The Institute of
Chartered Accountants
of Pakistan

Certificate in Accounting and Finance Stage Examination

9 March 2019
3 hours – 100 marks
Additional reading time – 15 minutes

Financial Accounting and Reporting-II

Q.1 (a) On 1 July 2018 Rectangle Limited (RL) entered into a sale and lease back agreement with Pentagon Leasing Limited in respect of a machine. The relevant details are as under:

Lease term	5 years
Remaining useful life	10 years
RL's incremental borrowing rate	11% per annum
	Rs. in million
Sale price to the lessor	60
Carrying value	42
Fair value	55
Semi-annual rentals in arrears	6

The transfer of machine by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale.

Required:

(i) Prepare journal entries in the books of RL in respect of the above transaction for the year ended 31 December 2018. **(07)**

(ii) Compute the gain/loss on rights transferred to be recorded in the books of RL on 1 July 2018 if fair value of the machine was Rs. 70 million. **(02)**

(b) Square Limited (SL) is a dealer of electronic items. SL acquires refrigerators of a particular model from a manufacturer at a discount of 15% on the retail price of Rs. 300,000 per unit.

On 1 January 2018, SL sold 12 refrigerators to Cube Hotel at retail price on lease. The rate of interest implicit in the lease was 10% per annum. The payment is to be made in three equal annual instalments payable in advance. Residual value at the end of 3 years is nil.

The market rate of interest is 14% per annum.

Required:

Prepare journal entries in the books of SL in respect of above transaction for the year ended 31 December 2018. **(07)**

(c) Discuss **three** shortcomings of earnings per share. **(03)**

Q.2 The following summarized trial balances pertain to Arrow Limited (AL) and its subsidiary Box Limited (BL) for the year ended 31 December 2018:

	AL		BL	
	Debit	**Credit**	**Debit**	**Credit**
	------------ Rs. in million ------------			
Sales	-	5,177	-	3,996
Cost of sales	3,255	-	2,448	-
Operating expenses	713	-	636	-
Other income	-	350	-	18
Tax expense	403	-	288	-
Share capital (Rs. 10 each)	-	3,720	-	1,600
Share premium	-	1,430	-	322
Retained earnings as at 1 January 2018	-	2,293	-	516
Current liabilities	-	713	-	651
Property, plant and equipment	5,418	-	1,934	-
Investments	1,600	-	-	-
Loan to BL's Director	10	-	-	-
Current assets	2,284	-	1,797	-
	13,683	**13,683**	**7,103**	**7,103**

Additional information:

(i) AL acquired 96 million shares of BL on 1 May 2018 at following consideration:

- Cash payment of Rs. 450 million
- Issuance of 40 million shares of AL at Rs. 25 each

(ii) On acquisition date, carrying values of BL's net assets were equal to fair value except the following:

- A building whose fair values and value-in-use were Rs. 390 million and Rs. 520 million respectively as against carrying value of Rs. 480 million. The group follows cost model for subsequent measurement of property, plant and equipment. The remaining life of building on acquisition date was 20 years. Fair value of the building has increased to Rs. 440 million at 31 December 2018.
- A brand which had not been recognized by BL. The fair value of the brand was assessed at Rs. 162 million. It is estimated that benefit would be obtained from the brand for the next 6 years.

(iii) AL measures the non-controlling interest at fair value. On the date of acquisition, the market price of BL's shares was Rs. 14 per share.

(iv) On 1 July 2018 AL sold an equipment to BL for Rs. 250 million at a gain of Rs. 20 million. BL has charged depreciation of Rs. 12.5 million on this equipment.

(v) In each month of 2018, BL sold goods costing Rs. 40 million to AL at cost plus 20%. At year end, 75% of the goods purchased in December were included in stock of AL.

(vi) BL's credit balance of Rs. 38 million in AL's books does not agree with BL's books due to Rs. 7 million charged by AL for management service on 26 December 2018. Total management fee charged by AL to BL since acquisition amounted to Rs. 16 million.

(vii) BL declared interim cash dividend of Re. 0.50 per share in December 2018. AL has correctly recorded the dividend in its books. However, BL has not yet accounted for the dividend.

(viii) The incomes and expenses of BL may be assumed to have accrued evenly during the year.

Required:
Prepare the following:

- consolidated statement of profit or loss for the year ended 31 December 2018. **(15)**
- consolidated statement of financial position as at 31 December 2018. **(10)**

Q.3 Triangle Limited (TL) was incorporated in 2017. The following information has been gathered for preparing the disclosures related to taxation for the year ended 31 December 2018:

(i) Profit before tax for the year amounted to Rs. 125 million (2017: Rs. 110 million)
(ii) Accounting depreciation for the year was Rs. 25 million (2017: Rs. 18 million)
(iii) Tax depreciation for the year was Rs. 21 million (2017: Rs. 42 million)
(iv) Rent is allowed for tax purposes on payment basis. Rent accrued as at 31 December 2018 amounted to Rs. 1 million (2017: Rs. 3 million)
(v) Insurance is also allowed for tax purposes on payment basis. Prepaid insurance as at 31 December 2018 amounted to Rs. 5 million (2017: Rs. 4 million)
(vi) Other income includes:

- interest of Rs. 10 million (2017: Rs. 7 million)
- dividend of Rs. 6 million (2017: Rs. 8 million)

(vii) Borrowing cost of Rs. 2 million was capitalized in 2018 on an under construction building. Borrowing cost is allowed for tax purposes in the year in which it is incurred.
(viii) Applicable tax rates are as follows:

	***2018**	**2017**
Dividend income	35%	20%
Interest income	Exempt	30%
All other incomes	35%	30%

The rates were changed through the Finance Act enacted on 10 January 2018.

