The Institute of Chartered Accountants of Pakistan

Certificate in Accounting and Finance Stage Examination

11 September 2017
3 hours – 100 marks
Additional reading time – 15 minutes

Financial Accounting and Reporting-II

Q.1 Following are the extracts from the financial statements of Universal Limited (UL) for the year ended 30 June 2017:

Statement of financial position as on 30 June 2017

Assets	2017	2016	Equity & liabilities	2017	2016
	Rs. in '000			Rs. in '000	
Property, plant and equipment	158,500	120,000	Share capital (Rs. 10 each)	175,000	150,000
			Retained earnings	54,434	21,500
Deferred tax asset	8,500	-	Revaluation surplus	10,000	-
Stock in trade	58,000	45,000	Debentures (Rs. 100 each)	18,000	20,000
Trade receivables	68,000	56,000	Deferred tax liability	-	6,000
Cash	39,434	48,000	Interest payable	1,000	2,500
			Trade payables	42,000	39,000
			Accrued liabilities	20,000	18,000
			Unearned maintenance	2,000	4,000
			Provision for taxation	10,000	8,000
	332,434	**269,000**		**332,434**	**269,000**

Statement of profit or loss for the year ended 30 June 2017

	Rs. in '000
Sales	273,000
Cost of sales	(187,500)
Gross profit	85,500
Operating expenses	(46,766)
Other income	11,200
Profit before interest and tax	49,934
Interest expense	(2,000)
Profit before tax	47,934
Tax expense	(15,000)
Profit after tax	32,934

Additional information:

(i) 60% of sales were made on credit.

(ii) UL maintains a provision for doubtful receivables at 6%. During the year, trade receivables of Rs. 7 million were written off.

(iii) Depreciation expense for the year was Rs. 22.5 million. 70% of the depreciation was charged to cost of sales.

(iv) Other income comprises of:
- gain of Rs. 3 million on disposal of vehicles for Rs. 12 million;
- maintenance income of Rs. 8 million; and
- discount of Rs. 10 per debenture which were redeemed during the year.

Required:

Prepare UL's statement of cash flows for the year ended 30 June 2017 using direct method. **(15)**

Q.2 Naba Power Limited (NPL) is preparing its financial statements for the year ended 30 June 2017. Following issues are under consideration.

(a) NPL entered into a contract on 1 August 2016 to supply customised batteries to a new customer. As per the terms of the agreement, NPL is required to deliver 50,000 batteries at the end of each month from December 2016 to September 2017 at a consideration of Rs. 15 million per month. Penalty for each late delivery or cancellation of the contract would be Rs. 5 million and Rs. 20 million respectively.

On 1 August 2016 NPL had estimated that cost of production would be Rs. 10 million per month. However, cost of production increased subsequently. Despite the increase in the cost of production, NPL made timely deliveries till May 2017 at a total cost of Rs. 99 million. Supply for June 2017 was made on 15 July 2017 at a total cost of Rs. 18 million of which Rs. 14 million had been incurred till 30 June 2017. It is estimated that Rs. 55 million would need to be spent to make the last 3 deliveries within time. **(06)**

(b) On 15 May 2017 an explosion occurred at one of NPL's factories. Several claims were filed by affected employees against NPL. The details are as under:

(i) Seven injured employees made claims before 30 June 2017 and further three injured employees lodged claims in July 2017. According to NPL's legal advisor, the probability that NPL would be determined to be negligent is 80%. If NPL is found negligent, the estimated average cost of each payout will be Rs. 1 million.

(ii) Additional four employees made claims before 30 June 2017, seeking compensation for the stress, rather than any injury, caused to them. If these claims succeed, the legal advisor is of the view that the estimated average cost of each payout will be Rs. 0.7 million. However, according to the legal advisor, the chance that these employees will succeed is 30%.

