THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Intermediate Examinations Autumn 2007

September 06, 2007

FINANCIAL ACCOUNTING (MARKS 100)

Module C (3 hours)

Q.1 D, E and F were partners in the firm DEF & Company and shared profit and loss in the ratio 5:3:2 respectively. On July 01, 2007, F informed the other partners that he has suffered heavy losses in one of his personal businesses and is unable to pay his debts. He therefore requested D & E to settle his account in the partnership. D & E agreed to continue the business without F but at the same time agreed to convert the partnership into a limited company named Paradise Limited.

The trial balance of the firm as on June 30, 2007 appeared as follows:

	Debit	Credit
	Rupees in thousands	
Cash in hand	8,000	
Trade debts	7,000	
Inventories	5,000	
Trade creditors		9,000
Other liabilities		5,000
Partners' capital – D		21,000
– E		13,000
– F		2,000
Land and building	10,000	
Plant	20,000	
	50,000	**50,000**

All the partners agreed to the following:

(i) On the basis of previous experience it was estimated that 4% of the trade debts will not be recovered. These shall be recorded in the new company accordingly.

(ii) A creditor has left the country about five years ago and is not expected to claim his dues amounting to Rs. 50 thousand.

(iii) A fully depreciated fixed asset costing Rs. 120 thousand was written off in March 2006. However the same is still in use and has a fair market value of Rs. 100 thousand.

(iv) Goodwill of the firm is estimated at Rs. 1,120 thousand. However, it shall not be recorded in the books of the new company.

(v) Expenses incurred on the incorporation of Paradise Limited amounting to Rs. 120 thousand were paid by E. The company will issue 6% preference shares in lieu of the above.

(vi) Salaries of Rs. 300 thousand had been credited to each partner's capital accounts while recording the distribution of profits for the year ended June 30, 2007. On the insistence of F, it was agreed that based on the amount of efforts put in by D & E, the salaries allowed to them should be reduced by 30%.

(vii) The paid-up capital of the company shall comprise of 4.0 million shares of Rs. 10 each, which shall be contributed equally by D & E.

Required:
Prepare the following:
(a) Partners' Capital Accounts
(b) Realization Account
(c) Opening Balance Sheet of Paradise Limited **(20)**

Q.2 Naseer Distributors have sole distribution rights of different products. These rights were bought at substantial prices. According to the company's policy the cost of distribution rights are amortized over a period of ten years at a rate of 15% per annum for the first five years and 5% per annum during the next five years.

While reviewing the accounting policies the management concluded that the policy of amortization of distribution rights does not reflect the pattern in which benefits flow to the company. Accordingly, they decided to amortize such rights over a period of eight years at a rate of 20% per annum for the first four years and 5% per annum during the last four years.

The relevant details are as follows:

Rupees in '000'

Products	**S**	**T**	**U**
Cost of distribution rights	50,000	40,000	27,000
Accumulated amortization upto June 30, 2007 *(Under the old policy)*	15,000	32,000	24,300
Recoverable value	31,000	4,000	250

The management has been following a policy of recording gratuity on the basis of payments. From this year it decided to account for the liability, in accordance with the International Accounting Standards. A consultant was hired who had submitted his report, the extracts from which are as under:

Rupees in '000'

Year	**Provision required**	**Payment made**
2005	1,500	200
2006	2,100	900
2007	2,500	700

Some of the extracts from the company's trial balances after charging amortization under the existing policy are as follow:

	Rupees in '000'	
	June 30, 2007	**June 30, 2006**
Sales	813,000	718,000
Purchases	610,000	520,000
Amortization on intangible assets	18,250	22,250
Depreciation expenses	12,000	12,000
Salaries	46,000	45,000
Gratuity	700	900
Stocks	22,000	26,000
Other expenses	90,000	87,000
Wastage sales	2,000	2,700
Gain on sale of property	42,000	-

Closing stocks as on June 30, 2007 was valued at Rs. 18,250 thousand. Income tax rate applicable to the company is 35%. Amortization is not allowed as tax expense whereas gratuity is allowed to the extent of payments made.

Required:
Prepare a profit and loss account for the year ended June 30, 2007 with comparative figures under the new policy in accordance with the requirements of International Accounting Standards (Ignore deferred tax). **(18)**

Q.3 Following is the trial balance of ABC Limited as at June 30, 2007.

	Debit	Credit
	Rupees in thousands	
Freehold land	17,000	
Building	60,000	
Accumulated depreciation – building		24,000
Plant and machinery	30,000	
Accumulated depreciation – plant and machinery		15,000
Motor vehicles	16,000	
Accumulated depreciation – motor vehicles		9,600
Furniture, fixtures and equipment	4,500	
Acc. Depreciation – furniture, fixtures and equipment		2,000
Long term deposits	4,000	
Investments	25,000	
Advance for expenses	1,500	
Other receivables	2,000	
Trade debtors	16,000	
Trade creditors		8,000
Other liabilities		1,300
Provision for gratuity		10,000
Long term deposits received from suppliers		5,200
Paid-up share capital		80,000
General reserve		19,700
Cash and bank balances	17,000	
Stock in hand – raw material	11,000	
– work in progress	4,500	
– finished goods	2,100	
Sales		334,050
Purchases – raw materials	216,000	
Discount on purchases		2,300
Purchase returns		17,000
Salaries and wages	24,000	
Depreciation expenses	9,050	
Advertising expenses	2,500	
All other expenses	66,000	
	528,150	**528,150**

Following details are available:

(i) Depreciation has been provided on straight line basis. Estimated useful lives are as under:

Building	25 years
Motor vehicles	5 years
All other fixed assets	10 years

(ii) Office furniture costing Rs 750 thousand and book value of Rs 150 thousand was traded in for Rs 120 thousand, against new furniture worth Rs 500 thousand. However, the new furniture was erroneously recorded at the net payment of Rs. 380 thousand.

