THE INSTITTUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF PAKISTAN (ICPAP)

Stage	**Skills**	Course Code	**S-403**
Examination	**Winter-2011**	Course Name	**Financial and Corporate Reporting**
Time Allowed	**03 Hours**	Maximum Marks	**100**

NOTES:
1. All questions are to be attempted.
2. Answers are expected to the precise, to the point and well written.
3. Neatness and style will be taken into account in marking the papers.

Question No 1:-

(A) On 1 October 2005 Dearing acquired a machine under the following terms:

	Hours	**Rs**
Manufacturer's base price		1,050,000
Trade discount (applying to base price only)		20%
Early settlement discount taken (on the payable amount of the base cost only)		5%
Freight charges		30,000
Electrical installation cost		28,000
Staff training in use of machine		40,000
Pre-production testing		22,000
Purchase of a three-year maintenance contract		60,000
Estimated residual value		20,000
Estimated life in machine hours	6,000	
Hours used – year ended 30 September 2006	1,200	
– year ended 30 September 2007	1,800	
– year ended 30 September 2008 (see below)	850	

On 1 October 2007 Dearing decided to upgrade the machine by adding new components at a cost of Rs200,000.This upgrade led to a reduction in the production time per unit of the goods being manufactured using the machine. The upgrade also increased the estimated remaining life of the machine at 1 October 2007 to 4,500 machine hours and its estimated residual value was revised to Rs40, 000.

Required:
Prepare extracts from the income statement and statement of financial position for the above machine for each of the three years to 30 September 2008. 12

(B) The definition of a liability forms an important element of the International Accounting Standards Board's *Framework for the Preparation and Presentation of Financial Statements* which, in turn, forms the basis for IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Required:
Define a liability and describe the circumstances under which provisions should be recognized. Give two examples of how the definition of liabilities enhances the reliability of financial statements. 8

Question No 2:-

Carpart, a public limited company, is a vehicle part manufacturer, and sells vehicles purchased from the manufacturer. Carpart has entered into supply arrangements for the supply of car seats to two local companies, Vehiclex an Autoseat.

(i) Vehiclex
This contract will last for five years and Carpart will manufacture seats to a certain specification which will require the construction of machinery for the purpose. The price of each car seat has been agreed so that it includes an amount to cover the cost of constructing the machinery but there is no commitment to a minimum order of seats to guarantee the recovery of the costs of constructing the machinery. Carpart retains the ownership of the machinery and wishes to recognize part of the revenue from the contract in its current financial statements to cover the cost of the machinery which will be constructed over the next year. (4)

(ii) Autoseat
Autoseat is purchasing car seats from Carpart. The contract is to last for three years and Carpart is to design, develop and manufacture the car seats. Carpart will construct machinery for this purpose but the machinery is so specific that it cannot be used on other contracts. Carpart maintains the machinery but the know-how has been granted royalty free to Autoseat. The price of each car seat includes a fixed price to cover the cost of the machinery. If Autoseat decides not to purchase a minimum number of seats to cover the cost of the machinery, then Autoseat has to repay Carpart for the cost of the machinery including any interest incurred. Autoseat can purchase the machinery at any time in order to safeguard against the cessation of production by Carpart. The purchase price would be the cost of the machinery not yet recovered by Carpart. The machinery has a life of three years and the seats are only sold to Autoseat who sets the levels of production for a period. Autoseat can perform a pre-delivery inspection on each seat and can reject defective seats. (6)

(iii) Vehicle sales
Carpart sells vehicles on a contract for their market price (approximately Rs20, 000 each) at a mark-up of 25% on cost. The expected life of each vehicle is five years. After four years, the car is repurchased by Carpart at 20% of its original selling price. This price is expected to be significantly less than its fair value. The car must be maintained and serviced by the customer in accordance with certain guidelines and must be in good condition if Carpart is to repurchase the

vehicle. The same vehicles are also sold with an option that can be exercised by the buyer two years after sale. Under this option, the customer has the right to ask Carpart to repurchase the vehicle for 70% of its original purchase price. It is thought that the buyers will exercise the option. At the end of two years, the fair value of the vehicle is expected to be 55% of the original purchase price. If the option is not exercised, then the buyer keeps the vehicle. Carpart also uses some of its vehicles for demonstration purposes. These vehicles are normally used for this purpose for an eighteen-month period. After this period, the vehicles are sold at a reduced price based upon their condition and mileage. (10)

Required:
Discuss how the above transactions would be accounted for under International Financial Reporting Standards in the financial statements of Carpart.

Question No 3:-

(A) KPK, a public limited company and Brown a public limited company utilize IAS 19 'Employee Benefits' to account for their pension plans. The following information refers to the company pension plans for the year to 30 April 2009:

(i) At 1 May 2008, plan assets of both companies were fair valued at Rs200 million and both had net unrecognized actuarial gains of Rs 6 million.

(ii) At 30 April 2009, the fair value of the plan assets of KPK was Rs 219 million and that of Brown was Rs276 million.

(iii) The contributions received were Rs 70 million and benefits paid were Rs 26 million for both companies. These amounts were paid and received on 1 November 2008.

(iv) The expected return on plan assets was 7% at 1 May 2008 and 8% on 30 April 2009.

(v) The present value of the defined benefit obligation was less than the fair value of the plan assets at both 1 May 2008 and 30 April 2009.

(vi) Actuarial losses on the obligation for the year were negligible for both companies.

(vii) Both companies use the corridor approach to recognized actuarial gains and losses.