Required:
Prepare the following:
- Note on taxation for inclusion in TL's financial statements for the year ended 31 December 2018 and a reconciliation to explain the relationship between tax expense and accounting profit. ***(Show comparative figures)*** **(11)**
- Computation of deferred tax liability/asset in respect of each temporary difference as at 31 December 2017 and 2018. **(07)**

Q.4 Amir Ali, ACA is CFO at Circle Limited (CL) and reports to Junaid, FCA who is the CEO. The financial year of CL ends on 30 April and its profit for the nine months ended 31 January 2019 was below target. In a management meeting held in February 2019, Junaid has proposed the following measures to improve the results.

(i) Annual maintenance of the manufacturing plant which is due in March 2019 should be deferred to May 2019. Production manager has warned that the deferral may affect the safety of the plant. However, Junaid is of the view that the maintenance was delayed two years ago as well and nothing adverse happened at that time.
(ii) Incorporation of the new revaluation report of CL's buildings should be deferred to the next year as the resulting increase in valuation is substantial and would result in increase in the deprecation for the year. Amir had initiated the revaluation during the year since the fair values of the buildings had increased materially. Junaid is of the view that the buildings were revalued last year and there is no need of such frequent revaluations.

Due to the dominant nature of Junaid, none of the participants opposed his views. The summary to implement the above actions has been received by Amir.

Amir has recently applied for an interest free car loan from CL which is expected to be approved in few days.

Required:
Briefly explain how Junaid may be in breach of the fundamental principles of Code of Ethics for Chartered Accountants. Also state the potential threats that Amir may face in the above circumstances and how he should respond. **(09)**

Q.5 Octagon Pakistan Limited (OPL) in is process of preparation of financial statements for the year ended 31 December 2018. During the year, OPL completed the construction of its head office building. Relevant details in this respect are as follows:

(i) Payments related to the construction of the building were as follows:

Description	Date of payment	Rs. in million
Construction permit fee	1-Jan-18	30
Advance to contractor	1-Jan-18	80
1st bill of contractor	1-Feb-18	250
2nd bill of contractor	1-May-18	360
3rd bill of contractor	1-Sept-18	170
Last bill of contractor	1-Jan-19	150
		1,040

(ii) The project was financed through the following sources:

- Excess cash of Rs. 200 million available with OPL on 1 January 2018 in a saving account at 10% per annum.
- Loan of Rs. 350 million at the rate of 16% per annum obtained on 1 February 2018. The principal is payable in 5 equal annual instalments alongwith interest, from 1 February 2019. The surplus funds available from the loan were invested in a saving account at 10% per annum.
- Withdrawals from running finance facilities arranged on 1 May 2018. The facilities were also used to finance other needs of OPL. Details of these facilities are as follows:

Name of bank	Balance as on 31 December 2018	Limit	Average balance	Finance cost
	----------------------- Rs. in million	-----------------------		
Bank X	130	150	140	15.4
Bank Y	340	600	390	44.2

(iii) Payment of 3rd bill of contractor includes Rs. 10 million which was charged by the contractor for damages sustained at the site on account of unexpected rains.

(iv) The work was stopped from 16 to 31 May 2018 to meet mandatory technical requirements. Further, on 16 September 2018, the building control authority stopped the construction work as it raised objections on the design of the building. The matter was resolved on 30 September 2018.

(v) Construction of the building was completed on 31 October 2018. However, it was inaugurated on 1 December 2018. The building has an estimated useful life of 30 years.

Required:
Prepare relevant extracts from OPL's statement of profit or loss for the year ended 31 December 2018 and statement of financial position as on that date. ***(Notes to the financial statements are not required. Borrowing costs are to be calculated on the basis of number of months)*** **(17)**

Q.6 Oval Limited (OL) deals in medicines and surgical instruments. OL is in the process of finalizing its financial statements for the year ended 31 December 2018. Following matters are under consideration:

(i) OL sells instruments A-1 and B-1 with 1-year warranty. These units are purchased from a manufacturer Star Limited (SL). The details of warranty are as under:

A-1: SL provides warranty services to the customers and recovers 50% of the cost from OL. However, in case of SL's default, the warranty services would have to be provided by OL.

B-1: OL provides warranty services to the customers and recovers the entire cost from SL.

On 31 December 2018, it is estimated that total cost of Rs. 4 million and Rs. 7 million would be incurred in next year for providing warranty services for A-1 and B-1 respectively sold in 2018.

(ii) In October 2018, OL was sued by a customer for Rs. 18 million on account of supply of substandard surgical instruments.

By end of the year, OL communicated to the customer via email to pay Rs. 5 million. In respect of the remaining amount of the claim, OL's lawyers anticipate that there is 70% probability that the court would award Rs. 6 million and 30% probability that the amount would be Rs. 4 million.

OL lodged a claim with the supplier in December 2018. The supplier principally accepted the claim to the extent of Rs. 9 million. However, OL is still negotiating with the supplier and it is probable that OL would recover a further sum of Rs. 3 million.

(iii) OL has imported 7,000 units of a medicine at a cost of Rs. 70 million. However, in November 2018, a study was published in a medical journal which reveals that results of an alternate medicine are much better. At year end, 5000 units were in stock. On 25 January 2019, 4000 units were sold at Rs. 8,000 per unit. OL also paid 10% commission.

Required:
Discuss how the above issues should be dealt with in the financial statements of OL for the year ended 31 December 2018. Support your answers in the context of relevant IFRSs. **(12)**

(THE END)