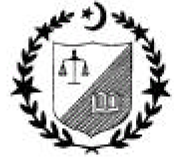
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN



Final Examinations Winter 2004

December 07, 2004

SPECIFIED PAPER OF ADVANCED ACCOUNTING & FINANCIAL REPORTING; MANAGEMENT ACCOUNTING; BUSINESS FINANCE DECISIONS

(Marks 100)
(3 hours)

Q.1 The Directors of Ocean Limited have decided to concentrate the company's activities on three core areas i.e. boat building, boat manning and tug services. As a result the company has offered for sale the Dry Port that it owns.

The existing managers of the dry port, along with some employees, are attempting to purchase the dry port through a leveraged management buy-out, and would form a new unquoted company, Ahmed (Private) Limited (APL). The total value of the dry port (free of any debt) has been independently assessed at Rs.35.0 million.

The managers and employees can raise a maximum, of Rs.4.0 million towards this cost. This would be invested in new ordinary shares issued at par value of Rs. 50 per share. Ocean Limited, as a condition of sale, propose to subscribe to an initial 20% equity holding in the company, and would repay all the debt of the dry port prior to the sale.

ABC Bank Limited is prepared to offer a floating rate loan of Rs.20.0 million to the management team, at an initial interest rate of KIBOR plus 3%. KIBOR currently is at 4%. This loan would be for a period of seven years repayable on maturity, and would be secured against the dry port's land and buildings. A condition of loan is that gearing measured by the book value of loans to equity, is no more than 100% at the end of four years. APL would be able to purchase a four-year interest rate cap at 9% for an upfront premium of Rs. 800,000.

A venture capital company VC Limited, is willing to provide upto Rs. 15.0 million in the form of unsecured debt with attached warrants. This loan would be for a period of five years with principal repayable in equal annual installments, and have a fixed interest rate of 11% per year. The warrants would allow VC limited to purchase 10 APL shares at a price of Rs.100 each for every Rs.10,000 of initial debt provided, at any time after two years from the date the loan is agreed. The warrants would expire after five years.

Last year the profit after tax of the dry port was Rs. 2,412,000 which is expected to increase by approximately 5% per year. Ocean Limited has offered to continue to provide central accounting, personnel and marketing services to APL for a fee of Rs. 3.0 million per year with the first fee payable in year1.

Required:

Prepare a report on the proposal discussing the advantages for the management buy-out. Include in your report the problems the new management is expected to face in managing the financial position and your suggestions in this regard. **(20)**

Q.2 Diamond (Private) Limited (DPL) is considering setting up new division to manufacture hand gloves for the local market. For this purpose, it has carried out a feasibility study at the cost of Rs. 100,000 which suggests that at the selling price of Rs. 65 per glove, DPL will be able to sell 10,000 gloves each year. Demand for this variety of gloves is expected to cease after five years. The following data related to cost has been collected:

- Gloves would be manufactured in a small facility specifically rented for this purpose. Monthly rental would be Rs. 8,000 per month.
- A manager would be employed to supervise the production at a salary of Rs.14,000 per month. The said person is currently working with DPL but is due to retire in the near future on a monthly pension of Rs. 5,000 per month payable by the company. His subsequent rights would not be affected if he is hired for glove division, however, he will not be getting any pension during this period.
- A machine would be imported to produce gloves at a cost of Rs. 500,000. DPL depreciated its asset over its useful life using the straight-line method. The machine is expected to have no residual value. However, it can be used for manufacturing of socks after five years. Currently DPL does not produce socks, but it may consider this option after five years. The replacement cost of the machine for producing socks after five years would be Rs. 150,000.
- DPL allocates head office cost to all products at the rate of Rs. 10.25 per direct labour hour. The total head office cost is expected to remain the same.
- Direct labour hours required for the production of one glove is 2, which will be paid at the rate of Rs. 10 per hour.
- 3 Kg of material per unit would be required at the rate of Rs. 3.5 per Kg.

The division is expected to commence production on January 01, 2004. The cost of capital of DPL is estimated to be 10% per year in real terms. All cash flows would arise at the end of each year, with the exception of purchase of machine and feasibility study cost which is payable on January 01, 2004. The directors of DPL are very confident about the accuracy of all the estimates with the exception of those relating to product life, annual sales volume and material cost per unit.

