentially dilutive ordinary shares}} \\ &= \frac{1,500,000 - 75,000 + 270,000^2}{1,000,000 + 250,000^3 + 50,000^4} \\ &= \frac{1,695,000}{1,300,000} \\ &= \underline{1.3038} \text{ or } \underline{1.30} \text{ per share} \end{aligned}$$

$$^1 \text{Preference dividend} = .06 \times 1,250,000 \\ = 75,000$$

²Use "if converted" method for the convertible bonds

Adjustment for interest expense (net of tax)	
(450,000 X .6)	270,000
³ Shares assumed to be issued if converted	
5,000,000 ÷ 1,000/bond X 50 shares	250,000

⁴Use treasury-share method to determine incremental shares outstanding

Proceeds from exercise of options	
(200,000 X R\$15)	<u>3,000,000</u>
Shares issued upon exercise of options	200,000
Shares purchasable with proceeds (Proceeds ÷ Average market price)	
(3,000,000 ÷ 20).....	<u>(150,000)</u>
Incremental shares outstanding	<u>50,000</u>

Solution of the Q. No. 3

(a)

The £ value of the loan is recorded as £4m (€10/2.5). The UK Company suffered an exchange loss of £1m.

(b)

The purchase will initially be recorded at the rate ruling at the transaction date:

$$\$400,000 / 2.0 = £200,000, \text{ with a trade payable of the same amount also being recognised.}$$

At 31 December 20X5, the cash outflow will be recorded at the rate ruling at the transaction date:

$$\$250,000 / 1.9 = £131,579$$

and the remaining trade payable, being a monetary liability, is translated at the same rate:

$$\$150,000 / 1.9 = £78,947$$

The plant and equipment, a non-monetary asset, is carried at the historic rate of £200,000.

Only cash flows appear in the statement of cash flows, so £131,579 will be shown within investing activities.

(c)

Management should recognise the investment property at £6,060,606 and £7,361,963 at 31 December 2012 and 31 December 2013 respectively.

The change in value is calculated as:

$$31 \text{ December } 20X2 \text{ (}\$10,000,000 / 1.65\text{)} \text{ } £6,060,606$$

$$31 \text{ December } 20X3 \text{ (}\$12,000,000 / 1.63\text{)} \text{ } £7,361,963$$

$$\text{Increase in fair value } £1,301,357$$

The increase in fair value of £1,301,357 should be recognised in the income statement as a gain on investment property. The investment property is a non-monetary asset. The movement in value attributable to movement in exchange rates £74,363 ($\$10,000,000/1.65$) – ($\$10,000,000/1.63$) should not be recognised separately because the asset is non-monetary.

(d)

Translating the shareholders' funds using the closing rate as at 31 December 20X3 gives €15,000 / 8 = £1,875. The non-controlling interest in the statement of financial position will be 40% * £1,875 = £750.

The dividend payable translated at the closing rate is €1,680 / 8 = £210. The amount payable to the non-controlling shareholders is 40% * £210 = £84.

The profit after tax translated at the average rate is €3,080 / 7 = £440. The non-controlling interest in profit is therefore 40% * £440 = £176.

The non-controlling share of the exchange difference is calculated as:

Opening net assets £ £
€15,000 – €1,400 = €13,600 At opening rate of €5:£1 2,720
At closing rate of €8:£1 1,700 1,020

Profits of €3,080 At average rate of €7:£1 440
At closing rate of €8:£1 385 55

Loss on retranslation of Camrumite's accounts 1,075
NCI share of loss £1,075 x 40% 430

Therefore the non-controlling interest in total comprehensive income is profit of £84 less exchange losses of £430 = £346 loss

The non-controlling interest can be summarised as follows.

