

PAPER 1

FINANCIAL REPORTING

MODEL QUESTION PAPER

Instruction: Answer Question 1 which is compulsory and any four out of the remaining Questions

Question 1(a) – Valuation of Goodwill – 8 Marks

The following is the extract from the Balance Sheets of Popular Ltd:

(Rs. in Lakhs)

Liabilities	31.3.2004	31.3.2005	Assets	31.3.2004	31.3.2005
Share Capital	500	500	Fixed Assets	550	650
General Reserve	400	425	10% Investments	250	250
Profit & Loss Account	60	90	Stock	260	300
18% Term Loan	180	165	Debtors	170	110
Sundry Creditors	35	45	Cash and Bank	46	45
Provision for Tax	11	13	Fictitious Assets	10	8
Proposed Dividend	100	125			
Total	1,286	1,363	Total	1,286	1,363

Additional Information –

- Replacement Value of Fixed Assets were Rs.1,100 Lakhs on 31.03.04 and Rs.1,250 Lakhs on 31.03.05 respectively.
- Rate of Depreciation adopted on Fixed Assets is 5% p.a.
- 50% of the Stock is to be valued at 120% of its Book Value.
- 50% of the Investments were Trade Investments.
- Debtors on 31st March 2005 include Foreign Debtors of \$35,000 recorded in the books at Rs.35 per US Dollar. The Closing Exchange Rate was \$ 1 = Rs. 39.
- Creditors on 31st March 2005 include Foreign Creditors amounting to \$ 60,000 recorded in the books at \$ 1 = Rs.33. The Closing Exchange Rate was \$ 1 = Rs. 39.
- Profit for the year 2004 – 05 included Rs.60 Lakhs being Government Subsidy which is not likely to recur.
- Rs.125 Lakhs of Research and Development Expenditure was written off to P & L A/c in the current year. This expenditure was not likely to recur.
- Future Maintainable Profits (pre-tax) are likely to be higher by 10%.
- Tax rate during 2004 –05 was 50%, effective future tax rate will be 40%.
- Normal Rate of Return is expected 15%.

One of the Directors of the Company Arvind, fears that the Company does not enjoy a Goodwill in the prevalent market conditions. Critically examine this and establish whether Popular Co. has or has not any Goodwill.

If your answers were positive on the existence of Goodwill, show the leverage effect it has on the Company's result.

Industry Average Return was 12% on Long-Term Funds and 15% on Equity Funds.

Solution:**1. Computation of Future Maintainable Profits (3 Marks)**

Particulars	Rs. Lakhs	
Profit for the year 2004–05		
Increase in Profit & Loss A/c	30.00	
Increase in Reserves	25.00	
Proposed Dividend	125.00	180.00
Add back: Tax $[(180.00 \times \text{Tax Rate of } 50\%) \div (100\% - \text{Tax Rate of } 50\%)]$		180.00
Profit Before Tax		360.00
Less: Income from Non-Trade Invest. (Rs.250 Lakhs $\times$ 10% $\times$ 50%)	12.50	
Forex Loss on Foreign Currency Creditors $[\$60000 \times (\text{Rs.}39 - \text{Rs.}33)]$	3.60	
Adjustment for Current Cost of Opening Stock 20% of 50% $\times$ 260	26.00	
Govt. Subsidy (non-recur in the future)	60.00	(102.10)
		257.90
Add: Forex Gain on Foreign Currency Debtors $[\$35,000 \times (\text{Rs.}39 - \text{Rs.}35)]$	1.40	
Research & Development Costs not to recur in future	125.00	
Adjustment for Current Cost of Closing Stock $[20\% \text{ of } 50\% \times 3,00,000]$	30.00	156.40
Adjusted Profit Before Tax		414.30
Add: 10% Increase anticipated in the future		41.43
Future Maintainable Profits Before Tax		455.73
Less: Tax Expense at 40% (Rs.455.73 $\times$ 40%)		182.29
Future Maintainable Profits After Tax		273.44
Add: Interest on Long Term Loan (after Tax) $[(\text{Rs.}165 \times 18\% \times (100 - 40\%)]$		17.82
Future Maintainable Profit After Tax Before Interest		291.26

Therefore, Future Maintainable Profit on-

(a) Long Term Capital Employed (including Long Term Loans) **Rs.291.26 Lakhs**(b) Net Worth (Shareholders Funds) **Rs.273.44 Lakhs**

Note: Depreciation effect on Replacement Value of Fixed Asset is not considered because of application of Going Concern principle. Also, depreciation on revalued figure is not deductible for income tax purposes and consequently does not make any difference in the tax outgo.

