THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Final Examinations Winter 2008

December 2, 2008

ADVANCED ACCOUNTING AND FINANCIAL REPORTING

(MARKS 100)
(3 hours)

Q.1 Golden Limited (GL) is a listed company and has held shares in two companies, Yellow Limited (YL) and Black Limited (BL), since July 1, 2006. The details of acquisition of shares in these companies are as follows:

(A) GL acquired 18 million shares in YL at par, when YL's reserves were Rs. 24 million. The acquisition was made by issuing four shares in GL for every five shares in YL. The market price of GL's shares at July 1, 2006 was Rs. 20 per share. A fair value exercise was carried out for YL's assets and liabilities at the time of its acquisition with the following results:

	Book Value	Fair Value
	Rupees in million	
Land	170	192
Machines	25	45
Investments	3	6

The remaining life of machine on acquisition was 5 years. The fair values of the assets have not been accounted for in YL's financial statements.

(B) 6 million shares in BL were acquired for Rs. 12 per share in cash. At the date of acquisition, the reserves of BL stood at Rs. 40 million.

The summarized income statement of the three companies for the year ended June 30, 2008 are as follows:

	GL	YL	BL
	Rupees in million		
Sales	875	350	200
Cost of sales	(567)	(206)	(244)
Gross profit / (loss)	308	144	(44)
Selling expenses	(33)	(11)	(15)
Administrative expenses	(63)	(40)	(16)
Interest expenses	(30)	(22)	(15)
Other income	65	-	-
Profit/(loss) before tax	247	71	(90)
Income tax	(73)	(15)	8
Profit/(loss) for the period	174	56	(82)

The following relevant information is available:

(i) The share capital and reserves as at July 1, 2007 were as follows:

	GL	YL	BL
	Rupees in million		
Ordinary share capital of Rs. 10 each	600	200	150
Reserves	652	213	108

The share capital of all companies have remained unchanged since their incorporation.

(ii) During the year, GL sold goods amounting to Rs. 40 million to YL. The sales were made at a mark up of 25% on cost. 30% of these goods were still in the inventories of YL at June 30, 2008.

(iii) GL manufactures a component used by BL. During the year, GL sold these components amounting to Rs. 20 million to BL. Transfers are made at cost plus 15%. BL held Rs. 11.5 million of these components in inventories at June 30, 2008.

(iv) All assets are depreciated on straight line method.

(v) Other income includes dividend received from YL on April 15, 2008.

(vi) During the year, YL paid 20% cash dividend to its ordinary shareholders.

(vii) An impairment test was carried out on June 30, 2008 for the goodwill of YL and investments in BL, appearing in the consolidated financial statements. The test indicated that:

- goodwill of YL was impaired by 20%;
- due to recent losses, the fair value of investment in BL has been reduced to Rs.40 million.

No such impairment was required in previous years.

Required:
Prepare, in a format suitable for inclusion in the annual report, a consolidated income statement for the year ended June 30, 2008. **(22)**

Q.2 Silver Construction Limited (SCL) was incorporated on July 1, 2007 with a share capital of Rs. 500 million. It is involved in the construction of bridges, dams, pipelines, roads etc. During the year ended June 30, 2008, the company commenced work on six contracts, details of which are as follows:

	C O N T R A C T S					
	I	**II**	**III**	**IV**	**V**	**VI**
	---------- Rupees in million ----------					
Total contract price	300	375	280	400	270	1,200
Billing up to June 30, 2008	200	110	280	235	205	1,200
Contract cost incurred up to June 30, 2008	248	68	186	246	185	1,175
Estimated further cost to complete	67	221	-	164	15	-

Following additional information is available:

(i) As per terms of Contract IV, the company will receive an additional Rs.40 million if the construction is completed within a period of twelve months from the commencement of the contract. The management feels that there is a 90% probability that it will be able to meet the target.

(ii) An amount of Rs. 16 million was incurred on Contract II on account of a change in design. The company has discussed it with the customer who has informed SCL that the amount is on the higher side and needs to be revised.

Required:

(a) Make relevant calculations and prepare appropriate extracts to be reflected in the Balance Sheet and Income Statement for the year ended June 30, 2008.

(b) Justify your accounting treatment in respect of the additional information provided above. **(19)**

Q.3 Red Limited has carried out the following transactions during the year ended June 30, 2008.

(a) On July 1, 2007, the company has received a loan of Rs. 100 million from Green Limited – a related party which is due for repayment after three years and does not carry any interest. The market interest rate for similar loans is 15% per annum. Red Limited is subject to taxation at the rate of 35%.

