Certificate in Accounting and Finance Stage Examination

The Institute of Chartered Accountants of Pakistan

4 March 2024
3 hours – 100 marks
Additional reading time – 15 minutes

Financial Accounting and Reporting-II

Instructions to examinees:

(i) Answer all **NINE** questions.
(ii) Answer in **black** pen only.
(iii) Multiple Choice Questions must be answered in answer script only.

Section A

Q.1 While reviewing the draft financial statements of Heavenly Limited (HL) for the year ended 31 December 2023, the following mistakes were identified:

(i) HL has classified its investment in Fair Limited (FL) as an investment in associate and has applied equity method, despite having no significant influence over FL.

On 1 May 2023, HL purchased 90,000 shares of FL having a par value of Rs. 50 each, representing 20% shareholding, at Rs. 180 per share. On 31 October 2023, FL paid a 30% interim cash dividend. FL reported a net profit of Rs. 24 million for the year ended 31 December 2023. The fair value of each share of FL was Rs. 270 as on 31 December 2023.

(ii) Bonds issued by HL have been treated as equity instruments.

On 1 April 2023, HL issued 40,000 bonds of Rs. 1,000 each at a premium of Rs. 300, redeemable in 8 years. The transaction cost associated with the issuance of these bonds was Rs. 20 per bond, which was expensed out. The coupon interest rate is 20% per annum, payable annually on 31 March. The approximate effective interest rate was 16% per annum. HL measures financial liabilities at amortized cost.

Required:
Prepare correcting entries in the books of HL for the year ended 31 December 2023. **(08)**

Q.2 Ravishing Limited (RL) is a shariah compliant listed company. RL's financial statements for the year ended 31 December 2023 were audited by Nida & Co. and Kapil & Co. as joint auditors at an audit fee of Rs. 25 million each. In addition, Nida & Co. and Kapil & Co. charged out-of-pocket expenses related to the audit of 2023, totalling Rs. 2 million and Rs. 1.8 million, respectively. RL's financial statements for the year ended 31 December 2022 were audited by Ali & Co. at an audit fee of Rs. 20 million, including out-of-pocket expenses of Rs. 1.5 million. Furthermore, Kapil & Co. provided tax services to RL amounting to Rs. 10 million in 2023 and Rs. 8 million in 2022.

Required:
In accordance with the requirements of the Fourth Schedule of the Companies Act, 2017:

(a) prepare a note on 'auditors' remuneration' for inclusion in RL's financial statements for the year ended 31 December 2023. ***(Show comparative figures)*** **(04)**
(b) list any **four** additional disclosures that are required to be made by a 'Shariah compliant company' listed on the Islamic index. **(03)**

Q.3 Alluring Limited (AL) is considering to enter into an arrangement with Charming Limited (CL) for the use of a photocopy machine for a period of five years. The initial draft contract fulfils all conditions to be classified as a lease contract. However, the following additional terms are under consideration between the parties for inclusion in the contract:

(i) Instead of fixed rentals, the lease rental would be based on the number of photocopies produced.
(ii) The machine will be placed in a common area where neighbouring office can also utilize it, by paying charges to CL.
(iii) AL will have the right to terminate the contract after three years.
(iv) CL will have the right to replace the machine with another machine.

Required:
For each additional term under consideration, evaluate whether its inclusion would affect the classification of the contract as a lease. **(08)**

Q.4 The following information pertains to the intangible assets of Irresistible Limited (IL):

(i) IL started a research and development project for a new product Alpha, on 1 February 2023. Up till the launch date of 1 December 2023, the following directly attributable costs were incurred on Alpha:

	Date(s) of incurrence	Rs. in million
Staff salary	February to November 2023	60
Equipment (useful life of five years)	1 April 2023	120
Consumables	February to November 2023	70
Consultant fee	May to November 2023	28
Total		**278**

Though the development activities started on 1 May 2023, the recognition criteria for the capitalization of internally generated intangible assets were met on 1 June 2023. All costs have been incurred evenly during the period mentioned against each cost. The useful life of Alpha is estimated to be six years.

(ii) On 1 July 2023, IL launched its new web site for online sale of its products. The web site was developed internally and met the criteria for recognition as an intangible asset. Directly attributable costs incurred for the web site are as follows:

	Rs. in million
Acquiring of web servers and its operating system	22
Capturing digital photographs of the products	6
Conducting feasibility studies and selecting preferences	2
Creating and uploading new content on the web site	13
Developing code and installing developed applications on the web server	8
Providing additional discount to customers for ordering through web site	9
Registering of domain names	3

It is estimated that the web site would be technologically obsolete in 4 years; however, IL plans to incur additional expenditures on the web site to incorporate new technologies, which will enable IL to use the web site for 8 years.

