**Certificate in Accounting and Finance Stage Examination**

**The Institute of Chartered Accountants of Pakistan**

7 March 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.

## Section A

Q.1 Rocky Road Limited (RRL) had a stock of 2,000 cows on 1 January 2019.

On 1 May 2019, RRL purchased 750 cows at fair value of Rs. 56,000 per cow. Further Rs. 2 million were incurred to transport the cows to the farm.

On 1 August 2019, RRL imported cattle feed of USD 150,000 against 70% payment. RRL also paid 5% custom duty on import. The feed is specially designed to provide vital nutrients to cows that keep them healthy and improve the quality of their produce. At year-end, 30% of the amount is payable whereas 40% of the feed is unused.

Following average fair values per cow are available:

| 1-Jan-19 | 1-May-19 | 31-Dec-19 | Average for the year |
|---|---|---|---|
| Rs. 50,000 | Rs. 56,000 | Rs. 61,000 | Rs. 57,000 |

Auctioneers charge a 2% commission on fair value from seller. Further, there is a government levy of 3% at the time of purchase and 4% at the time of sale on fair value.

Following exchange rates are available:

| Date | 1-Aug-19 | 31-Dec-19 | Average Aug-Dec | Average for the year |
|---|---|---|---|---|
| **1 USD** | Rs. 164 | Rs. 152 | Rs. 157 | Rs. 159 |

**Required:**
Prepare journal entries in RRL's books to record the above information for the year ended 31 December 2019. **(08)**

Q.2 Bilal has recently joined your organization. He has prepared a summary of classification and measurement requirements of financial assets which will help him in handling the transactions related to the financial assets. He has requested you to review the following summary:

| | Amortized cost | FV through OCI | FV through P/L |
|---|---|---|---|
| Business model | Hold to collect and sell | Hold to collect | Hold to sell |
| Cash flows | Solely payment of principal and interest | No condition | No condition |
| Categories | Debt and equity securities | Debt securities | Equity securities |
| Initial measurement | Fair value plus transaction cost | Fair value | Fair value plus transaction cost |
| Subsequent measurement | Amortized cost | Fair value less transaction cost | Fair value |

**Required**:
Prepare the corrected summary in the light of IFRSs. **(07)**

Q.3 Atif Anwar, ACA is Finance Manager at Hot Coffee Limited (HCL) and reports to Jamal Ahmed, FCA who is the CFO.

On returning from leaves, Atif noted that draft financial statements for the year ended 31 December 2019 have been prepared. He found that financial statements have not been updated for the revision in decommissioning cost related to a plant, as advised by the engineering department at the start of 2019. Atif discussed the matter with Jamal who advised him to finalize the financial statements without revising the decommissioning cost as HCL's profit would be decreased if revised cost would be taken into account.

Decommissioning cost related to the plant has increased from initial estimate of Rs. 50 million to Rs. 88 million. Applicable discount rate is 12%. This plant had a useful life of 6 years when it was purchased on 1 July 2017 at a purchase price of Rs. 860 million. HCL uses cost model for subsequent measurement of its property, plant and equipment and follows straight line method for charging depreciation.

**Required:**

(a) Compute the change in net profit, assets and liabilities if revised decommissioning cost is included in the financial statements for the year ended 31 December 2019. **(05)**

(b) Briefly explain how Jamal may be in breach of the fundamental principles of ICAP's Code of Ethics for Chartered Accountants. **(03)**

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

(i) Which of the following is a monetary item?

(a) Deferred tax liability
(b) Advance paid
(c) Income tax payable
(d) Inventories **(01)**

(ii) A conditional grant related to a biological asset measured at its 'fair value less estimated point-of-sale costs' should be recorded as income:

(a) over the period in which conditions would be fulfilled
(b) only when the grant becomes receivable
(c) only when the conditions are met
(d) over the life of related biological asset **(01)**

(iii) The applicable financial reporting framework and schedule of the Companies Act, 2017 for Large Sized Company are:

(a) IFRS and Fourth Schedule
(b) IFRS and Fifth Schedule
(c) Revised AFRS for SSE and Fourth Schedule
(d) Revised AFRS for SSE and Fifth Schedule **(01)**

(iv) Zameer Ansari is a car dealer. Cars are sold both on cash and finance lease basis. He has been selling a car at the following terms:

| | |
|---|---|
| Fair value | Rs. 5,000,000 |
| Annual lease rental in arrears | Rs. 1,646,199 |
| Market rate | 12% per annum |
| Lease term | 4 years |

What would be the effect on sales revenue and finance income if annual lease rental is increased to Rs. 1.8 million and all other terms remain the same?

