THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Advanced Accounting and Financial Reporting
Examiners' comments and Suggested answer
Certified Finance and Accounting Professional (CFAP)
Summer 2017 Examinations

Overall General Comment:

Only 5.69% students passed in this attempt as compared to 8.85% in the previous attempt. In fact, the result in the paper has been on the decline for the last five attempts. The primary reason is that the candidates seem unable to grasp the frequent and significant changes that are being introduced in the IFRSs. The students would have to allocate sufficient time for preparation and practice in order to be successful in this paper.

Question-wise Comments:

Question 1

25.34% candidates secured passing marks in this question.

Common errors:

1. Candidates missed the entire workings, especially the revaluation surplus and reversal of exchange gain on investment in YL.
2. The following types of mistakes were made in the calculation of goodwill:
   - Amount of bargain purchase in case of GL was adjusted against the amount of goodwill of YL.
   - WL's existing investment in YL at the time of obtaining the control should have been re-measured at fair value for computing goodwill. However the re-measurement was either ignored or fair value on 1 January 2016 i.e. T$ 18 per share was taken instead of T$ 23 per share i.e. fair value on the date of obtaining the control (1 April 2016).
   - Share in YL was taken as 100% or 72%, instead of 92%.
3. The following types of mistakes were made in the calculation of consolidated retained earnings and / or non-controlling interest:
   - Gain on de-recognition of associate and amount of bargain purchase were ignored.
   - While computing nine months profit of YL, interim dividend paid by YL was not taken into account.
   - Indirect holding adjustment was ignored.
4. The investment property which was rented out to the holding company should have been classified as Property Plant and Equipment, in the consolidated balance sheet but was shown as investment property.

Suggested answer:

White Limited
Consolidated Statement of Finance Position
As on 31 December 2016

	Rs. in million
Assets	
Goodwill [56.7**(W-1)**×20]	1,134.00
Property, plant and equipment [14,900+3,000+(325×20)+800]	25,200.00
Investment property (800–800)	-
Current assets [6,660+2,500+(305×20)]	15,260.00
Total assets	41,594.00

Equity & liabilities	
Share capital	11,400.00
Retained earnings **(W-2)**	15,089.65
Exchange reserves **(W-5)**	1,270.65
	27,760.30
Non controlling interest **(W-3)**	1,091.20
	28,851.50
Revaluation surplus [150+650÷20]	182.50
Current liabilities [6,360+2,300+(195×20)]	12,560.00
Total equity and liabilities	41,594.00

W-1: Goodwill	**GL**	**YL**
	Rs. in million	**T $ in million**
Cash payment	4,200.00	243.00 (270×90%)
Fair value of previously held equity (4.5×23)		103.50
Total cash consideration and NCI	4,200.00	346.50
Less : Fair value of net assets acquired		
Share capital	1,500.00	225.00
Retained earnings	3,500.00	90.00
	5,000.00	315.00
WL's share in net assets (GL:5,000×90%),(YL:315×92%)	4,500.00	289.80
Bargain purchase/Goodwill	**(300.00)**	**56.70**

W-2: Consolidated retained earnings	**Rs. in million**
WL (Given)	9,500.00
Post acquisition - GL [(7,900–3500)×90%]	3,960.00
Post acquisition - YL (2,148.75**(W-2.1)**×92%)	1,976.85
Bargain purchase **(W-1)**	300.00
Gain on derecognition of associate **(W-4)**	484.50
Reversal of exchange gain on investment in YL by WL [75×(20–17)]	(225.00)
Reversal of exchange gain on investment in YL by GL (270×(20–17)×92%	(745.20)
Elimination of income from investment property (800–650)×90%	(135.00)
Depreciation expense to be booked for the year by GL (650÷20)	(32.50)
Rent expense to be reversed in WL books	60.00
Rent income to be reversed in GL books (60×90%)	(54.00)
	15,089.65

W-2.1: Post acquisition profit of YL	**Rs. in million**
Profit for nine month [{(210-90)120+(225×10%)}×18]	2,565.00
Less: 10% interim dividend (22.5×18.5)	(416.25)
	2,148.75

W-3: Non-controlling interest

	Rs. in million
At acquisition (GL : (1500+3500)×10%)+(YL(225+90)×8%×17)	928.40
Post acquisition - GL [(7,900–3500)×10%]	440.00
Post acquisition - YL (2,148.75×8%)	171.90
Reversal of exchange gain on investment in YL by GL [270×(20-17) × 8%]	(64.80)
Elimination of income from investment property (800–650)×10%	(15.00)
Rent income to be reversed in GL books (60×10%)	(6.00)
Exchange gain relating to year-end transactions **(W-5)**	95.70
Indirect holding adjustment (270×10%×17)	(459.00)
	1,091.20