Required:
Prepare a note on 'Intangible assets' for inclusion in IL's financial statements for the year ended 31 December 2023, in accordance with the requirements of IFRSs.
('Total' column is not required) **(09)**

Q.5 Exquisite Limited (EL) entered into the following two contracts during the year ended 31 December 2023:

(i) On 1 October 2023, EL entered into a contract with Alpha Limited (AL) to provide monthly payroll processing service for two months. EL concluded that the service is a single performance obligation performed over time and is measured on time basis.

EL initially proposed a fee of Rs. 620,000 for each month in cash. However, due to liquidity problem, AL declined this offer. Instead, AL agreed to compensate EL with its 5,000 ordinary shares per month of service, totalling 10,000 shares for the entire contract. According to the terms of the contract, the shares are to be delivered upon the successful completion of each month of service.

As a result, EL received 5,000 shares on 31 October 2023 and another 5,000 shares on 30 November 2023. The fair value of each AL's share was Rs. 125 on 1 October 2023, Rs. 120 on 31 October 2023, Rs. 110 on 30 November 2023, and Rs. 108 on 31 December 2023 respectively.

EL holds all shares received from AL on 31 December 2023.

(ii) On 1 November 2023, EL also entered into a six months' contract to sell goods to Beta Limited (BL), a large global chain of retail stores. BL committed to make purchases of at least Rs. 20 million during the contract period.

The contract also required EL to make a non-refundable payment of Rs. 2 million to BL at the inception of the contract for the necessary changes to shelving to prominently display EL's products.

On 15 December 2023, EL sold goods having invoice value of Rs. 6 million to BL, which BL paid on 30 December 2023.

Required:
Prepare necessary accounting entries in EL's books for the year ended 31 December 2023 in accordance with the IFRSs. ***(No marks will be awarded for entries without dates)*** **(08)**

Q.6 Select the most appropriate answer(s) from the options available for each of the following Multiple Choice Questions.

(i) Magnificent Motors (MM) is a car dealer. It sells cars for cash and also offers a certain model for sale by lease. MM sold a car on lease on 1 January 2023. The following information is relevant:

Price of the car in a cash sale	Rs. 3,500,000
Cost of the car to MM	Rs. 2,500,000
Annual rental (in arrears)	Rs. 1,012,339
Lease term	4 years
Interest rate implicit in the lease	8%
Market rate of interest	10%
Estimated residual value (unguaranteed)	Rs. 200,000

Which of the following amounts is to be recognized as revenue on 1 January 2023?

(a) Rs. 3.50 million
(b) Rs. 3.21 million
(c) Rs. 3.35 million
(d) Rs. 2.36 million **(02)**

(ii) IFRS 8 would be applicable to a listed parent company's:

(a) separate financial statements as well as consolidated financial statements
(b) separate financial statements only
(c) consolidated financial statements only
(d) audited financial statements only **(01)**

(iii) The CFO of the company has asked you to submit the quarterly report to the bank for the compliance with loan covenants. He has also instructed you to recognise revenue on orders not yet delivered for increasing profits, to comply with bank loan covenants. The CFO explained that non-compliance of loan covenants will create financial difficulties for the company, which may result in the lay-off of certain employees, including yourself. However, the compliance of loan covenants will ensure that all employees will receive a higher salary increment.

Which of the following potential threats is **NOT** involved in the above situation?

(a) Self-interest threat
(b) Self-review threat
(c) Intimidation threat
(d) Advocacy threat **(01)**

(iv) Which of the following quantitative thresholds are specified by IFRS 8 for the identification of a reportable operating segment?

(I) Segment's reported external revenue is 10% or more of the combined external revenue of all operating segments
(II) Segment's net assets are 10% or more of the combined net assets of all operating segments

(a) Only (I)
(b) Only (II)
(c) Both (I) and (II)
(d) None of the two **(01)**

(v) Beautiful Limited (BL) operates a large dairy farm. In 2022, BL received a government grant of Rs. 30 million on the condition that BL adopts an organic cattle feed system and continues to do so for the next five years. If BL discontinues the organic cattle feed system at any time during five years, BL will have to repay the entire amount of the grant immediately. In 2024, the entire grant becomes repayable due to non-compliance by BL.

The amount taken to BL's statement of profit or loss for the year ending 31 December 2024 upon repayment of government grant would be:

(a) Rs. 18 million (b) Rs. 12 million (c) Rs. 30 million (d) Nil **(01)**

(vi) Which of the following is **NOT** required to be disclosed as a separate line item on the face of the financial statements as per the Fourth Schedule of the Companies Act, 2017?