2. Computation of Average Capital Employed (Rs. Lakhs) (2 Marks)

Particulars	31.03.2004	31.03.2005
Current Cost of Sundry Fixed Assets after providing depreciation @ 5%	1100.00	1,250.00
Current Cost of Stock	286.00	330.00
Trade Investments (50% of Total Investments)	125.00	125.00
Debtors	170.00	110.00
Exchange Rate Difference on Forex Debtors (W N-2)	—	1.40
Cash and Bank	46.00	45.00
Total Operating Assets	1727.00	1861.40
Less: Outside Liabilities		
18% Term Loans	180.00	165.00
Sundry Creditors	35.00	45.00
Exchange Rate Difference on Forex Creditors (W N-2)	—	3.60
Provision for Taxation	11.00	13.00
	226.00	226.60
Capital Employed	1501.00	1634.80
Average Capital Employed = $(1501.00 + 1634.80) / 2$	1567.90 Lakhs	

Capital Employed (Long Term Funds Approach) (1/2 Mark)

Equity Capital Employed	1634.80
Add: 18% Term Loan	165.00
Total Long Term Funds	1799.80

3. Computation of Goodwill (Rs. in Lakhs) (1½ Marks)

Particulars	Equity Funds Approach	Total Funds Approach
a. Future Maintainable Profit	273.44	291.26
b. Normal Rate of Return	15%	12%
c. Capitalisation Value of Future Maintainable Profits (a/b)	1822.93	2427.17
d. Capital Employed	1634.80	1799.80
e. Goodwill	188.13	627.37

4. Leverage Effect on Goodwill: (1 Mark)

- (a) Goodwill computed using Equity Fund Concept i.e. Rs.188.13, is low when compared to the Goodwill as computed using Total Funds Concepts i.e. Rs.627.37 Lakhs.
- (b) Leverage Effect on Goodwill = Rs.627.37 - Rs.188.13 = Rs.439.24 Lakhs

Question 1(b) – AS 16 – Borrowing Cost – 3 Marks

What are the items of Expense considered Borrowing Cost?

Answer: (Any Three Items = 1 Marks × 3 Points)

The following are the items of Expense considered as Borrowing Costs as per AS 16 –

- Interest and Commitment Charges on Bank Borrowings and other short-term and long-term borrowings,
- Amortisation of discounts or premiums relating to borrowings,
- Amortisation of ancillary costs incurred in connection with arrangement of borrowings
- Finance Charges in respect of assets acquired under other similar arrangements, and
- Exchange Differences arising from foreign currency borrowings, to the extent that they are regarded as an adjustment to interest costs.

Question 1(c) – Accounting Standards – Applicability – 5 Marks

Discuss the relaxation in disclosure and reporting requirements prescribed in Accounting Standards afforded to Level II Enterprises

Answer:

- Level II enterprises are completely exempt from the provisions of **(2 Marks)**
 - AS 17 – Segment Reporting,
 - AS 18 – Related Party Disclosures
 - AS 24 – Discontinuing Operations
- AS 19 – Paras 22(c), (e) and (f), 25 (a), (b) and (e), 37(a), (f) and (g) and 46(b), (d) and (e) with respect to disclosures of AS 19 are not applicable to Level II enterprises.
- AS 20 is applicable to Level II and Level III enterprises, if they disclosed EPS. AS 20 is applicable to all companies, (irrespective of category of Level) as part IV of Schedule VI to the Companies Act, 1956 requiring disclosure of EPS. However, all the enterprises including companies, who fall within in Level II or Level III, are not required to disclose diluted EPS and information required by Para 48 of AS 20

4. Provisions of AS 25 are as of now applicable to only those companies who publish interim financial statements. Normally only Listed Companies publish interim financial statements pursuant to Listing Agreements.
5. Paras 67 of AS 29 is not applicable to Level II enterprises and Paras 66 and 67 are not applicable to Level III enterprises.

