The Institute of Chartered Accountants of Pakistan

Certificate in Accounting and Finance Stage Examination

26 September 2020
3 hours – 100 marks
Additional reading time – 15 minutes

Financial Accounting and Reporting-II

Instructions to examinees:
(i) Answer all **EIGHT** questions.
(ii) Answer in **black** pen only.
(iii) Multiple Choice Questions must be answered in answer script only.

Section A

Q.1 On 1 January 2019, Jannat Limited (JL) issued 1.6 million debentures of Rs. 100 each at a premium of Rs. 10 each. The transaction cost associated with the issuance of these debentures was Rs. 5.5 per debenture. The coupon interest rate is 16% per annum payable annually on 31 December. Khushi Limited (KL) purchased 0.32 million of these debentures on 1 January 2019.

On 1 January 2019, the approximate effective interest rates were 15% and 14% per annum for JL and KL respectively. As on 31 December 2019, the debentures were quoted on Pakistan Stock Exchange at Rs. 112 each.

Debentures are subsequently measured at amortized cost by JL and fair value through profit or loss by KL.

Required:
Prepare journal entries in the books of JL and KL for the year ended 31 December 2019. **(07)**

Q.2 On 16 June 2020, an aircraft of Sukoon Airlines Limited (SAL) made an emergency landing near a factory building. Though all persons on board were safe, the nearby factory was damaged. As a result, two factory workers lost their lives and five workers were injured.

After one week of this accident, SAL's CEO informed in a press conference that SAL will pay Rs. 1.5 million for each loss of life and Rs. 1 million for each injured worker.

On 8 July 2020, the factory owner filed a claim of Rs. 25 million for factory damages. The case is still pending; however, SAL's legal advisor is of the view that there is 70% probability that the amount of damages would be Rs. 20 million and 30% probability that the amount would be Rs. 15 million.

Due to this accident, the aircraft was damaged beyond repairs and consequently SAL cannot use this aircraft anymore. The aircraft was acquired on lease on monthly rental of USD 0.5 million for 10 months expiring on 31 October 2020. As per lease agreement, if aircraft faces any accident, SAL is required to pay monthly rentals to the lessor till settlement of insurance claim. The insurance claim was settled on 31 August 2020.

Required:
In the context of relevant IFRSs, discuss how the above issues should be dealt with in the financial statements of SAL for the year ended 30 June 2020. **(07)**

Q.3 Roshni Limited (RL) is a listed company and is engaged in manufacturing of textile products. RL generates 30% of its revenue from exports to Middle East, out of which 60% are made to only one customer i.e. Hakeem Limited. RL has various operating segments. Apart from external sales, some of these segments make internal sales as well.

Following amounts have been extracted from RL's draft financial statements for the year ended 30 June 2020:

	Rs. in million
Revenue	2,530
Operating expenses	(2,050)
Profit before tax	455
Total assets	1,600
Total liabilities	980

Detailed financial information is reported internally to the chief operating decision maker of each segment. However, following disclosure on operating segments is prepared for inclusion in notes to the financial statements for the year ended 30 June 2020:

	Spinning	**Weaving**	**Others**	**Total**
	-------------------- **Rs. in million**	--------------------		
External revenue	1,010	560	960	2,530
Operating expenses	(760)	(460)	(830)	(2,050)
Net interest	(43)	18	-	(25)
Profit before tax	207	118	130	455
Assets	700	350	490	1,540

Required:
Prepare list of errors and omissions in the above disclosure. ***(Redrafting of disclosure is not required)*** **(08)**

Q.4 Select the most appropriate answer from the options available for each of the following Multiple Choice Questions.

(i) In relation to IAS 21, which of the following statements is correct?

(a) Exchange gains and losses arising on the retranslation of monetary items are recognised in other comprehensive income for the period
(b) Non-monetary items carried at fair value in a foreign currency are retranslated at the date when the fair value was measured
(c) An intangible asset is a monetary item
(d) Non-monetary items carried at cost in a foreign currency are retranslated at the reporting date **(01)**

(ii) An entity acquires property on lease for a non-cancellable period of 3 years. The lease payments are payable semi-annually in arrears beginning from first year. What would be the impact of this transaction on lessee's current and gearing ratios upon commencement of lease?

(a) Decrease in current ratio as well as gearing ratio
(b) Decrease in current ratio and increase in gearing ratio
(c) Increase in current ratio and decrease in gearing ratio
(d) Increase in current ratio as well as gearing ratio **(02)**

(iii) Fazl Limited owns a herd of cows recorded at Rs. 36 million on 1 January 2019. At 31 December 2019, these cows have a fair value of Rs. 50 million. A commission of 4% would be payable upon sale.

What is the correct accounting treatment for the cows at 31 December 2019 according to IAS 41?

(a) Hold at Rs. 36 million
(b) Re-measure to Rs. 50 million, taking gain of Rs. 14 million to the profit or loss
(c) Re-measure to Rs. 48 million, taking gain of Rs. 12 million to other comprehensive income
(d) Re-measure to Rs. 48 million, taking gain of Rs. 12 million to the profit or loss **(01)**

(iv) Which of the following is one of the conditions set out in IFRS 16 for an arrangement to be classified as a lease?