£
Balance at 1 January 20X3 (£2,720 x 40%) 1,088
Non-controlling interest in profit for the year 176
Non-controlling interest in exchange losses (430)
834
Balance at 31 December 20X3 750
Dividend payable to non-controlling interest 84
834

Solution of the Q. No. 4

(a) The treatments will be as follows:

1. The earnings are treated as an inflow of cash and should be reported as part of the net cash provided by operating activities in the statement of cash flows. There should be Tk.810,000 of income before extraordinary items because extraordinary items should be separated from operating activities.
2. The Tk.315,000 depreciation expense is neither an inflow nor an outflow of cash. Because depreciation is an expense, it was deducted in the computation of net income. Accordingly, the Tk.315,000 must be added back to income before extraordinary items in the operating activities section because it was deducted in determining earnings, but it was not a use of cash.
3. The write-off of uncollectible accounts receivable against the allowance account has no effect on cash because the net accounts receivable remain unchanged. An adjustment to income is only necessary if the net receivable amount increases or decreases. Because the net receivable amount is the same before and after the write-off, an adjustment to income would not be made. The Tk.51,000 of bad debt expense does not affect cash but would be added back to income because it affects the amount of net accounts receivable. The recording of bad debt expense reduces the net receivable because the allowance account increases. Although bad debt expense is not usually treated as a separate item to be added back to income from operations, it is accounted for by analyzing the accounts receivable at the net amount and then making the necessary adjustment to income based on the change in the net amount of receivables.
4. The Tk.6,000 gain realized on the sale of the machine is an ordinary gain, not an extraordinary gain, for accounting purposes. This Tk.6,000 gain must be deducted from

net income to arrive at net cash provided by operating activities. The proceeds of Tk.36,000 (Tk.30,000 + Tk.6,000) are shown as a cash inflow from investing activities.

5. Generally, extraordinary items are investing or financing activities and the cash inflow or outflow resulting from such events should be reported in the investing or financing activities section of the statement of cash flows. In this case, no cash flow resulted from the lightning damage. The net loss (a noncash event) must be added back to net income (under the indirect method) as one of the adjustments to reconcile net income to net cash provided by operating activities.
 6. The Tk.75,000 use of cash should be reported as a cash outflow from investing activities. The Tk.200,000 issuance of common stock and the Tk.425,000 issuance of the mortgage note, neither of which affects cash, should be reported as noncash financing and investing activities.
 7. This conversion is not an inflow or an outflow of cash, but it is a significant noncash financing activity and should be reported in a separate schedule or note.
- (b) The consideration will be as follows:
1. This situation can exist because companies vary as to whether they are using an implicit or explicit set of assumptions when interest rates are disclosed. In the implicit approach, two or more assumptions do not individually represent the best estimate of the plan's future experience with respect to these assumptions, but the aggregate effect of their combined use is presumed to be approximately the same as that of an explicit approach. In the explicit approach, each significant assumption reflecting the best estimate of the plan's future experience solely with respect to that assumption must be stated. As a result, some companies are presently using an implicit approach, others an explicit approach. GAAP requires yet more consistency in discount rates. It requires companies to use rates on high quality fixed income investments currently available whose cash flows match the timing and amount of the expected benefit payments. As a result, this large variance in interest rates will probably disappear to some extent. However, it should be noted that companies will have some leeway in establishing settlement rates. In addition, the expected return on assets will also be different among companies.
 2. This situation will occur because the net funded position of the plan is required to be reported. That is, companies are required to report as a liability the excess of their projected benefit obligation over the fair value of plan assets. In the past, the basic liability companies reported was the excess of the amount expensed over the amount funded.
 3. This statement is questionable. If a financial measure purports to represent a phenomenon that is volatile, the measure must show that volatility or it will not be representationally faithful. Nevertheless, many argue that volatility is inappropriate when dealing with such long-term measures as pensions. A good example of where dampening might be useful is the recognition of gains and losses. If assumptions prove to be accurate estimates of experience over a number of years, gains or losses in one year will be offset by losses or gains in subsequent periods, and amortization of gains and losses would be unnecessary. The main point is that volatility per se should not be considered undesirable when establishing accounting principles. Although some managements may consider volatility bad, this belief should not influence standard-setting. However, it is clear from some of the compromises made in GAAP that certain procedures were provided to dampen the volatility effect.