(3 Marks in total for Points 2 to 4)

Question 2(a) – Accounting Standards – Comprehensive – 12 Marks

On 30th September 2003, Beta Enterprises Ltd was incorporated with an Authorised Capital of Rs.50 Lakhs. Its first accounts were closed on 31st March 2004 by which time it had become a Listed Company, with an Issued, Subscribed and Paid Up Capital of Rs.40 Lakhs in 4 Lakh Equity Shares of Rs.10 each.

The Company started off with two lines of business viz. Engineering Division and Chemicals Division, with equal asset base w.e.f 01.04.2004. The Ceramics Division was started by the Company on 1st April 2005. The following data is gathered from the Company's books for the year ended 31st March 2006.

Trial Balance as on 31st March 2006 (Rs. 000s)

Particulars	Dr.	Particulars	Cr.
Cost of Sales of Engineering Division	2,600	Sales of Engineering Division	6,000
Cost of Sales of Chemicals Division	4,300	Sales of Chemicals Division	8,000
Cost of Sales of Ceramics Division	900	Sales of Ceramics Division	1,500
Administration Costs	2,000	Depreciation on Fixed Assets	1,500
Distribution Costs	1,500	Trade Creditors	500
Interim Dividend Paid	1,200	Equity Capital in Shares of Rs.10 each	4,000
Fixed Assets at Cost	9,000	Retained Profits	1,000
Stock on 31 st March 2006	400		
Trade Debtors	440		
Cash at Bank	160		
Total	22,500	Total	22,500

Additional Information:

- Administration Costs should be split between the divisions in the ratio of 5 : 3 : 2.
- Distribution Costs should be spread over divisions in the ratio of 3 : 1 : 1.
- Directors have proposed a final dividend of Rs.8 Lakhs.
- Some of the users of Ceramics Division are unhappy with the products and have lodged claims against the Company for damages of Rs.7.5 Lakhs. The Claim is hotly contested by the Company on legal advice.
- Fixed Assets worth Rs.30 Lakhs were added in the Ceramics Division on 01.04.2005. Fixed Assets are written off over a period of 10 years on Straight Line Basis, in the books. However, for Income Tax purposes, Depreciation at 20% on Written Down Value of the assets is allowed by the Income Tax Authorities.
- Income Tax Rate may be assumed at 35%.
- During the year, Engineering Division had sold to Alpha Ltd, goods having a sales value of Rs.25 Lakhs. Mr.Gamma, the Managing Director of Beta Enterprises Ltd owns 100% of the issued Equity Shares of Alpha Ltd. The Sales made to Alpha Ltd were at normal selling prices of Beta Enterprises Ltd.

You are required to prepare the Profit and Loss Account for the year ended 31st March 2006 and a Balance Sheet as on that date. Your answer should include Notes and Disclosures as per Accounting Standards.

Solution:

1. Profit and Loss Statement for the year ended 31st March 2006 (2 Marks)

Particulars				Rs. 000s
A. INCOME	Sales	(6,000 + 8,000 + 1,500)		15,500
B. EXPENDITURE	Cost of Sales	(2,600 + 4,300 + 900)	7,800	
	Distribution Costs		1,500	
	Administration Costs		<u>2,000</u>	11,300
C. PROFIT / LOSS	Profit before Tax for the year			4,200
Less:	Tax Expense	Current Tax (See WN)	1,239	
		Deferred Tax (See WN)	231	1,470
	Profit after Tax for the year			2,730
D. APPROPRIATION	Balance brought forward from previous year	(See WN) (1,000 – 210)		790
Add:	Profit after Tax for the year			<u>2,730</u>
	Total Profits available for appropriation			3,520
Less:	Dividends	Interim Dividend	1,200	
		Final Dividend	800	2,000
	Balance carried to Balance Sheet			1,520

2. Balance Sheet of Beta Enterprises Ltd as on 31st March 2006 (2 Marks)

Liabilities	Rs.000s	Assets	Rs.000s
Share Capital: Issued & Subscribed 4,00,000 Eq Shares of Rs.10 fully paid up	4,000	Fixed Assets: Gross Block 9,000 Less: Depreciation 1,500	7,500
Reserves and Surplus: P & L Account	1,520	Current Assets, Loans and Advances	
Deferred Tax Liability	441	Stock 400	
Current Liabilities and Provisions		Debtors 440	
<u>Current Liabilities:</u> Creditors	500	Cash at Bank <u>160</u>	1,000
<u>Provisions:</u> Provision for Taxation	1,239		
Proposed Dividend	800		
Total	8,500	Total	8,500