Required:

a) Determine whether DPL should set up the new division. **(08)**

b) Demonstrate through calculation the sensitivities of the net present value of manufacturing gloves **(09)**

Q.3 On July 1, 2003, K Ltd uses 'Fair Value Model' for valuation of its investment property. K Ltd purchased an investment property at 10% less than market value. The market value was Rs. 1,000,000. It was agreed that the payment would be made over the remaining useful life of the property i.e. on July 1, 2005. It was further decided that interest @ 10% per annum would be charged on reducing balance method. K Ltd also incurred the following expenditures; Lawyer's fee Rs. 30,000; property transfer tax Rs. 50,000 and Rs. 20,000 as other transaction cost. On June 30, 2004 market value of the investment property was 20% higher than the carrying value. Profit before tax on that date without considering the impact of the above transaction was Rs. 300,000.

Required:

Under IAS 40 "Investment Property" calculate as on June 30, 2004.

a) The carrying amount of the investment property.
b) Profit before tax after considering the impact of the above transactions. **(10)**

Q.4 ABS Ltd. has 50% interest in a jointly controlled entity namely Petaro Products Ltd. Balance Sheet of ABS Limited and Petaro Products Ltd. as at June 30, 2003 are as follows:

Balance Sheet	**ABS Ltd.**	**Petaro Products Ltd.**
	Rs. 000	
Issued, subscribed and paid up capital	1,000	200
General Reserves	200	-
Unappropriated profit	200	40
	1,400	240
Current liabilities		
Creditors	100	10
Accrued expenses	100	10
	1,600	260
Fixed assets – net of depreciation		
Building	200	-
Plant	200	100
Vehicles	100	40
Furniture	100	-
	600	140
Long term investments	500	-
Current assets		
Stock	200	40
Receivables	200	60
Cash and bank balances	100	20
	500	120
	1,600	260

Required:

A venturer should report its interest in a jointly controlled entity using one of the two reporting formats for proportionate consolidation under benchmark treatment given in IAS 31 (reformatted 1994) Financial Reporting of Interest in Joint Ventures. One reporting format is using line-by-line basis. Prepare consolidated balance sheet of ABS Ltd using the other format for proportionate consolidation under benchmark treatment. **(15)**

Q.5 Danish Ltd issued half of its authorized capital of ordinary shares of Rs 10 each during the year ended June 30, 2003 as follows:

a) Purchased machinery worth Rs. 6,000,000 against issue for 660,000 shares.
b) Paid commission @ 4% on 400,000 shares which were subscribed and paid by general public.
c) Promoters acquired 190,000 shares at par, paid Rs 150,000 in cash and for balance surrendered a plot of land in favour of the company.

Preliminary expenses incurred amounted to Rs 800,000

The management decided that no depreciation to be charged as the machinery was installed in June 2004 and to write off deferred costs, if any, over the maximum period allowed under the Companies Ordinance, 1984.

Further Information:

Sales Rs 700,000; cost of goods sold Rs 350,000; administration and selling expenses Rs 150,000. No tax provision is required.

Required:

Prepare balance sheet of Danish Ltd from the given information meeting maximum disclosure requirements under the Companies Ordinance, 1984. **(16)**

Q.6 A small project has the following time schedule:

Activity	Time in months
1 – 2	2
1 – 3	2
1 – 4	1
2 – 5	4
3 – 6	8
3 – 7	5
4 – 6	3
5 – 8	1
6 – 9	5
7 – 8	4
8 – 9	3

Required:

(a) Compute the total float for each activity.
(b) Find out the critical path and its duration. **(10)**

Q.7 Shelton Corporation manufactures product ‘P’. The Production Department has developed another process of manufacturing which will change the cost structure altogether as give below:

	Existing process **Rs.**	New process **Rs.**
At 10,000 unit production:		
Raw materials	270,000	170,000
Direct labour	102,000	78,500
Factory Rent	80,000	80,000
Utilities – Fixed	100,000	100,000
“ - Variable	40,000	100,000
Other FOH – Fixed	100,000	220,000
“ - Variable	8,000	31,500

Product ‘P’ is getting popular day by day and production level is expected to grow substantially in near future.

Required:

Determine the production level at which the management should decide to switch over to the new process. **(12)**

(THE END)