THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Intermediate Examinations   Spring 2007

March 6, 2007

FINANCIAL ACCOUNTING (Marks 100)

Module C (3 hours)

Q.1 Following information is available from the records of Best Furniture Limited (BFL):

(i) A lease agreement was negotiated with a leasing company in October, 2006 for a nails manufacturing machine having fair value of Rs. 1,000,000. The lease rental has been agreed at Rs. 325,000 and is payable at the end of each year for three years. BFL replaces such machines after 5 years.

(ii) The same leasing company has also leased an electrical wood cutter at a lease rental of Rs. 50,000 payable at the end of each year for a term of two years. Fair value of the cutter is Rs. 100,000. Although such cutters can be used for more than four years but BFL replaces them in two and half years' time.

At the end of the term BFL will have an option to purchase the leased items at a price to be agreed between the parties. BFL's incremental borrowing rate is 11%.

Required:
Explain with reference to IAS 17 (Leases), whether the above leases shall be classified as an operating lease or a finance lease in the books of Best Furniture Limited. **(09)**

Q.2 Model Security Limited (MSL) is a supplier of high quality security systems. The company also provides services for maintenance of the systems. Following are some of the transactions which were carried out in January, 2007:

(i) Two systems were delivered to a customer on January 05, 2007. According to the terms of sale, MSL was required to install the systems within three months. The installation work was completed on February 28, 2007. Sale price and installation charges of Rs. 60,000 and Rs. 25,000, respectively, had been paid by the customer in advance.

(ii) A service contract was signed under which MSL was required to provide repair and maintenance with parts and accessories. A non-refundable annual fee amounting to Rs. 60,000 was received as advance on January 01, 2007.

(iii) A firm contract was signed, for supply of sixty systems at a price of Rs. 55,000 each. The systems were required to be altered for the customer's specific requirement. It was agreed that in case of cancellation, the customer will have to pay a compensation equal to 25% of the total agreed price. MSL has estimated that it would have to bear a cost of Rs. 12,000 to bring the systems in general saleable condition. According to the agreement, the customer had paid 25% advance on January 17, 2007.

(iv) Three systems have been delivered and installed at the office premises of Mr. Fine, a close friend of Chief Executive Officer (CEO), on January 08, 2007. The accountant has not recorded the sale, as the amount of discount has not been decided by the CEO. List price of each system is Rs. 2.5 million.

Required:
With reference to IAS 18 (Revenue) explain how and when the sale should be recorded in each of the above case. **(08)**

Q.3 Following data is available with Pink Limited in respect of two of its regular customers who are engaged in the same kind of business:

	Customer 'A'	Customer 'B'
	(Rs. in million)	
Stock in trade	22.00	74.00
Trade debtors	14.67	51.80
Other current assets	21.00	8.00
Trade creditors	37.40	53.10
Bank overdraft	-	10.00
Sales	176.00	259.00
Cost of sales	149.60	212.38

Credit committee of Pink Limited has decided to allow credit limit of Rs. 18 million to both customers. However, Mr. Alam, a member of the committee, had some reservations on extending credit facility to customer 'A'.

Required:
Compute and interpret the relevant ratios of each customer and submit your comments on the opinion of Mr. Alam. **(10)**

Q.4 Following is a summarized trial balance of Gray Limited as on December 31,

	(Rs. in million)	
	2006	**2005**
Debits		
Fixed asset- tangible (net of accumulated depreciation)	292	103
Capital work in progress	-	210
Intangible asset	12	12
Accumulated amortization on intangible asset	8	4
Inventories	3	5
Trade receivables	311	200
Other receivables	5	8
Bank balances	14	8
Cost of sales	992	943
Administrative expenses	145	132
	1,782	1,625
Credit		
Payables	242	225
Paid up capital	100	75
Share premium	150	125
Sales	1,232	1,150
Retained earnings	58	50
	1,782	1,625

Following further information is available:

(i) Retained earnings have been debited in 2006, on account of dividend payments of Rs. 25 million (2005: Rs. 22 million) and on account of dividend proposed and approved in January, 2007 amounting to Rs. 42 million.

There was no change in 'Paid up capital account' during the year 2005.

(ii) During the year 2005, cost incurred on testing of a new plant amounting to Rs. 12 million was accounted for as an intangible asset.

(iii) No depreciation was charged on the new plant mentioned in (ii) above although it was ready for intended use on January 01, 2006. The cost of plant is Rs. 210 million and rate of depreciation is 15%.