(a) Revaluation surplus on property, plant and equipment
(b) Capital work in progress
(c) Long term deposits and prepayments
(d) Unclaimed dividend **(01)**

(vii) If an asset incorporates both intangible and tangible elements, it should be treated under:

(a) either IAS 16 or IAS 38 but once opted should be applied to all such assets consistently
(b) IAS 38
(c) IAS 16 and IAS 38 by segregating the cost of each element
(d) either IAS 16 or IAS 38 depending on which element is significant **(01)**

(viii) IFRS 16 permits certain assets to be exempt from the recognition treatment for right-of-use assets. Which **TWO** of the following assets leased to an entity would be permitted to be exempt?

(a) An equipment costing Rs. 45 million leased for 60 months
(b) An item of furniture costing Rs. 30,000 leased for 24 months
(c) A new motor vehicle with a cost of Rs. 1.5 million leased for 12 months
(d) A laptop costing Rs. 150,000 leased for 36 months, which is expected to be sub-leased for 24 months **(01)**

(ix) Which **TWO** of the following are primary indicators for determining functional currency of an entity?

(a) The currency that mainly influences sales prices for goods and of the country whose competitive forces and regulations mainly determine the sales prices of its goods
(b) The currency in which receipts from operating activities are usually retained
(c) The currency in which funds from financing activities are generated
(d) The currency that mainly influences labour, material and other costs **(01)**

Section B

Q.7 Handsome Limited (HL) is in the process of finalizing its financial statements for the year ended 31 December 2023. The following information has been gathered for preparing the disclosures related to taxation:

(i) Profit before tax for the year ended 31 December 2023 was Rs. 466 million.
(ii) Tax depreciation exceeds accounting depreciation by Rs. 116 million. An impairment loss of Rs. 50 million was also recognised in profit or loss. Under tax laws, impairment does not affect taxable profit.
(iii) During the year, HL sold a machine whose tax WDV exceeded accounting WDV by Rs. 35 million.
(iv) Interest income for the year was Rs. 60 million, of which Rs. 15 million was accrued as at 31 December 2023. Through a finance act enacted on 18 December 2023, interest income which was previously exempt, will now be taxable from 2024 on receipt basis.
(v) Salaries expenses and insurance expenses amounting to Rs. 32 million and Rs. 16 million respectively, pertaining to the year ended 31 December 2022, were disallowed by tax authorities due to non-deduction of withholding tax. HL has decided not to file appeal on this.
(vi) Stores and spares as at 31 December 2023 were Rs. 180 million after deducting a loss of Rs. 19 million for net realizable value. This adjustment is not allowable for tax purposes.
(vii) Dividend income for the year is Rs. 28 million. Dividends are taxable at a reduced rate of 10%.
(viii) During the year, HL paid fines of Rs. 24 million which are not deductible for tax purposes.
(ix) During the year, HL expensed out payments of Rs. 70 million related to the restructuring of one of its business segments. As per tax laws, these payments are to be allowed as an expense over a period of 5 years from 2023 to 2027.
(x) Net deferred tax asset as on 1 January 2023 arose on account of:

	Rs. in million
Property, plant and equipment	42
Unused tax losses	(54)
	(12)

(xi) During 2022, HL incurred a tax loss of Rs. 284 million, against which HL expected at that time to be able to utilize Rs. 180 million against future taxable income.
(xii) Applicable tax rate is 30% except for dividend income.

Required:
(a) Prepare a note on taxation for inclusion in HL's financial statements for the year ended 31 December 2023, including a reconciliation to explain the relationship between tax expenses and accounting profit. **(12)**
(b) Compute the deferred tax liability/asset in respect of each temporary difference as at 31 December 2023. **(05)**

(Comparative figures are not required)

Q.8 Following are the summarized statements of financial position of Winsome Limited (WL) and Superb Limited (SL) as on 31 December 2023:

	WL	SL
	----- Rs. in million -----	
Property, plant and equipment	1,900	900
Investments	2,000	-
Other assets	690	700
	4,590	**1,600**
Share capital (Rs. 10 per share)	2,500	750
Share premium	-	120
Retained earnings	820	510
Liabilities	1,270	220
	4,590	**1,600**

Additional information:

(i) On 1 April 2023, WL acquired a 75% shareholding in SL at the following considerations:

- Immediate cash payment of Rs. 288 million.
- Further amount of Rs. 288 million to be paid on 31 March 2025.
- Transfer of WL's freehold land having a carrying value and fair value of Rs. 710 million and Rs. 660 million respectively.