3. Notes on Accounts (Disclosures as per Accounting Standards) (3 Marks)**(a) Segmental Disclosures (Business Segments) (Rs.000s)**

Particulars	Engineering Division	Chemical Division	Ceramics Division	Total
Sales	6,000	8,000	1,500	15,500
Less: Cost of Sales	2,600	4,300	900	7,800
Administration Cost (5:3:2)	1,000	600	400	2,000
Distribution Cost (3:1:1)	900	300	300	1,500
Segment Profit/Loss	1,500	2,800	(100)	4,200
Original Cost of Assets (Equal Capital Base)	3,000	3,000	3,000	9,000
Depreciation at 10% p.a.				
For the year ended 31.03.2005	300	300	NIL	600
For the year ended 31.03.2006	300	300	300	900

(c) Computation of Current Tax for the year (1 Marks)

Particulars	Rs. 000s
Profit Before Tax for the year	4,200
Add: Depreciation provided in the books (300 + 300 + 300)	900
	5,100
Less: Depreciation as per Income Tax Act (480 + 480 + 600)	1,560
Taxable Income under the Income Tax Act	3,540
Current Tax Expense at 35%	1,239

(c) Computation of Deferred Tax Liability (2 Marks)

Particulars	Rs. 000s
A. Timing Difference on Opening Balance of Fixed Assets	
WDV of Fixed Assets as per books (6,000 – 10% SLM Depreciation for 2004–05)	5,400
WDV of Fixed Assets as per IT Act (6,000 – 20% WDV Depreciation for 2004–05)	4,800
Difference between the above	600
Deferred Tax Liability at 35% on 600 (since WDV Depreciation > SLM Depreciation) This has been adjusted against Opening Balance of Retained Profits.	210
B. Deferred Tax Liability for the year ending 31st March 2006	
Depreciation as per Books (6,000 + 3,000) × 10% SLM Depreciation	900
Depreciation as per Income Tax Act (20% on 4,800 + 20% on 3,000)	1,560
Difference between the above	660
Deferred Tax Liability at 35% on 660 (to be carried forward)	231

(d) Contingent Liabilities not provided (1/2 Mark)

The Company is contesting claim for damages for Rs.7,50,000 and as such the same is not acknowledged as debts.

(e) Related Party Disclosures (AS – 18) (1 ½ Marks)

Under AS – 18, Related Party includes individuals owing, directly or indirectly, an interest in voting power of reporting enterprise which gives them control or significant influence over the enterprise, and relatives of any such individual. In the above case, Mr.Gamma as a Managing Director controls the operating and financial actions of Beta Enterprises Ltd. He also owns 100% Share Capital of Alpha Ltd. thereby exercising control over it. Hence, Alpha Ltd. is a Related Party. The disclosure to be made are as under –

Name of the Related Party and nature of relationship	Alpha Ltd.; Common Director
Nature of the transaction	Sale of goods at normal commercial terms
Volume of the transaction	Sales to Alpha Ltd worth Rs.25 Lakhs

Question 2(b) – Not For Profit Organisation - 4 Marks

A University receives two grants – one from the Ministry of Human Research to be used for AIDS Research. This grant is for Rs.45,00,000, which includes Rs.3,00,000 to cover indirect expenses incurred in administering the grant. The second grant of Rs.35,00,000 received from a reputed Trust is to be used to set up a centre to conduct seminars on AIDS related matters from time to time. During the year, it also received Rs.5,00,000 worth of equipment donated by a well-wisher to be used for AIDS research. During the year 2003 -04, the University spent Rs.32,25,000 of the Government Grant and incurred Rs.3,00,000 Overhead Expenses. Rs.28,00,000 were spent from the grant received from the Trust.

Show the necessary Journal Entries in the books of the University.