(a) Increase in sales revenue and increase in finance income
(b) Decrease in sales revenue and increase in finance income
(c) No change in sales revenue and increase in finance income
(d) Increase in sales revenue and no change in finance income **(02)**

(v) An entity purchased patent for its product A in 2014 for 20 years. In 2019, the entity purchased patent of a competing product for 20 years to eliminate competition for product A. However, the entity does not intend to manufacture the competing product. The cost of purchasing second patent for competing product should be:

(a) expensed out in 2019
(b) capitalized and amortized over 20 years
(c) capitalized and amortized over 15 years
(d) capitalized and only assessed for impairment at year end **(01)**

(vi) Computer hardware and related operating system, which is an integral part of the computer hardware, are treated under:

(a) IAS 16 as a combined asset
(b) IAS 38 as a combined asset
(c) IAS 16 for computer hardware and IAS 38 for operating system
(d) IAS 16 or IAS 38 at the option of the entity **(01)**

(vii) According to IFRSs, if a financial report contains both consolidated financial statements of a parent, as well as parent's separate financial statements, segment information is required:

(a) only in the consolidated financial statements
(b) only in the parent's separate financial statements
(c) in both sets of financial statements
(d) Either in the consolidated or parent's separate financial statements **(01)**

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## Section B

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Q.5 On 1 January 2019, French Vanilla Leasing Limited (FVLL) purchased a machine costing Rs. 200 million having useful life of 8 years. Residual value of the machine at end of its useful life is estimated at Rs. 16 million.

On 1 February 2019, FVLL entered into a lease agreement for this machine with Cotton Candy Limited (CCL) for a non-cancellable period of 2.5 years with effect from 1 March 2019. Under the agreement, eight instalments of Rs. 12 million are to be paid quarterly in arrears commencing from the end of 3rd quarter i.e. 30 November 2019.

FVLL has incorporated an implicit rate of 15% per annum which is not known to CCL. Incremental borrowing rate of CCL is 16% per annum.

On 1 April 2019, CCL completed installation of the machine at a cost of Rs. 4 million and put it into use.

Both companies follow straight line method for charging depreciation.

**Required:**
Prepare journal entries for the year ended 31 December 2019 in the books of FVLL and CCL to record the above transactions. **(15)**

Q.6 Following are the summarized statements of financial position of Pistachio Limited (PL), Mint Limited (ML) and Jalapeno Limited (JL) as on 31 December 2019:

| | PL | ML | JL |
|---|---|---|---|
| | --------- Rs. in million --------- | | |
| Property, plant and equipment | 850 | 750 | 500 |
| Investment in ML at cost | 900 | - | - |
| Investment in JL at cost | 170 | - | - |
| Inventories | 300 | 340 | 200 |
| Trade receivables | 240 | 200 | 150 |
| Cash and bank balances | 60 | 170 | 50 |
| | **2,520** | **1,460** | **900** |
| | | | |
| Share capital (Rs. 10 per share) | 1,400 | 700 | 400 |
| Share premium | - | 100 | - |
| Retained earnings | 780 | 480 | 340 |
| Liabilities | 340 | 180 | 160 |
| | **2,520** | **1,460** | **900** |

**Additional information:**

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

| Date of investment | Holding % | Investee | Retained earnings of investee Rs. in million |
|---|---|---|---|
| 1-Jan-19 | 25% | JL | 200 |
| 1-Apr-19 | 80% | ML | 360 |

(ii) The following considerations relating to acquisition of ML's shares are still unrecorded:

- Transfer of PL's freehold land having carrying value and fair value of Rs. 88 million and Rs. 108 million respectively.
- Cash of Rs. 115 million would be paid in February 2020 if ML's net profit for the year 2019 would increase by 20% as compared to last year. Fair value of this consideration on acquisition date was estimated at Rs. 70 million. At year-end, the said target has been achieved by ML.

(iii) On the date of investment, the fair values of each share of ML and JL were Rs. 18 and Rs. 16 respectively.

(iv) At the date of acquisition of ML, carrying values of ML's net assets were equal to fair value except for inventory which was carried at Rs. 130 million and had a fair value of Rs. 180 million. 20% of this inventory is still included in ML's inventory as at 31 December 2019.

(v) On 1 July 2019, ML sold a machine to PL for Rs. 55 million at a gain of Rs. 10 million. The remaining useful life of the machine at the time of disposal was 5 years.

(vi) JL paid 10% dividend for the half year ended 30 June 2019. PL recorded this as other income.

(vii) During the year, PL made sales of Rs. 72 million to JL at 20% above cost. 60% of these goods were sold by JL during the year.

(viii) As at 31 December 2019, PL has receivable of Rs. 8 million from JL.

(ix) An impairment test carried out at year-end has indicated that goodwill of ML has been impaired by 10%.

(x) PL measures non-controlling interest at the acquisition date at its fair value.

(xi) PL's discount rate is 14%.

**Required:**

(a) Prepare PL's consolidated statement of financial position as at 31 December 2019 in accordance with the requirements of IFRSs. **(18)**

(b) List down the additional information having no effect in your working in (a) above. **(02)**

Q.7 The following balances have been extracted from the trial balance of Mint Lemonade Limited (MLL) as at 31 December 2019:

| | **Rs. in million** |
|---|---|
| Trade receivables | 1,200 |
| Capital work in progress | 910 |
| Allowance for bad debts as on 1 January 2019 | 44 |
| Sales | 2,500 |
| Cost of goods sold | 1,320 |
| Research and development | 180 |
| Dividend receivable | 10 |
| Administrative expenses | 302 |
| Selling and distribution expenses | 200 |
| Finance cost | 48 |
| Dividend income | 30 |
| Capital gain | 50 |
| Other income | 36 |

While finalizing the financial statements of MLL, the following issues have been noted:

(i) Trade receivables include a balance of Rs. 40 million which needs to be written off. MLL maintains a provision for doubtful debts at 5% of trade receivables.