Solution of the Q. No. 5

Q. No. 5

Consolidated Balance Sheet		
	£	£
Fixed assets		
Intangible assets (101,300+110,580(W2))		211,880
Tangible assets (660,700+635,300+24,000-1000(W1)-3,000(W7))		1,316,000
Investment in joint venture (W6)	-	90,100
		1,617,980
Current assets		
Stock (235,400+195,900-2400)(W5)	428,900	
Trade and other debtors (174,900+78,800-50,000)	203,700	
Cash at bank and in hand (23,700+11,900+10,000)	45,600	
	678,200	
Creditors: amounts falling due within one year		
Trade and other creditors (151,200+101,800-40,000)	(213,000)	
Taxation (85,000+80,000)	(165,000)	
Deferred consideration	(441,000)	
	(819,000)	
Net current liabilities		(140800)
Net Asset		<u>14,77,180</u>
Capital and reserves		
Equity attributable to owners of Tong well Ltd		
Called up share capital (£1 shares)		100,000
Revaluation reserve		125,000
Profit and loss account (W4)		10,62,155
		12,87,155
Non-controlling interest (W3)		1,90,025
		<u>14,77,180</u>

Workings

W- 1 Net assets – Watling Ltd

	Year end £	Acquisition £	Post acq £
Called up share capital	500,000	500,000	-
Profit and loss account reserve			
Per Q	312,100	206,700	
Less intangible ((72,000 + 18,000)	(72,000)	(90,000)	
Fair value adj re tangible fixed asset (120,000 – (92,000 × 48/46))	24,000	24,000	
Dep thereon (24,000 × 2/48)	1,000	-	
Tangible fixed asset PURP (W7)	(3,000)		
	<u>760,100</u>	<u>640,700</u>	<u>119400</u>

W- 2: Goodwill – Watling Ltd

Cost of investment (250,000 + (441,000 – 41,000 (W4)))	650,000
Less share of net assets at acquisition (640,700 (W1) ×75%)	(480,525)

Impairment to date	169,475
Amortisation to date (169,475 * 2/10years)	(25,000)
	(33,895)
	<u>110,580</u>

W- 3: Non-controlling interest – Watling Ltd

Non-controlling interest at acquisition (640,700 × 25%)	160,175
Share of post-acquisition reserves (119,400 (W1) × 25%)	29,850
	<u>190,025</u>

W-4: Profit and loss account reserve

Tong well Ltd	1,084,800
Unwinding of discount on deferred consideration: Two years (441,000 – (441,000/1.05 ²))	(41,000)
Less PURP (Watling Ltd) (W5)	(2,400)
Watling Ltd (119,400 (W1) × 75%)	89,550
Groveyay Ltd (W6)	3,600
Less impairments to date (25,000 + 10,000)	(35,000)
Less goodwill amortisation to date (33,895 (W2) + 3,500 (W6))	(37,395)
	<u>1,062,155</u>

W- 5: Stock PURPs

	%	Grove way Ltd	Watling Ltd
SP	100	15,000	12,000
Cost	(80)	(12,000)	(9,600)
GP	20	3,000	2400

W- 6: Investment in joint venture – Grove way Ltd

Cost		100,000
Add post acquisition profits		12,000
Less PURP (W5)		(3,000)
		9,000
*40%		3,600
		103,600
Less impairment to date		(10,000)
Less amortisation to date ((100,000 – (40% * 200,000)) * 21/120months)		(3,500)
		<u>90,100</u>

W- 7: Tangible fixed asset PURP – Watling Ltd

Asset now in Tong well Ltd's books at 15,000 × 1/3	5,000
Asset would have been in Watling Ltd's books at 10,000 × 1/5	(2000)
	3,000

ii

Goodwill journal entries

Dr: Intangible assets – goodwill 39,160
 Dr: Called up share capital 320,000
 Dr: Profit and loss account reserve 112,300
 Cr: Investments 385,000
 Cr: Non-controlling interest (320,000 + 112,300) × 20% 86,460

= THE END =