(iii) 80% of all such payouts are recoverable according to the terms of the insurance policy. **(05)**

(c) On 1 November 2016 a new law was introduced requiring all factories to install specialized safety equipment within five months. The equipment costing Rs. 15 million was ordered in February 2017 to be installed by 30 April 2017. However the supplier delayed installation till 31 July 2017. On 5 August 2017 the company received a notice from the authorities levying a penalty of Rs. 1.6 million i.e. Rs. 0.4 million for each month during which the violation continued. It is probable that this penalty will be recovered from the supplier. **(04)**

Required:
Discuss how each of the above issues should be dealt with in NPL's financial statements for the year ended 30 June 2017. ***(Quantify effects where practicable)***

Q.3 On 1 July 2016, Sunshine Limited (SL) acquired four licenses namely A, B, C and D for a period of ten years. The following information is available in respect of these licenses:

(i)

	A	B	C	D
Cost of license **(Rs. in million)**	200	230	90	60
Expected period of cash generation from acquisition date	12 years	indefinite	6 years	12 years
Active market value at 30 June 2017 **(Rs. in million)**	170	300	65	No active market
Renewal cost **(Rs. in million)**	65	85	2	1

(ii) The renewal would allow SL to use the licenses for another five years.
(iii) SL uses the revaluation model for subsequent measurement of its intangible assets.
(iv) An independent valuer has estimated the value of license 'D' at Rs. 130 million.

Required:
Determine the amounts that should be recognised in respect of the licenses in the statement of financial position and statement of profit or loss for the year ended 30 June 2017. **(10)**

Q.4 The following balances are extracted from the records of Present Limited (PL) and Future Limited (FL) for the year ended 30 June 2017:

	PL		FL	
	Debit	**Credit**	**Debit**	**Credit**
	-------------- Rs. in million --------------			
Sales		2,060		1,524
Cost of sales	1,300		846	
Selling and administrative expenses	350		225	
Investment income		190		50
Gain on disposal of fixed assets - net		35		
Taxation	80		60	
Share capital (Rs. 10 each)		3,500		2,600
Retained earnings as on 30 June 2017		1,996		704

Additional information:

(i) PL acquired 65% shares of FL on 1 September 2016 against the following consideration:
- Cash payment of Rs. 900 million.
- Issuance of shares having nominal value of Rs. 1,000 million.

The fair value of each share of PL and FL on acquisition date was Rs. 16 and Rs. 12 respectively. Retained earnings of PL and FL on the acquisition date were Rs. 1,671 million and Rs. 506.5 million respectively.

At acquisition date, fair value of FL's net assets was equal to their book value except a brand which had not been recognised by FL. The fair value of the brand is assessed at Rs. 90 million. PL estimates that benefit would be obtained from the brand for the next 10 years.

(ii) The incomes and expenses of FL had accrued evenly during the year except investment income. The investment income is exempt from tax and had been recognised in August 2016 and received in September 2016.

(iii) On 1 January 2017 PL sold a manufacturing plant having carrying value of Rs. 42 million to FL against cash consideration of Rs. 30 million. The plant had a remaining useful life of 6 years on the date of disposal.

(iv) On 1 February 2017 FL delivered goods having sale price of Rs. 100 million to PL on 'sale or return basis'. 40% of these goods were returned on 1 May 2017 and the remaining were accepted by PL. 20% of the goods accepted were included in the closing inventory of PL. FL earned a profit of 33.33% on cost.

(v) Both companies paid interim cash dividend at the rate of 5% in May 2017.

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

(vii) PL measures the non-controlling interest at its fair value.

Required:

(a) Prepare consolidated statement of profit or loss for the year ended 30 June 2017. **(13)**

(b) Compute the amounts of consolidated retained earnings and non-controlling interest as would appear in the consolidated statement of financial position as at 30 June 2017. **(04)**

Q.5 Usman is a Chartered Accountant and has been working as Finance Director in Mehran Limited (ML) for the past one year. He reports to the CEO who is also a Chartered Accountant.

Recently, Usman has received a bill issued by an advertising agency which is duly approved for payment by the Director Marketing. Usman believes that the amounts agreed to be paid under the contract far exceed the value of services to be provided by the advertising agency and that the payment would be redirected to obtain a sales contract. He has discussed the matter with CEO who has advised him to process the payment in ML's business interest. The CEO also informed Usman that if the said contract is secured, the management staff will be entitled to a handsome bonus.