(b) On August 1, 2007, the company granted 200,000 employees' stock options at Rs. 5, when the market price was Rs. 13 per share. 95% of the options were exercised between March 1, 2008 and April 30, 2008. The remaining options lapsed. The share capital of the company is divided into shares of Rs. 10 each.

(c) The company holds 500,000 shares of Green Limited (GL), a listed company, which were purchased many years ago at Rs. 10 per share. The transaction cost on purchase was Rs. 120,000. The shares were classified as available for sale. On May 31, 2008, the fair value of GL's shares was Rs. 20 per share. On the same day, GL was acquired by Orange Limited (OL), a listed company. As a result, Red Limited received 200,000 shares of OL which had a market value of Rs. 65 per share, on that date.

Required:
Prepare journal entries to record the above transactions including the effect of deferred tax thereon, if any, in the books of Red Limited, for the year ended June 30, 2008. **(21)**

Q.4 Blue-chip Asset Management Limited is in the process of finalizing the financial statements of one of its open ended mutual fund. Following information is available from the Fund's records;

	Rs. in "000"
Net assets - opening balance	350,050
Net income for the year	65,325
765,900 units issued during the year against	85,015
717,480 units redeemed during the year against	77,488

The par value of each unit is Rs. 100.

Required:
Prepare the statement of movement in unit holders' Fund for the year ended June 30, 2008. **(10)**

Q.5 Violet Power Limited is running a coal based power project in Pakistan. The Company has built its plant in an area which contains large reserves of coal. The company has signed a 20 years agreement for sale of power to the Government. The period of the agreement covers a significant portion of the useful life of the plant. The company is liable to restore the site by dismantling and removing the plant and associated facilities on the expiry of the agreement.

Following relevant information is available:

(i) The plant commenced its production on July 1, 2007. It is the policy of the company to measure the related assets using the cost model;
(ii) Initial cost of plant was Rs. 6,570 million including erection, installation and borrowing costs but does not include any decommissioning cost;
(iii) Residual value of the plant is estimated at Rs. 320 million;
(iv) Initial estimate of amount required for dismantling of plant, at the time of installation of plant was Rs. 780 million. However, such estimate was reviewed as of June 30, 2008 and was revised to Rs. 1,021 million;
(v) The Company follows straight line method of depreciation; and
(vi) Real risk-free interest rate prevailing in the market was 8% per annum when initial estimates of decommissioning costs were made. However, at the end of the year such rate has dropped to 6% per annum.

Required:
Work out the carrying value of plant and decommissioning liability as of June 30, 2008. **(08)**

Q.6 You are working as a Financial Analyst in Brown Venture Capital Limited. Your company has received an offer for equity investment in a large group of companies. While reviewing the consolidated financial statements of the group and detailed offer documents, you have noted the following significant judgments, estimates and assumptions used in preparation of the consolidated financial statements, which may have an impact on the independent evaluation of the affairs and operations of the group.

Operating Lease Commitments
The Group has entered into commercial property leases as a Lessee. The Group has determined, based on an evaluation of the terms and conditions of the arrangements, that it does not acquire all the significant risks and rewards of ownership of these properties and so accounts for the contracts as operating leases.

Convertible Preference Shares
The Group has determined, based on an evaluation of the significant terms and conditions of the issue, that these securities fall under the category of liability rather than equity, and have been disclosed and accounted for accordingly.

Pension and Other Post Employment Benefits
The cost of defined benefit pension plans and other post employment benefits is determined using actuarial valuations. The actuarial valuation involves making assumptions about discount rates, expected rates of return on assets, future salary increases, mortality rates and future pension increases. Due to the long term nature of these plans, such estimates are subject to significant uncertainty.

Impairment of Non-Financial Assets
All non-financial assets including goodwill and other intangibles are assessed for impairment at each reporting date and at any other time when there are indications of impairment. When value in use calculations are undertaken, management has to estimate the expected future cash flows from the asset or cash-generating unit and choose a suitable discount rate in order to calculate the present value of such cash flows.

Useful Lives of Property, Plant And Equipment
The Group has invested significant amounts in acquisition of items of property, plant and equipment (PPE). Generally, the Group follows a prudent practice and estimates the useful economic lives of such assets to the enterprise on a minimum side.

Provision for Decommissioning
The activities of the Group normally give rise to obligations for site restoration. In determining the amount of the provision, assumptions and estimates are required in respect of discount rates and the expected cost of dismantling and removing the plants from the site.

Required:
You have assessed that the managements judgments, estimates and assumptions may turn out to be incorrect. What will be the impact of any error in management’s estimates and assumptions, on the following:

- Liquidity, profitability and gearing ratios of the group;
- Business valuation of the group.

Give brief explanations to justify your conclusions. **(20)**

(THE END)