Solution: (For all the Journal Entries, with Narration, 4 Marks)

S.No.	Particulars	Dr.	Cr.
1.	Bank A/c To Revenue Fund (Restricted) A/c (Being Grants received from Government Rs.45,00,000 & Private Trust Rs.35,00,000 recorded)	80,00,000	80,00,000
2.	Expenses (Appropriate Heads) A/c To Bank A/c (Being recording of expenditure incurred Rs.32,25,000 from Government Grants & Rs.28,00,000 from Private Grant)	60,25,000	60,25,000
3.	Equipment A/c To Revenue Fund (Restricted) A/c (Being Equipment received from a well wisher as donation recorded)	5,00,000	5,00,000
4.	Revenue Fund (Restricted) A/c To Income – Government Grant To Income – Private Grants (Being Revenue recognized in Restricted Fund to the extent of grant utilized during the current year)	60,25,000	32,25,000 28,00,000
5.	Revenue Fund (Restricted) A/c To Bank A/c (Being Overhead Expenses incurred to administer the grant, accounted) Note: Actually, the expenses are incurred in Unrestricted Revenue Fund and reimbursed from this Fund.	3,00,000	3,00,000

Question 3(a) – AS 19 – Sale and Lease Back – 7 Marks

ASE a Stock Exchange organized as an Association of Persons was demutualised and converted into ASE Ltd pursuant to an agreement with the Securities Exchange Board of India. As per the terms of the agreement, the trading rights of the members of the erstwhile ASE (AOP), were to be purchased by ASE Limited in consideration for issue of shares of ASE Ltd. Also the trading rights acquired by the ASE Ltd was to be leased out to the members of erstwhile ASE (AOP).

ABC Ltd was a member of the Erstwhile ASE AOP holding trading rights and pursuant to the agreement with SEBI surrendered his trading rights to the newly formed ASE Ltd, in consideration for shares issued to him and the same trading rights were allotted back to ABC Ltd pursuant to the lease agreement. The particulars of the transaction were as follows –

Particulars	Value
Fair Value of the Trading Rights	Rs. 45 Crores
Carrying amount of the Trading Rights	Rs. 50 Crores
Fair Value of Shares issued	Rs. 55 Crores
Annual Lease Rentals	Rs. 8 Crores
Period of Lease	8 years
Unexpired life of the Trading Right	10 years
Lessee's Incremental borrowing Rate	10%
Lessee's Cost of Capital – IRR	12%
Annuity Factor – 10% for 8 years	5.335
Annuity Factor – 12% for 8 years	4.968

Show the Extract of Balance Sheet at the end of the accounting year assuming that the Sale and Lease Back Transaction was entered into in the beginning of the Accounting Period. **7 Marks**

Solution:

1. **Effect of Transaction:** When an asset is sold and leased back on a finance lease, it effectively results in the same asset being capitalized at a different amount and is similar to revaluation of that asset.
2. **Deferral:** Any Excess or Deficiency of Sales Proceeds over the Carrying Amount should not be immediately recognized as Income or Loss in the P & L Account of the Seller – Lessee.
3. **Amortisation:** Such Gain / Loss as above should be deferred and amortised over the lease term in **proportion** to the **depreciation** of the Leased Asset.
4. **Impairment Losses:** No adjustment is necessary in respect of Fair Value, unless there has been an impairment in Value, in which case the carrying amount is reduced to recoverable amount as per AS – 28.
5. Considering the above facts the following is the accounting treatment in respect of the sale and lease transaction —

1. Amortization of the Trading Right – (2½ Marks)

Particulars	Rs. Crores
1. Fair Value of Lease Asset	45.00
2. Value of the Asset based on the PV of MLP based on Incremental Borrowing Rate = 5.333 (Annuity Factor based on IBR – 10%) $\times 8 = 42.68$	42.68
3. Therefore, Amount to be Capitalized = Lower of Rs.45.00 Cr. And Rs.42.68 Cr.	42.68
4. Salvage Value at the end of the Lease Period (as per AS 26)	NIL
5. Value to be Amortised	42.68
6. Time period for Amortisation – Assuming that ABC Ltd will be given an opportunity to retain the trading right after the expiry of Eighth Year	10
7. Amortisation Per Annum	4.27
8. Amortised Value at the end of the First Year	=38.41

2. Computation of Gain to be Recognized (1½ Mark)

Particulars	Rs. Crores
1. Sale Consideration – Issue of Securities – The Fair Value of Security or the Outgoing Asset whichever is more clearly evident is to be adopted. Here it is taken that the Fair Value of the Security is more clearly evident and hence the same is adopted	55.00
2. Carrying Amount of Trading Rights	50.00
3. Gain on Sale of the Asset	5.00
4. Gain to be recognized at the end of the first year – $1/10^{\text{th}}$	0.50