(a) The lessee has the right to obtain substantially all of the economic benefits from use of the asset
(b) The lease term covers substantially all of the economic life of the asset
(c) The lessor has a substantive right of substitution
(d) The lessor has the right to direct the use of the asset **(01)**

(v) Which of the following is **NOT** a disclosure requirement under the Fifth Schedule of the Companies Act, 2017?

(a) Distinction between capital and revenue reserves
(b) General nature of any un-availed credit facilities
(c) Capacity of an industrial unit
(d) Remuneration of chief executive, directors and executives **(01)**

(vi) Which of the following is correct in accordance with IAS 21?

(a) Functional currency and presentation currency of an entity must be same
(b) Functional currency and presentation currency of an entity must be different
(c) Functional currency of an entity is identified by reference to environment of the business
(d) Functional currency of an entity is identified by reference to the functional currency of its parent entity **(01)**

(vii) IAS 41 applies to:

(a) change in fair value of a herd of livestock
(b) logs held for sale in a wood yard
(c) cost of developing a new type of crop seed
(d) cost of making irrigation system having life of more than 1 year **(01)**

(viii) You are working in finance department of Kamyaab Motors Limited (KML), a listed company. The draft results of KML for the year are encouraging and are likely to increase KML's share price upon public announcement. Your best friend is heavily in debt and has recently asked for your assistance. He has helped you on numerous occasions in the past. In the context of ICAP's Code of Ethics, you should:

(a) keep confidentiality about KML's results; however, you can buy KML's shares to use the gain upon disposal to help your friend
(b) tell your friend about KML's results and let him decide whether he should buy KML's shares or not
(c) keep confidentiality about KML's results by all means
(d) keep confidentiality about KML's results but just tell your friend to buy the KML's shares **(02)**

Section B

Q.5 The following amounts are extracted from the records of Manzil Limited (ML), Himmat Limited (HL) and Koshish Limited (KL) for the year ended 31 December 2019:

	ML	HL	KL
	---------- Rs. in million ----------		
Sales	800	315	132
Cost of sales	(540)	(180)	(97)
Operating expenses	(114)	(60)	(6)
Other income	41	-	8
Finance cost	(20)	(12)	(5)
Retained earnings as at 31 December 2019	3,600	322	200

Additional information:

(i) Details of ML's investments are as follows:

Date of investment	Holding %	Investee	Share capital (Rs. 10 each) of investee
1 Aug 2015	25%	KL	Rs. 400 million
1 May 2019	60%	HL	Rs. 600 million

(ii) Consideration for acquisition of HL's shares comprises of:

- transfer of ML's building having carrying value and fair value of Rs. 150 million and Rs. 226 million respectively at acquisition date. The disposal of building has been recorded at carrying value.
- issuance of 16 million ordinary shares of ML after one month of acquisition. The market price of ML's shares at the date of acquisition was Rs. 30 each. However, the market price increased to Rs. 32 when shares were issued.

(iii) At the date of acquisition of HL, carrying value of its net assets was equal to fair value except the following:

- A manufacturing plant whose fair value exceeded its carrying value by Rs. 60 million. The remaining useful life of the plant on the acquisition date was 8 years.
- A contingent asset of Rs. 50 million as disclosed in HL's financial statements which had an estimated fair value of Rs. 15 million. At year-end, this contingent asset is disclosed in HL's financial statements at Rs. 46 million.

(iv) Impairment test carried out at year-end has indicated that goodwill of HL has been impaired by 10%.

(v) On 15 August 2019, HL and KL paid 5% dividend for the half year ended 30 June 2019. ML recorded its share as other income.

(vi) On 30 June 2019, KL sold a machine having carrying value of Rs. 60 million to ML for Rs. 68 million. The remaining useful life of the machine at the time of disposal was 5 years.

(vii) On 15 November 2019, HL and KL purchased 600,000 and 400,000 ordinary shares of Jazba Limited (JL) respectively at price of Rs. 150 each plus 2% transaction cost. HL and KL classified the investment as financial asset at fair value through other comprehensive income. These investments have not been re-measured at year-end. Market price of JL's share was Rs. 138 at year-end. Total share capital of JL consists of 20 million shares.

(viii) ML measures non-controlling interest at the proportionate share of acquiree's identifiable net assets.

Required:
Prepare ML's consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 2019. **(19)**

Q.6 Qabil Limited (QL) is in process of finalizing its financial statements for the year ended 31 December 2019. Following information pertains to QL's intangible assets:

(i) Intangible assets as at 31 December 2018 were as follows:

	Product design	**ERP software**
	---- Rs. in million ----	
Cost	750	200
Accumulated amortization / impairment	75	80
	------- Years -------	
Useful life	10	8

(ii) Cost incurred on development of product design was capitalised in 2018. The competition for the product is increasing. QL has estimated the following net cash inflows from the product:

Year	2020	2021	2022	2023	2024	2025 & onwards
Net cash inflows (Rs. in million)	190	170	140	100	80	Nil

Pre-tax and post-tax discount rates are 12% and 10% respectively.