W-4: Gain on derecognition of associate

	Rs. in million
Fair value of investments on 1 April 2016 (4.5×23×17)	1,759.50
Less: Cost of investment (75×17)	(1,275.00)
Gain	484.50

W-5: Exchange reserves

Relating to goodwill	**T$**	**Conversion rate**	**Rs. in million**
Balance on acquisition date i.e. 1 April 2016	56.70	17.00	963.90
Balance as on 31 December 2016	56.70	20.00	1,134.00
			170.10
Relating to translation of FS foreign operations	**T$**	**Conversion rate**	**Rs. in million**
Net assets as on 31 December 2016	435.00	20.00	8,700.00
Net assets on acquisition date	315.00	17.00	5,355.00
Profit since acquisition {120 + (225×10%)}	142.50	18.00	2,565.00
Dividend paid	(22.50)	18.50	(416.25)
	435.00		7,503.75
Exchange gain for the year ended 31 December 2016	-		1,196.25
Less: Exchange gain relating to NCI (1,196.25×8%)			95.70
Exchange gain to parent			1,100.55
Total exchange reserves (170.10+1,100.55)			1,270.65

Question 2

05.35% candidates secured passing marks in this question.

Common errors:

Part (a)

1. Imputed dividend to class A preference shares was ignored (not deducted) in computing the profit available to ordinary shareholders. Some of the candidates did consider the dividend but made various types of errors in computing it as they could not compute the impact of discounting.
2. Various types of errors were seen in determining the ratio of distribution of undistributed earnings between ordinary and Class B preference shareholders.
3. Instead of computing the overall basic earnings per share, the distributed earnings per share and the undistributed earnings per share were given.

Suggested answer:

	Rs. in million
Profit for the year	150.00
Less: Dividend	
Class A Preference shareholders (9÷1.09×2)	16.51
Class B Preference shareholders (300×6%)	18.00
Profit attributable to class B preference shareholders [90.49**(W-1)**×3÷(20+3)**(W-2)**]	11.80
	46.31
Profit available for ordinary shareholders	103.69
Earnings per share (103.16÷10)	10.37

W-1: Undistributed earnings

Profit after tax	150.00
Less: Imputed dividend	(16.51)
Dividend to class B preference shares	(18.00)
Dividend to ordinary shareholders	(25.00)
Undistributed earnings	90.49

W-2: Determination of ratio for distribution of undistributed earnings between ordinary and class B preference shareholders

	No. of outstanding shares (in million)	**Weight**	**Product**
Ordinary shareholder	10	2	20
Class B preference shareholder	3	1	3
			23

Part (b)

1. According to IFRS 9, at initial recognition, the company may make an irrevocable option to present subsequent changes in fair value in non-trading equity investments in other comprehensive income instead of profit and loss account. The accounting treatment for investment in KL depended on whether the option was taken or not. Similar situation applied to investment in BL when it decided to hold the shares for a longer period. Instead, only one of the two treatments was explained.
2. Investment in KL was classified as held to maturity or available for sale instead of non-trading investment.
3. If company elected irrevocable option to record subsequent changes in fair value through other comprehensive income then impairment loss against non-trading investments as given in the question should be accounted for through other comprehensive income rather than profit or loss account. This aspect was not explained.
4. Incorrect treatment of transaction cost was made. In the case of investment in BL and also in case of investment in KL where irrevocable option to charge subsequent changes through OCI was not exercised, transaction costs should have been charged to P&L, but were capitalized.

Suggested answer:

Investment in KL

Initial measurement
According to IFRS 9, at initial recognition, RIL may make irrevocable election to present subsequent changes in fair value in equity investment in other comprehensive income instead of profit or loss account.

If RIL opted as above, investment in KL would initially be recognized at fair value plus transaction costs i.e. Rs. 20 million.

However, if RIL opted to measure the investment at fair value through profit and loss (FVTPL), investment should initially be measured at Rs. 19.96 million (20/1.002) and transaction costs of Rs. 0.04 million (20–19.96) should be charged to profit and loss account.

Subsequent measurement
On 31 December 2016, if fair value through other comprehensive income has been opted, investment in KL should be measured at fair value of Rs. 12.4 million and a loss of Rs. 7.6 million [20–12.4(155,000×80)] (instead of Rs. 5 million) should be booked through other comprehensive income.

According to IFRS 9, amount presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain / (loss) within equity.