As per tax laws, only write offs are allowed as deduction.

(ii) Capital work in progress includes interest cost of Rs. 84 million on specifically acquired bank loan during the year. However, interest of Rs. 16 million earned by investing surplus funds available from the bank loan has been included in other income.

As per tax laws, borrowing costs are allowed when incurred.

(iii) Research and development represents cost incurred for a new product started on 1 February 2019. The recognition criteria for capitalization of internally generated intangible asset was met on 1 May 2019. The product was launched on 31 October 2019. It is estimated that the useful life of this new product will be 5 years. It may be assumed that all costs accrued evenly over the period.

Research and development cost is allowed as tax deduction over 10 years.

(iv) Tax depreciation for the year ended 31 December 2019 exceeded accounting depreciation already recorded in books, by Rs. 200 million.

(v) Office building of ML had net book value of Rs. 900 million on 31 December 2018 with remaining useful life of 12 years. During 2019, MLL decided to opt revaluation model for its building. Consequently, fair value of building at start of 2019 was determined at Rs. 1,200 million. Such revaluation has not yet been accounted for. Depreciation on office building under cost model has already been recorded in the books.

Revaluation does not affect taxable profit.

(vi) Capital gain is exempt from tax. Dividend was taxable on receipt basis at 15% in 2019. However, with effect from 1 January 2020, dividend received would be taxable at 20%.

(vii) Applicable tax rate is 32% except stated otherwise.

**Required:**

(a) Prepare MLL's statement of profit or loss and other comprehensive income for the year ended 31 December 2019. **(08)**

(b) Prepare note on taxation for inclusion in MLL's financial statements for the year ended 31 December 2019 including a reconciliation to explain the relationship between tax expense and accounting profit. **(12)**

Q.8 **For the purpose of this question, assume that the date today is 1 February 2020.**

You are the Finance Manager of Wonderland Limited (WL). Your assistant is preparing financial statements of WL for the year ended 31 December 2019. He has brought following matters for your consideration:

(i) In mid of 2019, WL launched new model of laptops with the name of Champ which became popular among customers.

In November 2019, WL started receiving complaints about incidents of electric shock and excessive heating. Some of these incidents resulted in serious injuries to customers. Several customers filed claims for damages with WL for injuries. The matter was highly publicized in media as well.

On 1 December 2019, WL suspended sales of Champ. WL conducted an inquiry which led to the conclusion that these incidents were happening because of defective chargers. On 25 December 2019, WL announced that all customers can collect the replacement charger from 15 January 2020 and onwards from WL's service center without any additional cost. The sales of Champ will also resume on the same date at a reduced price. Further, it has been internally decided that a free USB shall be given to customers coming for collecting replacement chargers as a good gesture.

The matter was raised with the supplier of chargers i.e. Battery Limited (BL). On 20 January 2020, BL admitted the fault and agreed to only adjust the cost of the defective chargers against the future purchases.

In respect of this matter, your assistant has proposed a provision of Rs. 105.3 million in financial statements for the year ended 31 December 2019 having the following breakup:

| | | **Rs. in million** |
|---|---|---|
| 1. | Cost of replacement chargers to be acquired for: | |
| | ▪ customers | 6.8 |
| | ▪ wholesaler and retailers | 2.3 |
| | ▪ closing stock of Champ with WL | 4.9 |
| 2. | Recovery from BL | (11.5) |
| 3. | Cost of USBs to be given | 5.8 |
| 4. | Expected litigation cost and settlements in respect of claims for damages for injuries to customers including Rs. 5.4 million for claims made in January 2020 and Rs. 10 million for claims expected to be received in future. | 25.9 |
| 5. | Decrease in WL share price in December 2019 | 38.4 |
| 6. | Marketing cost to be incurred in 2020 to counter the negative publicity by the incidents | 15.5 |
| 7. | Decrease in gross profit for 2020 due to reduction in selling price | 17.2 |
| | | **105.3** |

**(10)**

(ii) In November 2019, WL introduced a promotion scheme in which a scratch card was included in each pack of one of its products. These cards carry cash prizes ranging from Rs. 100 to Rs. 50,000 and are valid for claims till 29 February 2020.

All scratch cards were printed by system and packed directly into the product without any human interaction. As per the scheme, WL had decided to include total prizes of Rs. 25 million.

As at year-end, WL had already received claims for prizes worth Rs. 32 million. An inquiry has led to the conclusion that the software for printing scratch card has certain programming errors which has led to printing of unknown amount of total prizes as compared to the original plan of WL.

Further, claim of Rs. 12 million had been received till 31 January 2020. Considering the reputation, WL would honour all the claims. **(04)**

**Required:**
Discuss how the above issues should be dealt with in the financial statements of WL for the year ended 31 December 2019. Support you answer in the context of relevant IFRSs.

**(THE END)**