3. Computation of Interest and Principal Repayment (1 Marks)

Particulars	Rs. Crores
1. Amount of Liability	42.68
2. Amount of Interest at Incremental Borrowing Rate of 10% ($42.68 \times 10\%$)	4.27
3. Amount of Lease Rental	8.00
4. Therefore, Principal Repayment (Lease Rental 8.00 Less Interest 4.27)	3.73

4. Balance Sheet of ABC Ltd (Lessee) as at the end of First Year (Rs.Crores) (Extract) (2 Marks)

Liabilities	Rs	Rs	Assets	Rs	Rs
Deferred Income Account	5.00		Investment in Shares of ASE Ltd (50+5)		55
Less: Transfer to Profit & Loss A/c	(0.50)	4.50			
			Asset on Finance Lease	42.68	
Lease Liability	42.68		Less: Amortisation	(4.27)	38.41
Less: Repayment of Principal	(3.73)	38.95			

(Each item, ½ Mark)

Question 3(b) – AS 21 and 23 – Consolidation of Financial Statements – 9 Marks

Following are the Balance Sheets of H Ltd and its only subsidiary S Ltd as at 31.03.2009 – (Rs.Lakhs)

Liabilities	H Ltd	S Ltd	Assets	H Ltd	S Ltd
Equity Share Capital (Rs.10)	125	40	Fixed Assets	250	100
Capital Reserve	20	—	Investments	75	—
Capital Redemption Reserve	—	10	Current Assets	375	140
Free Reserves	320	75			
15% Debentures	100	50			
Current Liabilities	135	65			
Total	700	240	Total	700	240

H Ltd purchased 3 Lakh shares in S Ltd on 01.07.2008 for Rs.60 Lakhs. On that date S Ltd had Rs.40 Lakhs in its free reserves. S Ltd had bought back 20% of its shares on 01.10.2008 at the then prevailing market price of Rs.25 per share. The buy back was sourced out of accumulated profits.

Remaining investments of H Ltd includes investment in 30% of Equity of A Ltd, an unlisted Company, acquired on 01.04.2008, when its net worth was Rs.40 Lakhs. On 31.03.2009, its net worth was Rs.50 Lakhs.

Current Liabilities of S Ltd includes Bills Payable of Rs.2 Lakhs to H Ltd, of which H Ltd had discounted Rs.1.20 Lakhs with its bankers.

S Ltd had sold goods costing Rs.5 Lakhs at Rs.7 Lakhs to H Ltd on 01.04.2008. The entire goods are still lying in stock as at the above Balance Sheet date.

Find out the amounts of Capital Reserve / Goodwill on consolidation. Also find out, the amount of Group Reserves to be incorporated in the Consolidated Balance Sheet and the Extent of Minority Interest.

Answer:

1. Basic Information

Company Status	Dates	Holding Status
Holding Company = H Ltd	Acquisition: 01.07.2008	% held by H Ltd in A Ltd = 30%
Associate Enterprise = A Ltd	Consolidation: 31.03.2009	% held by H Ltd in S Ltd = 75%
Subsidiary = S Ltd		Minority Interest (S Ltd) = 25%

2. Analysis of Reserves

(a) S Ltd (Subsidiary Company) (2 Marks including 1 Mark for Computation of CRR and Treatment of CRR as Pre Acquisition Reserves)

Free Reserves

	Date of Consolidation	75.00
As on 01.07.2008 (DOA)	40.00	01.07.08 to 31.03.09
Less: Trfr. To Capital Redemption Reserve	(10.00)	(Balancing Figure)
Less: Premium on Buy Back	(15.00)	60.00
Pre-Acquisition Reserve	15.00	Post Acquisition Reserve

Note:

• **Amount Transferred to Capital Redemption Reserve**

Paid Up Capital Redeemed / Bought Back = Closing Capital $\times \frac{20\%}{100\% - 20\%} = 40 \times \frac{20\%}{80\%}$	10.00
Less: Buy Back Funded by Fresh Issue of Equity / Preference	NIL
Amount to be transferred to Capital Redemption Reserve	10.00