Required:
Briefly explain how CEO is in breach of the fundamental principles of ICAP's code of ethics. Also state the potential threats which Usman may face under the circumstances, along with available safeguards (if any). **(08)**

Q.6 Following information has been extracted from the draft financial statements of Marvellous Limited (ML) for the year ended 30 June 2017:

Statement of financial position

	2017	2016
	Rs. in million	
Property, plant and equipment	700	612
Retained earnings	275	240
Deferred tax liability	58	52
Provision for taxation	12	16

Statement of profit or loss

Profit before taxation	65	85
Taxation	30	25
Profit after taxation	35	60

The following matters are under consideration of the management:

- It was identified that ML's obligation to incur decommissioning cost related to a plant has not been recognised. The plant was acquired on 1 July 2014 and had been depreciated on straight line basis over a useful life of four years. The expected cost of decommissioning at the end of the life is Rs. 50 million. Applicable discount rate is 8%.
- In view of significant change in the expected pattern of economic benefits from an item of the equipment, it has been decided to change the depreciation method from reducing balance to straight line. The equipment was purchased on 1 July 2015 at a cost of Rs. 80 million having estimated useful life of 5 years and residual value of Rs. 16 million. The depreciation at the rate of 27.5% on reducing balance method is included in the above draft financial statements.

The following balances pertain to ML's statement of financial position as on 30 June 2015:

	Rs. in million
Property, plant and equipment	650
Retained earnings	180
Deferred tax liability	40
Provision for taxation	24

Applicable tax rate is 30%. Tax authorities consider decommissioning cost as an expense when paid.

Required:
Prepare extracts from the following (including comparative figures) for the year ended 30 June 2017:

(a) Statement of financial position **(08)**
(b) Statement of profit or loss **(03)**
(c) Correction of error note **(06)**

Q.7 Emotional Limited (EL) is preparing its financial statements for the year ended 30 June 2017. Following are the details of additions to property, plant and equipment made during the year:

Addition 1: Construction of tanks and pipelines
Summary of cost incurred on tanks and pipelines is as follows:

Description	Rs. in million	Date of payments
Advance to contractor	200	1 August 2016
Construction permit fee	100	1 August 2016
Suppliers of construction material	600	1 September 2016
1st bill of contractor	500	1 January 2017
2nd bill of contractor	200	1 March 2017
Last bill of contractor	200	1 May 2017

In order to finance the project, EL obtained a 3 year loan of Rs. 1,200 million at the rate of 12% per annum on 1 August 2016. The principal is payable in three equal annual instalments along with interest, from 1 August 2017. The surplus funds available from the loan were invested in a saving account at 8% per annum.

The remaining cost was financed through cash withdrawals from EL's existing running finance facilities. Details of these facilities are as follows:

Name of bank	Running finance			Mark-up %
	Limit	Balance as on 30 June 2017	Average balance	
	---------- Rs. in million ----------			
Bank Q	500	450	400	12.5
Bank W	700	650	300	14.0

The tanks and pipelines were put into operation upon completion on 1 April 2017.

Addition 2: Acquisition of machinery on lease
On 1 January 2017 EL acquired machinery having fair value of Rs. 185 million, on lease for a non-cancellable period of four years. Rentals of Rs. 54 million are to be paid annually in advance on 1 January. EL's incremental borrowing rate is 13.7%. EL also paid initial direct cost of Rs. 10 million in respect of the machinery.

The following information is also available:
(i) During the year ended 30 June 2017, EL made a profit before tax of Rs. 500 million, after incorporating the effects of above transactions.
(ii) EL charges depreciation at the rate of 10% on tanks and pipelines.
(iii) EL's tax rate is 30%. Tax authorities allow depreciation at the rate of 20% on tanks and pipelines. Full year's tax depreciation is allowed in the year of addition.
(iv) As per tax laws:
- all lease related payments are allowed in the year of payment; and
- borrowing costs are allowed when incurred.
- investment income is taxable when earned.

(v) There are no temporary differences in current and previous years other than those evident from the information provided above.

Required:
Prepare relevant extracts from EL's statement of financial position as on 30 June 2017. ***Notes to the financial statements are not required. Borrowing costs are to be calculated on the basis of number of months.*** **(18)**

(THE END)