

June 06, 2001

ADVANCED FINANCIAL ACCOUNTING
PE-1 (PAPER-1)

(MARKS 100)
(3 HOURS)

- Q.1(a) IAS-8 emphasizes that extra-ordinary items are expected to be rare. IAS-8 includes only two examples of events that might give rise to extra ordinary items. What are these events? **(03)**
- (b) What will be the result of a reclassification of available-for-sale securities to the held-to-maturity category? **(03)**
- (c) The following information pertains to Beta Ltd's investment in equity securities:
- (i) On June 30, 2000 Beta reclassified a security acquired during the year for Rs.700,000. It had a Rs.500,000 fair value when it was reclassified from trading to available-for-sale.
- (ii) An available for sale security costing Rs. 750,000 written down to Rs. 300,000 in 1999 because of an other than temporary impairment of fair value had a Rs. 600,000 fair value on June 30, 2000.
- Required:** Work out the net effect of the above items on Beta's net income for the year ended June 30, 2000 (show computation) **(07)**

- Q.2 A Ltd. acquired 30% of the share capital of B Ltd. on July 1, 2000 at a cost of Rs.2.70 M. The book value of the shares purchased by A Ltd was only Rs.2.10 M, according to B Ltd's financial statements as on June 30. A Ltd is willing to pay this excess for the following three reasons:
- i) B Ltd owned fixed assets with an estimated remaining life of 10 years that were worth atleast Rs.0.25 M more than book value.
- ii) B Ltd owned some very valuable pieces of real property acquired atleast 10 years ago which now are worth atleast Rs.1.25 M more than their book value.
- iii) A Ltd believes that B Ltd has developed organization structure which would work to their mutual benefit; that this goodwill did in fact exists. However, A Ltd has a policy of goodwill amortization over 10 years.

Both companies closed their books on December 31, 2000. B Ltd earned a profit of Rs. 2.10 M spread uniformly over the entire year. Also on December 31, 2000 B Ltd paid a dividend of Rs.1.40 M.

Required:

- (a) Compute the total amount of goodwill based upon the price paid by A Ltd for their stores acquired in B Ltd.
- (b) Prepare journal entries in the books of A Ltd relating to the investment in B Ltd for the year ended December 31, 2000 using (i) Cost method (ii) Equity method **(15)**

(2)

Q.3 The following are the balance sheets of Royal Ltd as at June 30, 1999 and 2000:

	June 30,	
	<u>2000</u>	<u>1999</u>
	(Rupees in thousands)	
Cash	8,000	7,000
Trade debts	11,280	11,680
Stock-in-trade	18,500	17,150
Fixed assets	33,070	29,670
Accumulated depreciation	(11,650)	(10,400)
Investment in B Ltd	3,050	2,750
Loan receivable	<u>2,700</u>	<u>--</u>
Total Assets	<u>64,950</u>	<u>57,850</u>
Accounts payable	10,150	9,550
Income Tax payable	300	500
Dividend payable	800	900
Finance lease obligations	4,000	---
Share capital	5,000	5,000
Share premium	15,000	15,000
Unappropriated profits	<u>29,700</u>	<u>26,900</u>
Total Liabilities and Equity	<u>64,950</u>	<u>57,850</u>

Additional data

- On June 30, 1999 Royal acquired 25% shares of B Ltd for Rs.2,750,000. On that date the carrying value of B's assets and liabilities, which approximate their fair value was Rs.11,000,000. B reported income of Rs.1,200,000 for the year ended June 30, 2000.
- During financial year 2000, Royal lent Rs.3,000,000 to Queen Ltd, an unrelated company. Queen made the first semi annual principal repayment of Rs.300,000 plus interest at 10% on April 1, 2000.
- On July 2, 1999 Royal sold equipment costing Rs.600,000 with a carrying amount of Rs.350,000 for Rs.400,000 cash.
- On June 30, 2000 Royal entered into finance lease for machinery. The PV of the annual rental payment is Rs.4,000,000 which equals the fair value. Royal made the first rental payment of Rs.600,000 when due on July 2, 2000.
- Net income for the year 2000 was Rs.3,600,000
- Royal declared and paid cash dividend as follows:

	<u>2000</u>	<u>1999</u>
Declared	June 15, 2000	June 15, 1999
Paid	August 30, 2000	August 30, 1999
Amount	Rs. 800,000	Rs.900,000

Required: Prepare a Cash Flow Statement for Royal Ltd. for the year ended June 30, 2000 (Worksheet and supplemental Schedule not required) (15)

(3)

Q.4 The following proforma Profit and Loss Account was prepared by a newly hired accountant at Rainbow Ltd. for the year ended June 30, 2000.