All considerations have been correctly recorded in WL's books on acquisition date but no subsequent adjustment has been made.

(ii) At the date of SL's acquisition, the carrying values of SL's net assets amounted to Rs. 1,132 million, which was equal to fair value, except for an equipment with a remaining life of 8 years assessed at Rs. 64 million above its carrying value.

(iii) Goodwill on the acquisition of SL amounted to Rs. 320 million.

(iv) On 1 July 2023, SL sold a machine to WL for Rs. 160 million, resulting in a gain of Rs. 20 million. The machine had a remaining useful life of 5 years. Out of Rs. 160 million, Rs. 35 million remains unpaid as on 31 December 2023.

(v) WL measures non-controlling interest at the acquisition date at its fair value.

(vi) On 1 July 2022, WL acquired 15 million shares of Cute Limited (CL), out of a total of 50 million Rs. 10 shares, for Rs. 290 million. This investment in CL is carried at cost in WL's books.

(vii) CL paid a 12% final dividend for the years 2022 and 2023 which WL recorded as other income upon receipt. The breakup of total comprehensive income of CL for 2023 and 2022 is as follows:

	2023	2022
	---- Rs. in million ----	
Profit	90	80
Other comprehensive income	40	-
Total comprehensive income	**130**	**80**

(viii) An impairment test carried out at year-end has indicated that goodwill of SL has been impaired by 10%, while the investment in CL has been impaired by Rs. 22 million.

(ix) A fair value gain of Rs. 48 million needs to be recorded in respect of WL's remaining investments.

(x) A discount rate of 20% per annum may be used wherever required.

Required:

Prepare WL's consolidated statement of financial position as at 31 December 2023 in accordance with the requirements of IFRSs. ***(Show all necessary workings)*** **(18)**

Q.9 **For the purpose of this question, assume that the date today is 1 March 2024.**

You have recently assumed the role of Finance Manager at Gorgeous Limited (GL). Your first assignment is the finalization of GL's financial statements for the year ended 31 December 2023. The CEO has identified four specific matters where provisions may be necessary, in accordance with IAS 37. However, the CEO is uncertain about the accurate estimation of these provisions. Below are the details concerning these matters:

(i) Provision for renewal fees:
GL acquired a license for Rs. 96 million in 2023. The license is initially valid for a period of five years, with the option for renewal every five years at a cost of Rs. 35 million. Considering the substantial renewal fees, GL plans to renew the license only once and intends to sell it at the end of the eighth year. **(03)**

(ii) Provision for engine replacement:
At the start of 2023, the government imposed a ban on the use of diesel engines in vehicles effective from 31 December 2023. As of that date, GL owned eight vehicles equipped with diesel engines, which could only be utilized in 2024 after engine replacement or potentially sold at a loss in their current condition. On 31 December 2023, it was estimated that the cost of replacing the engines would be Rs. 15 million. However, the engines of the vehicles were replaced in January and February 2024 at a cost of Rs. 20 million. **(03)**

(iii) Provision for net realizable loss:
As of 31 December 2023, GL held inventory items with a cost of Rs. 100 million. However, the selling prices of these items were experiencing continual decline in the market. At 31 December 2023, the estimated selling price was Rs. 75 million. Subsequently, 80% of these inventory items were sold in January and February 2024 at Rs. 50 million, while the remaining 20% is anticipated to be sold at Rs. 15 million. **(04)**

(iv) Provision for pending court case:
Ten employees have initiated legal action against GL for alleged unfair dismissals in 2023. Summary of two key correspondences with the GL's legal advisor regarding this matter is as follows:

- *Correspondence dated 31 December 2023:*
  GL's legal advisor has opined that the dismissals were fair, with only a 30% probability that the court may rule in favor of the employees, necessitating compensation. The potential compensation amount varies, but is estimated to be Rs. 2 million per employee.

- *Correspondence dated 29 February 2024:*
  In light of new evidence presented to the court in February 2024, GL's legal advisor now believes that the dismissals were unfair. There is a 70% probability that the court may rule in favour of employees and order GL to pay Rs. 3 million to each employee.

Moreover, GL anticipates that if these claims are successful, three additional employees who were similarly dismissed in 2023 may also pursue legal recourse. Therefore, based on latest correspondence with the legal advisor, GL is considering a settlement with these three employees before they initiate legal proceedings. **(05)**

The discount rate of 15% may be used, if required.

Required:
Identify whether a provision under IAS 37 needs to be made for each of the above matters. Also, discuss the effect of the above matters on GL’s financial statements for the year ended 31 December 2023 in accordance with IFRSs.

(THE END)