(iv) The company had made no provision in the years 2004 and 2005 in respect of some of its overdue debtors as they were fully secured then. However, the security has been impaired and management now feels that a provision for Rs. 2, 4 and 5 million is necessary in respect of the years 2004, 2005 and 2006, respectively.

Required:

(a) Make necessary adjusting entries. Ignore taxation. **(10)**

(b) Prepare 'Statement of Changes in Equity' for the year ended December 31, 2006. **(16)**

Q.5 White Limited is engaged in the construction of small townships. It announced a new township with a name and style of 'Ashiyana'.

The estimated cost of the project is as under:

Land	Rs. 180 million
Construction	Rs. 100 million

The company planned to finance the project through shareholders' equity, bank loan and down payments to be received from buyers. The land required for the project was in the possession of the company and had been acquired in 2003. The construction started on January 01, 2006 and completed on November 30, 2006.

Details of costs incurred are as follows:

Date of Bills	Particulars	Rs. in million
Feb 16, 06	Documentation	2.50
Mar 16, 06	Land preparation	13.50
May 16, 06	Structure	50.00
Dec 16, 06	Finishing	38.50

All the above bills were paid on the same dates except for Rs. 15 million included in finishing cost, which was paid in January, 2007.

Funds were arranged as under:

Date	Source	Rs. in million	Finance cost
Mar 01, 06	Shareholders equity	10.00	Yield required is 30%
Mar 01, 06	Bank Loan-A	30.00	Carry markup @ 12% p.a.
Mar 01, 06	Bank Loan-B	40.00	Carry markup @ 18% p.a.
Dec 16, 06	Down payments	24.50	No financial cost

Required:

Determine the amount of borrowing cost that can be capitalized by the company under IAS 23 (Borrowing Costs). **(15)**

Q.6 Following transactions were carried out by Yellow Limited during the year ended June 30, 2006.

(i) Mr. Sharp, a well-known management consultant was hired, to conduct a three weeks workshop on time management for the staff of the company at a fee of Rs. 0.5 million. Mr. Sharp is the son of the Chief Executive Officer.

(ii) A loan of Rs. 30 million was obtained from Blue Bank Limited. The loan was negotiated by Mr. Slim, General Manager Finance of Yellow Limited, who was formerly a senior executive of the Bank.

(iii) Three used delivery trucks of the company were sold to Red Supplies Limited, which supplies approximately 60% of the total raw material used by the company.

(iv) Granted interest bearing loan to its Chief Executive Officer for construction of house in accordance with the company's policy relating to employees' benefit.

(v) Paid mobilization advance of Rs. 9 million against a construction contract to Orange Limited which is owned by Mr. Clear, a member of a reputed business family. Two influential directors of the company are nephews of Mr. Clear.

(vi) The company awarded a contract for plant maintenance services to its subsidiary Brown (Pvt.) Limited effective August 01, 2007.

(vii) The company has nominated a director in Purple Limited who participates actively in its operational decisions. However, no business relations exist between the two companies.

Required:
For each case, discuss the requirement of IAS 24 (Related Party Disclosures) as regards the following disclosures in the financial statements for the year ended June 30, 2006:

(a) Related party relationship; and
(b) Related party transactions. **(14)**

Q.7 A summarized trial balance of Green Limited for its first year is given below:

	(Rs. in million)	
	Debit	**Credit**
Paid up capital	-	131.50
Payables	-	3.50
Land	60.00	-
Buildings	35.00	-
Other fixed assets-tangible	22.00	-
Product research costs	15.00	-
Product development costs	12.00	-
Stocks	6.50	-
Accounts receivables	5.50	-
Cash and bank balances	8.00	-
Revenues	-	108.00
Expenditures	79.00	-
	243.00	243.00

All adjustments have been made except for the following:

(i) Depreciation has to be charged on buildings and other fixed assets at the rate of 15%. The rate of tax depreciation is 30%.

(ii) Half of the research and development costs are allowable for tax purposes in the first year. The balance amount shall be permanently disallowed.

(iii) The company amortizes intangible assets over a period of three years.

(iv) The company's profit is subject to tax at the rate of 35%.

(v) Interest of Rs. 1.25 million was paid on a short term loan received from directors, which is not an allowable expense under the tax laws.

Required:
Prepare journal entries for necessary adjustments including taxation. Show necessary workings. **(18)**

(THE END)