RAINBOW LIMITED
PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED JUNE 30, 2000

Revenue and gains

Gross Sales
Purchases discounts
Recovery of accounts receivable written off in prior years
Interest revenue
Gain on early extinguishment of debt
Total revenue and gains

Expenses and losses:

Cost of goods sold
Sales returns and allowances
Selling expenses
General and administrative expenses
Cash dividends declared
Total expenses and losses

Income before discounted operations and
Extraordinary item

Discounted operations:

Loss on disposal of discontinued styles, net of tax effect.

Extraordinary item:

Correction of errors in prior years' statement, net of tax effect
Retained earnings at beginning of year
Income tax
Net income
Retained earning at end of year.

Additional information:

- ◆ Rainbow uses the allowance method to account for uncollectible accounts.
- ◆ The loss on disposal of discontinued styles resulted from the sale of outdated styles within a product line.
- ◆ Rainbow had no temporary tax differences at the beginning or the end of the year.

Required:

Identify seven weaknesses in classification and presentation in the above statement. Explain the proper classification and presentation. Do not prepare a corrected statement.

(15)

(4)

Q.5 The newly hired Financial Controller of Indus Engineering working closely with the previous controller during the year 2000 made changes in accounting policies, corrected several errors in the financial statements from 1999 and before and instituted new accounting policies. The financial statements for the year 2000 of Indus Engineering for the year 2000 will be presented in comparative form with its previous year's financial statements.

List A, given below, represents classification of these transactions as a change in accounting principles, a change in accounting estimate, a correction of an error in previously presented financial statements or none of these. List B represents the general accounting treatment required for these transactions.

List A

- (i) Indus Engineering manufactures heavy equipment to customer specifications on a contract basis. On the basis that it is preferable, accounting for these long-term contracts was switched from the completed contract method to the percentage of completion method.
- (ii) As a result of a production breakthrough, it has been determined that manufacturing equipment previously depreciated over 15 years should be depreciated over 20 years.
- (iii) The equipment that Indus Engineering manufactures is sold with a 5-year warranty. Because of a production breakthrough, Indus reduced its computation of warranty costs from 3% of sales to 1% of sales.
- (iv) Indus changed from LIFO to FIFO to account for its finished goods inventory.
- (v) Indus changed from FIFO to average cost to account for its raw materials and work-in-process inventories.
- (vi) Indus sells extended services contract on its products. Since related services are performed over several years, in the year 2000 Indus changed from the cash method to the accrual method of recognizing income from these service contracts.
- (vii) Indus changed its method of depreciation of office equipment from an accelerated method to the straight-line method to reflect cost more closely in later years.
- (viii) Indus instituted a pension plan for all employees in FY 2000. Indus has not previously had a pension plan.

List B

- (a) Cumulative effect approach - include the cumulative effect the adjustment resulting from the accounting change or error correction in the 2000 financial statements, and do not restate the 1999 financial statements.
- (b) Retroactive restatement approach - Restate the 1999 financial statements and adjust 1999 beginning retained earnings if the error or change affects a period prior to 1999.
- (c) Prospective approach - Report 2000 and future financial statements on the new basis, but do not restate 1999 financial statements.

Required:

For each item (i) to (viii), select one from List B. Give brief reason for your selection in each case.

(20)

Q.6 State the criteria, which should be met by a segment to qualify as reportable segment, under IAS-14.

(07)

(5)

Q.7 Farhan Ltd. traditionally follows a highly aggressive working capital policy with no term borrowing. Key details from its recent accounts are:

	Rs. in million
Sales (all on credit)	10.00
Earnings before mark-up and tax	2.00
Mark-up payment for the year	0.50
Shareholders' funds	20.00
(Comprising Rs.10 m as share capital and Rs. 10 m as revenue reserve) (Face value of shares is Rs.10/-)	
Debtors	0.40
Stocks	0.70
Trade Creditors	1.50
Short Term Running Finance	3.00

A major supplier which accounts for 50% of Farhan's cost of sales has offered Farhan the opportunity to pay for supplies within 15 days in return for a discount of 5% on the invoiced value.

Farhan holds no cash balance but able to borrow from banks at 12%. Tax rate on corporate profit is 33%.

Required:

Determine the costs and benefits to Farhan of the above offer specifically considering the effect on:

- The working capital cycle
- Mark-up cover
- Profit after tax
- EPS
- Return on equity
- Capital gearing

(15)

(THE END)