Required:
Show how the use of the expected return on assets can cause comparison issues for potential investors using the above scenario for illustration. 8

(B) The IASB's *Framework for the Preparation and Presentation of Financial Statements* requires financial statements to be prepared on the basis that they comply with certain accounting concepts, underlying assumptions and (qualitative) characteristics. Five of these are:
Matching/accruals Substance over form Prudence Comparability Materiality

Required:
Briefly explain the meaning of each of the above concepts/assumptions. 5

(C) For most entities, applying the appropriate concepts/assumptions in accounting for inventories is an important element in preparing their financial statements.

Required:
Illustrate with examples how each of the concepts/assumptions in (B) may be applied to accounting for inventory. 7

Question No 4:-

(A) PPN issued a RS10 million 3% convertible loan note at par on 1 April 2007 with interest payable annually in arrears. Three years later, on 31 March 2010, the loan note is convertible into equity shares on the basis of Rs 100 of loan note for 25 equity shares or it may be redeemed at par in cash at the option of the loan note holder. One of the company's financial assistants observed that the use of a convertible loan note was preferable to a non-convertible loan note as the latter would have required an interest rate of 8% in order to make it attractive to investors. The assistant has also commented that the use of a convertible loan note will improve the profit as a result of lower interest costs and, as it is likely that the loan note holders will choose the equity option, the loan note can be classified as equity which will improve the company's high gearing position. The present value of Rs 1 receivable at the end of the year, based on discount rates of 3% and 8% can be taken as:

	3%	**8%**
	$	$
End of year 1	0·97	0·93
2	0·94	0·86
3	0·92	0·79

Required:
Comment on the financial assistant's observations and show how the convertible loan note should be accounted for in PPN income statement for the year ended 31 March 2008 and statement of financial position as at that date. 12

(B) During the year ended 31 March 2006, PBX experienced the following transactions or events:

(i) Entered into a finance lease to rent an asset for substantially the whole of its useful economic life.

(ii) A decision was made by the Board to change the company's accounting policy from one of expensing the finance costs on building new retail outlets to one of capitalising such costs.

(iii) The company's income statement prepared using historical costs showed a loss from operating its hotels, but the company is aware that the increase in the value of its properties during the period far outweighed the operating loss.

Required:
Explain how you would treat the items in (i) to (iii) above in PBX financial statements and indicate on which of the Framework's qualitative characteristics your treatment is based. 8

Question No 5:-

Burley, a public limited company, operates in the energy industry. It has entered into several arrangements with other entities as follows:

(i) Burley and Slite, a public limited company, jointly control an oilfield. Burley has a 60% interest and Slite a 40% interest and the companies are entitled to extract oil in these proportions. An agreement was signed on 1 December 2008, which allowed for the net cash settlement of any over/under extraction by one company. The net cash settlement would be at the market price of oil at the date of settlement. Both parties have used this method of settlement before. 200,000 barrels of oil were produced up to 1 October 2009 but none were produced after this up to 30 November 2009 due to production difficulties. The oil was all sold to third parties at Rs 100 per barrel. Burley has extracted 10,000 barrels more than the company's quota and Slite has under extracted by the same amount. The market price of oil at the year-end of 30 November 2009 was Rs 105 per barrel. The excess oil extracted by Burley was settled on 12 December 2009 under the terms of the agreement at Rs 95 per barrel. Burley had purchased oil from another supplier because of the production difficulties at Rs 98 per barrel and has oil inventory of 5,000 barrels at the year-end, purchased from this source. Slite had no inventory of oil. Neither company had oil inventory at 1 December 2008. Selling costs are Rs 2 per barrel.

Burley wishes to know how to account for the recognition of revenue, the excess oil extracted and the oil inventory at the year-end. 6

(ii) Burley also entered into an agreement with Jorge, and Heavy, both public limited companies on 1 December 2008. Each of the companies holds one third of the equity in an entity, Wells, a public limited company, which operates offshore oilrigs. Any decisions regarding the operating and financial policies relating to Wells have to be approved by two thirds of the ventures. Burley wants to account for the interest in the entity by using proportionate consolidation, and wishes advice on the matter. The oilrigs of Wells started operating on 1 December 1998 and are measured under the cost model. The useful life of the rigs is 40 years. The initial cost of the rigs was Rs 240 million, which included decommissioning costs (discounted) of Rs 20 million. At 1 December 2008, the carrying amount of the decommissioning liability has grown to Rs 32·6 million, but the net present value of decommissioning liability has decreased to Rs 18·5 million as a result of the increase in the risk-adjusted discount rate from 5% to 7%. Burley is unsure how to account for the oilrigs in the financial statements of Wells for the year ended 30 November 2009. Burley owns a 10% interest in a pipeline, which is used to transport the oil from the offshore oilrig to a refinery on the land. Burley has joint control over the pipeline and has to pay its share of the maintenance costs. Burley has the right to use 10% of the capacity of the pipeline. Burley wishes to show the pipeline as an investment in its financial statements to 30 November 2009. 7

(iii) Burley has purchased a transferable interest in an oil exploration license. Initial surveys of the region designated for exploration indicate that there are substantial oil deposits present but further surveys will be required in order to establish the nature and extent of the deposits. Burley also has to determine whether the extraction of the oil is commercially viable. Past experience has shown that the license can increase substantially in value if further information as to the viability of the extraction of the oil becomes available. Burley wishes to capitalize the cost of the license but is unsure as to whether the accounting policy is compliant with International Financial Reporting Standards 7

Discuss with suitable computations where necessary, how the above arrangements and events would be accounted for in the financial statements of Burley.

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