If fair value through profit or loss has been opted, then RIL should account for the loss of Rs. 7.56 million (20–0.04(transaction cost)–12.4) through profit and loss account.

Investment in BL

Initial measurement
The investment in BL should be recognized as held for trading at fair value of Rs. 64.87 million (65÷1.002) and transaction cost of Rs. 0.13 million should be charged to profit and loss account.

Subsequent measurement
As at 30 November 2016, the investment should be re-measured to fair value at the market price of Rs. 83.835 million (135,000×621) and a gain of Rs. 18.965 million (83.835–64.87) shall be booked in the profit and loss account.

Reclassification of asset
On 30 November 2016 when RIL decided to hold the shares for a longer period, investment in BL should be reclassified from held for trading to non-trading investment. Further, RIL may make irrevocable election that investment in BL would be re-measured at fair value through other comprehensive income, as discussed in the case of KL above. Similarly, treatment on 31 December 2016 would depend on whether RIL opted to re-measure at fair value through OCI or not.

Question 3

01.87% candidates secured passing marks in this question.

Common errors:

1. In computing the goodwill, market based replacement award was ignored while determining the total consideration.
2. In computing the goodwill, deferred tax was ignored.

3. In the computation of deferred tax, tax on unrealized profit on closing stock held by PAL was taken as 25% instead of 35% whereas tax on unrealized profit on closing stock held by LG was taken as 35% instead of 25%. Similarly, tax rate of 35% was applied on undistributed profit of NAL in both cases i.e. where such profit was to be realised by way of dividend and also where the profit was to be realised through sale of investments.
4. Increase in intrinsic value of replacement award from Rs. 90 million to Rs. 150 million was ignored in the computation of deferred tax.
5. Deferred tax was computed by applying the tax rate on the difference between fair value and tax base without taking into account the deferred tax at acquisition i.e. Rs. 24 million.

Suggested answer:

Computation of goodwill

Cash consideration	2,000.00
Market based measure of replacement awards	140.00
Total consideration transferred	2,140.00
Net assets acquired	
Fair value of assets	3,618.00
Fair value of liabilities	(1,888.00)
Development expenditure	153.00
Contingent liability	(25.00)
Adjustment in deferred tax **(W-1)**	(70.85)
	1,787.15
Goodwill	352.85

Impact on deferred tax as on 31 December 2016:	**Timing difference**	**Tax rate**	**Deferred tax**
Effect of deferred tax on acquisition **(W-1)**			(70.85)
Unrealized profit on closing stock held by PAL (80×20%)	(16.00)	35.0%	(5.60)
Unrealized profit on closing stock held by LG (140×15%)	(21.00)	25.0%	(5.25)
Undistributed profit of NAL – Associate (to be realized through dividend) [(50–20)×30%×60%)]	(5.40)	12.5%	(0.68)
Undistributed profit of NAL – Associate (Realized through sale) [(50–30)×30%×40%)]	(3.60)	17.5%	(0.63)
Increase in intrinsic value (150–90)	(60.00)	25.0%	(15.00)
			(98.01)

W-1: Adjustment for deferred tax on 1 January 2016

	Fair value	**Carrying value**	**Impact on Taxable /(deductible) time difference**	**Tax rate**	**Deferred tax liability/(assets)**
Property, plant and equipment	1,532	1,259	273.00	35%	95.55
Investments	490	367	123.00	35%	43.05
Retirement benefit obligations	60	17	(43.00)	35%	(15.05)
Development expenditure	153	-	153.00	35%	53.55
Contingent liability	25	-	(25.00)	35%	(8.75)
Unused tax losses	300	-	(300.00)	25%	(75.00)
Intrinsic value of share options	90	-	(90.00)	25%	(22.50)
Net adjustment in deferred tax					**70.85**

Question 4

0.96% candidates secured passing marks in this question.

Common errors:

1. Percentage of completion method was used without giving any reason to support such approach whereas revenue is to be recognized when control is transferred. Since it was clearly mentioned in the question that control was transferred after completion of the building, there was no point in discussing the issue further.
2. Imputed interest was not taken into consideration.
3. Revenue from maintenance service was not separated from total revenue.
4. Cost of land was not considered in the fixed assets of 2015.
5. Contract liabilities were not classified further as current and non-current.