(iii) On 1 January 2019, QL entered into an agreement to replace existing ERP software with a new ERP software at a cost of Rs. 360 million. According to the agreement, 40% payment was made on signing of the contract while the remaining amount was paid evenly over customization and installation period which completed on 31 October 2019.

The entire cost of project was financed through a running finance from Honehaar Bank at mark- up of 15% per annum. The software became operational on 1 November 2019. QL expects to use it for a period of 9 years.

The existing ERP software will be continued till 31 December 2020.

(iv) On 1 January 2019, QL acquired a licence for Rs. 600 million for a period of 5 years. QL made an initial payment of Rs. 100 million and the remaining amount will be paid in two equal instalments on 1 January 2020 and 2021. Cash price equivalent of the license is Rs. 520 million.

On expiry of 5 years, the license is renewable for further five years at an insignificant cost of Rs. 15 million. QL intends to renew the license and sell it at the end of 8^{th} year.

In the absence of any active market, QL has estimated that residual value of the license would be Rs. 80 million and Rs. 60 million at the end of 8^{th} year and 10^{th} year respectively.

Required:
Prepare a note on 'Intangible assets' for inclusion in QL's financial statements for the year ended 31 December 2019 in accordance with the requirements of IFRSs. **(15)**

Q.7 Following information have been extracted from the financial statements of Fakhr Limited (FL) for the year ended 31 December 2019:

(i)

	2019 Draft	2018 Audited	2017 Audited
	--------- Rs. in million ---------		
Net profit	84	98	72
Revaluation surplus arising during the year*	25	(14)	-

****Transfer to retained earnings is made upon de-recognition of related asset.***

(ii) Share capital and reserves as at 1 January:

	2018	2017
	----- Rs. in million -----	
Share capital (Rs. 10 each)	300	300
Revaluation surplus	102	102
Retained earnings	348	276

(iii) On 1 March 2018, FL declared a final cash dividend of 10% for the year ended 31 December 2017. On 1 November 2018, FL issued 40% right shares to its ordinary shareholders at Rs. 24 per share. On 1 August 2019, an interim bonus of 15% was declared.

Following matters need to be incorporated in the draft financial statements of FL:

(i) To provide more relevant and reliable information about investment property, it has been decided to change the measurement basis for investment property from cost model to fair value model.

The only investment property of FL is a building purchased on 1 January 2016 at a cost of Rs. 150 million. 60% of the cost represents building component having estimated useful life of 20 years and residual value of Rs. 10 million. The depreciation is included in the above draft financial statements. The fair value of the investment property has increased by 6% in each year since acquisition.

(ii) It was identified that annual payments in respect of machine acquired on lease have been recorded as rent expense.

FL entered into a lease agreement for a machine with Aaqil Limited (AL) for a non-cancellable period of 7 years on 1 January 2018. Instalment of Rs. 25 million is to be paid annually on 31 December each year. Implicit rate is 12% per annum.

Required:
Prepare FL's statement of changes in equity (including comparative figures) for the year ended 31 December 2019. ***('Total' column is not required)*** **(18)**

Q.8 Dua Limited (DL) is in the process of finalizing its financial statements for the year ended 31 December 2019. The following information have been gathered for preparing the disclosures relating to taxation:

(i) Accounting loss before tax for the year amounted to Rs. 140 million. It includes:

- an amount of Rs. 2 million recovered from a customer whose debt had been written off in 2018. As per tax laws, receivable written offs are allowed as deduction.
- dividend of Rs. 16 million earned against equity investment in a UK based company. As per tax laws, this dividend income is exempt from tax in Pakistan as 20% tax was paid in UK.

(ii) The movement of owned property, plant and equipment for 2019 is as follows:

	Accounting WDV	**Tax base**
	------ Rs. in million -------	
Opening balance	1,700	1,116
Additions	460	480
Impairment	(72)	-*
Depreciation	(470)	(284)
Disposals	(144)	(92)
Closing balance	1,474	1,220

**** impairment is not allowed for tax purposes.***

Difference of Rs. 20 million in 'Additions' represents foreign exchange loss on acquisition which was considered as part of the cost of the asset as per tax laws.

(iii) As per tax laws, research expense for the year is allowable in the next year. Research expense for the year amounted to Rs. 25 million (2018: Rs. 64 million).

(iv) Rent expense is allowed for tax purposes on payment basis. Rent prepaid as at 31 December 2019 amounted to Rs. 6 million (2018: Rs. 1 million).

(v) As on 31 December 2018, DL had carried forward tax losses of Rs. 90 million against which DL had always expected that it is probable that future taxable profit will be available.

(vi) Tax rate is 35%.

Required:

(a) Prepare a note on taxation for inclusion in DL's financial statements for the year ended 31 December 2019 and a reconciliation to explain the relationship between tax expense and accounting profit. **(11)**

(b) Compute deferred tax liability/asset in respect of each temporary difference as at 31 December 2019 and 2018. **(05)**

(THE END)