



**UNIVERSITY EXAMINATIONS: 2013/2014**

**EXAMINATION FOR THE MASTERS OF SCIENCE (MSC) IN COMMERCE  
(FINANCE AND ACCOUNTING)**

**MFA 605 ADVANCED ACCOUNTING THEORY (EVE)**

**DATE: APRIL, 2014**

**TIME: 3 HOURS**

---

**INSTRUCTIONS: Answer Question One and Any Other Three Questions**

---

**QUESTION ONE (31 MARKS)**

The International Accounting Standards Board (IASB) identified three situations in which the going concern assumption is relevant namely when measuring assets and liabilities, when identifying liabilities and when disclosing information about the entity. In a typical case involving a Motors company, the vehicle's ignition inadvertently switches off and disables the airbags. This has occasioned the recall of six vehicle models.

The ignition switch recall appears to be spiralling out of control with people killed after their vehicles' ignition inadvertently switched off, disabling the airbags exceeding 300 claims. Litigators are also looking to line up clients that have been affected by the recall. As a matter of fact if the Directors are aware of potential exposure to litigation and fail reveal it, that's fraud. The financial statements of the company have disclosures about the claim or any recall.

**Required**

- a) Explain the differences between accruals, provisions and contingent liability in the context of the above case (6 Marks)
- b) By discussion the liability recognition criteria, explain to the management why there is need to create provision in the above case (6 Marks)

- c) Outline and explain the various uncertainties that the management should consider when making estimate for possible accounting provisions in the above case (8 Marks)
- d) Explain why the management should consider the going concern in the above case and state other factors that must be considered in evaluation the ability of the company to continue as a going concern (7 Marks)
- e) Explain agency theory of accounting and ethical theory of accounting in the context of the above case (4 Marks)

### **QUESTION TWO (23 MARKS)**

The board of directors of Queer Ltd is concerned about the declining performance of the company. They have been informed of the need to issue loss warning as a listing requirement. The management is of the view that this is alarmist, and have approached you on how to manage the situation by manipulating revenue or “cooking” the books.

- a) Evaluate in detail the importance of revenue recognition criteria (8 Marks)
- b) State and explain the items that can be classified as Other Comprehensive Income (OCI) under the International Financial Reporting Standards framework (8 Marks)
- c) Discuss the kind of information that is considered to be useful by the capital providers. (7 Marks)

### **QUESTION THREE (23 MARKS)**

Positive accounting theory sets out to explain and predict how accounting procedures affect a company and provides an insight into the factors that influence a manager’s choice of accounting policies. Positive accounting theory is descriptive and looks to develop theories which are descriptions of what happens in the “real world”.

#### **Required**

- a) Clearly distinguish the normative theory of accounting from the positive accounting theory. (6 Marks)
- b) Discuss in details the process of development inductive accounting theories. (7 Marks)
- c) Discuss the rationale for social and environmental reporting in the company financial report. (6 Marks)
- d) Highlight the need for a converged conceptual framework for preparation and presentation of financial statements (4 Marks)

#### **QUESTION FOUR (23 MARKS)**

An impact assessments and benefit-cost analysis are tools, not rules applied by management in selection and application of accounting policies. They are mechanisms to inform decision making, not the decision itself. The decision itself is and must be an exercise of judgment by an accountant. Policy must be based on and express that judgment, rather than be dictated by a cold numerical calculus.

- a) Explain briefly what is meant by substance over form (4 Marks)
- b) Discuss procedure the management follows in choice of accounting policy and how it may influence the reliability and relevance of accounting information (7 Marks)
- c) Explain the effect of cash basis of accounting on volatility of profit (4 Marks)
- d) Discuss whether the absolute usefulness of the financial statements is achievable (8 Marks)

#### **QUESTION FIVE (23 MARKS)**

The objective of measurement is to contribute to the faithful representation of relevant information about the resources of the entity, claims against the entity and changes in resources and claims; and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. A single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements.

##### **Required**

- a) Briefly explain different basis of measurement and their application to the elements of financial statements (8 Marks)
- b) Briefly explain the relevance of fair value basis of measurement in reference to the hierarchy of fair value determination (8 Marks)
- c) Depreciation and amortization are estimated measurement for accounting purpose, explain why they are estimates and discuss using an example the accounting treatment of change in rate of depreciation or amortization. (7 Marks)

#### **QUESTION SIX (23 MARKS)**

Prime Ltd operates a staff gratuity for all contractual employees. The scheme pays, at the end of service contract, 15 days salary for every completed year of service (assume 360 days in a year). The management estimate the average service life of the employees to be 6 years. Purity joined the company on 1<sup>st</sup> July 2011 at the age of 30 years with a starting salary of Ksh 25,000. The company

offers its employee a standard annual salary increment of 8% every 30<sup>th</sup> June. All other benefits are commensurate to performance. The discount rate applicable is 12%. The management have only accounted for gratuities paid on cash basis in the past.

**Required**

- a) Explain why the management need to exercise judgment and make assumptions when accounting in a non-ideal environment (3 Marks)
- b) Explain the effect of accrual basis of accounting on volatility of profit and explain why it can result in profit smoothening (5 Marks)
- c) Estimate the present value of the staff gratuity that is required as at 30<sup>th</sup> June 2014 and state the assumption you made to facilitate estimation and discuss in details the relevance and reliability of your estimates (7 Marks)
- d) Discuss why it is necessary to trade-off reliability and relevance of the information contained in the financial statements in a non-ideal accounting environment (8 Marks)