Suggested answer:

Builders & Developers
Extracts from statement of financial position
As on 31 December 2016

	2016	**2015**
	------ Rs. in million ------	
Fixed Asset		
Land	-	50
Current Asset		
Contract cost (80.20+32.60+5.8)÷18×12	-	79.07
Non current liabilities		
Contract liability	27.30	35.10
	(3.9×7)	(39–3.9)
Current liabilities		
Contract liability	7.80	264.65
	(3.9×2)	(236+3.9+24.75)

Builders & Developers
Extracts from statement of comprehensive income
As on 31 December 2016

	2016	**2015**
	------ Rs. in million ------	
Revenue (sale of building) [275–39(3×10×1.3)]+38.24	274.24	-
Less: Contract cost		
Land	(50.00)	-
Direct material	(80.20)	-
Direct labour	(32.60)	-
Other cost directly related to the contract	(5.80)	-
	(168.60)	-
Profit from sale of building	105.64	
Revenue (maintenance service) (3×1.3)	3.90	-
Less : Contract cost	(3.00)	-
Profit from maintenance services	0.90	-
Gross profit	106.54	
Interest expense [**2016**:(275+24.75)×9%×6/12; **2015**:275×9%]	(13.49)	(24.75)
Net profit	93.05	(24.75)

Question 5

01.01% candidates secured passing marks in this question.

Common errors:

1. The hedge was treated as a cash flow hedge whereas it was a fair value hedge because the company had entered into the swap agreement with the purpose of hedging the fair value of the company's debt rather than its repayment.
2. Swap has to be recorded initially at its fair value. Since the swap was entered at market rates, its fair value was zero at the agreement date and therefore no accounting entry was required. The students generally failed to explain this point.
3. The requirement was to explain the accounting treatment whereas many students gave general entries.
4. No comments were offered with regard to the amount of brokerage.

Suggested answer:

On 1 October 2016

As the company entered into the swap agreement with the purpose of hedging the fair value of the company's own debt, therefore this is a fair value hedge.

The loan should initially be recognized at fair value. Swap has to be recorded initially at its fair value. Since the swap was entered at 'market rates', its fair value is zero at the agreement date and therefore no accounting entry is required on that date.

Brokerage of Rs. 1 million with respect to swap arrangement should be charged to profit and loss account.

On 31 December 2016

PTL should record net interest expense of Rs. 17.483 million for the quarter ended 31 December 2016.

	Rs. in million
Interest expense on TFC (900 × 8% × 3 ÷ 12)	18.000
Interest expense on SWAP (900 × 6.27% × 3 ÷ 12)	14.108
Interest income on SWAP (900 × 6.5% × 3 ÷ 12)	(14.625)
	17.483

At 31 December 2016, the hedge is required to be assessed and effectiveness of hedge is required to be determined, to decide whether hedge accounting is to be continued or not.

Being 'receive fixed' and 'pay variable' interest rate swap, fair value hedge accounting rules are to be applied.

	Rs. in million
TFCs issued at par	900.00
Fair value at 31 December 2016 (992×0.9)	892.80
Gain in TFCs – Other income	**7.20**

The swap is deemed effective and hedge accounting shall continue to be used. By considering this, swap liability of Rs. 7.29 million should be recorded through profit and loss account and debenture liability should be reduced by Rs. 7.2 million. (changes being reported in profit and loss account)

Question 6

77.08% candidates secured passing marks in this question.

Common error:

Part (a)

The question was quite straight forward and the performance was good but there were many students who did not have any knowledge of the Islamic Financial Accounting Standards and could not write anything worthwhile. Many students used guesswork i.e. tried to answer in terms of IFRS 16.

Suggested answer:

When an asset is sold with an intention to enter into an Ijarah arrangement, gain or loss shall be recorded as follows:

Sold at fair value:
Profit or loss should be recognized immediately.

Sold at below fair value:
If the sale price is below fair value, any profit or loss should be recognized immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used.

Sold at above fair value:
If the sale price is above fair value, the excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

Part (b)

Common error:

1. Net commission expenses and underwriting expenses were not computed or computed incorrectly.
2. Proper headings were missing.

Suggested answer:

Real General Insurance Limited
Statement of Expenses
For the year ended 31 December 2016

Class	Commissions	Deferred commissions		Net commission expense	Other management expense	Underwriting expense	Commission from reinsurers	Net underwriting
		Opening	Closing					
Direct and Facultative	------------------------------ (Rs. in million) -----------------------							
Fire and property damage	460	210	222	448	352	800	333	**467**
Motor	189	87	89	187	640	827	-	**827**
Miscellaneous	73	27	30	70	104	174	136	**38**
	722	**324**	**341**	**705**	**1,096**	**1,801**	**469**	**1,332**
Treaty								
Proportional	-	-	-	-	-	-	-	-
Grand total	**722**	**324**	**341**	**705**	**1,096**	**1,801**	**469**	**1,332**

(The End)