No other additions or deletions were made during the year.

(iii) Purchase returns include a sum of Rs 2,350 thousand which represents the cost of an item which was returned to the supplier erroneously. On the balance sheet date the supplier was holding the item on behalf of the company and delivered it back after the year end.

(iv) On the basis of physical stock check carried out at the factory premises on June 30, 2007 the value of closing stock was determined as under:

	Rs. in '000'
Raw material	8,200
Work in process	3,240
Finished goods	530

(v) The management intends to hold the investments on long term basis.

(vi) 60 % of all expenses other than directly attributable expenses are allocated to manufacturing.

Required:
Prepare the balance sheet and the profit and loss account alongwith the notes on fixed assets and cost of goods sold. Make all possible disclosures as required under the International Accounting Standards and Companies Ordinance, 1984. **(25)**

Q.4 As part of annual routine, PQR & Company is testing the value of its assets to ascertain the impairment (if any). Following information is available in respect of the assets:

Assets	**WDV**	**Value in use**	**Forced sale value**	**Fair value**
	Rupees in thousand			
A	3,200	3,100	2,400	2,500
B	1,500	1,200	1,225	1,400
C	1,700	1,500	1,900	2,000

Every asset is sold through public tender, which costs around Rs. 50,000. Assets A and C are required to be dismantled at the time of sales and the cost of dismantling is Rs. 100 thousand and Rs. 200 thousand respectively. Sale agreements of the assets are prepared by the company's legal advisor whose annual fee is Rs. 365 thousand. It takes about 4 days to draft a sale agreement.

Required:
Compute impairment (if any) on each asset. **(07)**

Q.5 You are the Chief Financial Officer of Breeze Limited, a newly incorporated company which manufactures portable air conditioners. The company has started commercial production on September 01, 2006. While reviewing the financial statements on July 31, 2007 before presentation to the board of directors for approval, you found that the following information has not been dealt with in the financial statements:

(i) While constructing the factory building it was agreed with the Union Council of the area that any damage caused to a nearby school will be restored by the company. As a gesture of goodwill the company had also offered that a donation of Rs. 500,000 would be given to the school provided the Union Council also gives a similar grant. On the balance sheet date, it was almost certain that the Union Council would pay the grant. The damage caused by construction was restored at a cost of Rs. 650,000 in July 2007. The Union Council paid the grant of Rs. 500,000 to the school in July 2007.

(ii) Within six months from the start of commercial production, the company was required to maintain an in-house workers' canteen and provide subsidized meals to its workers. The cost of construction of such canteen was Rs. 800,000; whereas cost for running the canteen was Rs. 142,000 per month. The company failed to comply with the requirement of the law.

The concerned authority took a serious note of the situation and issued a show cause notice on July 18, 2007. To avoid adverse consequences the company decided to start construction of the canteen immediately. It was also decided that during the construction period, the company would reimburse the full amount of meal expenses of its workers. The construction is expected to be completed on August 30, 2007.

(iii) The company allows full refund if the goods sold by it are returned within two months from the date of sale. According to the best estimate, the goods return ratio is 10 percent. The returned goods can be sold in second hand market at cost which is 60% of the selling price. The accounts were appropriately adjusted on June 30, 2007 based on the above estimates. The actual returns and the relevant information is summarized below:

Month of sales	Amount of sales	Returns during the month		
		May, 07	June, 07	July, 07
	Rs. in million			
May, 07	28.00	-	0.20	2.10
June, 07	32.00	-	-	0.40

Required:
Discuss each event in the light of the relevant International Accounting Standards and suggest how these should be dealt in the financial statements for the year ended June 30, 2007. **(15)**

Q.6 Focus Limited is engaged in manufacturing multimedia projectors. The company spends heavily on research and development to introduce improvements in the existing products.

A free lance researcher Mr. Talent sent a conceptual paper to the company on development of a new type of projector which will significantly enhance the life and quality of the product.

An agreement was reached between Mr. Talent and the company whereby Mr. Talent agreed to conduct and supervise the research and development process at a lump sum remuneration of Rs. 8 million. However, in case the research was unsuccessful, he agreed to reduce his remuneration to a time based salary of Rs. 2,000 per hour.

The process of research commenced from July 2006 and the following costs were incurred upto June 30, 2007.

	Rs. In million
Tools purchased	2.000
Furnishing of the new laboratory	0.800
Salaries paid to research associates	1.620
Cost of conducting tests in U.K. on a device which was ultimately used in the final product	0.400
Remuneration paid to Mr. Talent on successful completion of research	4.500
Expenses on preparing technical feasibility	0.250
Cost of manufacturing the samples before commencement of commercial production	0.240
Material imported for commercial production	1.700
Final payment to Mr. Talent	3.500
Product launching expenses	1.200

Required:
Discuss the accounting treatment of each of the above costs incurred by the company in the light of International Accounting Standard 38 'Intangible Assets'. **(15)**

(THE END)