MOCK TEST PAPER – 1

FINAL COURSE: GROUP – I

PAPER – 1: FINANCIAL REPORTING

SUGGESTED ANSWERS/HINTS

1. (a) (i) Tangible objects or intangible rights carrying probable future benefits, owned by an enterprise are called assets. N Ltd. sells these empty bottles by calling tenders. It means further benefits are accrued on its sale. Therefore, empty bottles are assets for the company.

(ii) As per AS 2 "Valuation of Inventories", inventories are assets held for sale in the ordinary course of business. Stock of empty bottles existing on the Balance Sheet date is the inventory and N Ltd. has detailed controlled recording and accounting procedure which duly signify its materiality. Hence stock of empty bottles cannot be considered as scrap and should be valued as inventory in accordance with AS 2.

(b) In the case of tax free companies, no deferred tax liability or asset is recognized in respect of timing differences that originate and reverse in the tax holiday period. Deferred tax liability or asset is created in respect of timing differences that originate in a tax holiday period but are expected to reverse after the tax holiday period. For this purpose, adjustments are done in accordance with the FIFO method.

In the first year, out of ₹ 200 lakhs, ₹ 80 lakhs will reverse in the tax holiday period. Therefore, Deferred Tax Liability will be created on remaining timing difference of ₹ 120 lakhs @ 35% (i.e.) ₹ 42 lakhs.

In the second year, the entire ₹ 400 lakhs will reverse only after the tax holiday period. Therefore, deferred tax charge in the Statement of Profit and Loss for the second year will be ₹ 400 x 35% = 140 lakhs and total deferred tax liability in the Balance Sheet will be (42+140) = ₹ 182 lakhs.

(c) According to Lev and Schwartz, the value of human capital embodied in a person of age τ is the present value of his remaining future earnings from employment. Their valuation model for a discrete income stream is given by the following formula:

$$V\tau = \sum_{t=\tau}^{t} \frac{I(t)}{(1+r)^{t-\tau}}$$

Where,

V_τ = the human capital value of a person τ years old.

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I(t) = the person's annual earnings up to retirement.

r = a discount rate specific to the person.

t = retirement age.

Value of employees

$$= \frac{30,000}{(1+0.15)^{(62-60)}} + \frac{30,000}{(1+0.15)^{(62-61)}}$$

$$= \frac{30,000}{(1+0.15)^{2}} + \frac{30,000}{(1+0.15)}$$

= 22,684.31 + 26,086.96 = 48,771.27

Value of the employees = ₹ 48,771.27× 50 = ₹ 24,38,564

(d) Presentation of MAT credit in the financial statements:

Balance Sheet : Where a company recognizes MAT credit as an asset on the basis of the considerations specified in the Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961, the same should be presented under the head 'Long-term or Short term Loans and Advances' as the case may be if there is a convincing evidence of realization of the asset then it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Short-term Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, would continue to be presented under the head 'Long-term or Short term Loans and Advances' as the case may be if it continues to meet the considerations stated in paragraph 11 of the Guidance Note.

Statement of Profit and Loss: According to explanation given in para 21 of AS 22, "Accounting for Taxes on Income" in the context of Section 115JB of the Income-tax Act, 1961, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the Statement of profit and loss in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognized as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the statement of profit and loss and presented as a separate line item therein.

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2. Consolidated Balance Sheet of M Ltd. with its subsidiaries E Ltd. and N Ltd.

As on 31st March, 2013

Particulars	*Note No.*	*(₹ in thousand)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital		40,000
(b) Reserves and Surplus	1	11,645
(2) **Minority Interest**	2	8,005
(3) **Current Liabilities**		
(i) Trade payables	3	4,900
(ii) Other current liabilities	4	4,650
Total		69,200
II. **Assets**		
Non-current assets		
Fixed assets		
Tangible assets	5	69,200
Total		69,200

Notes to Accounts

			(₹ in thousand)	*(₹ in thousand)*
1.	Reserves and surplus			
	Capital Reserve [Refer Note 5]		902.5	
	General Reserve	₹		
	M Ltd.	1,800		
	E Ltd.	160		
	N Ltd.	112.5	2,072.5	
	Profit & Loss A/c	₹		
	Balance on 1.04.12	1,500		
	Profit during 12-13	7,000		
	Add: Interest on Loan	400		
		8,900		
	Less: Proposed dividend	(4,000)		
		4,900		
	Add: P & L of E Ltd.	2,720		
	Add: P & L of N Ltd.	1,050	8,670	11,645

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2.	Minority interest			
	E Ltd.		4,880	
	N Ltd.		3,125	8,005
3.	Trade payables			
	Creditors			
	M Ltd.		2,500	
	E Ltd.		1,000	
	N Ltd		1,400	4,900
4.	Other current liabilities			
	Proposed Dividend			
	M Ltd.		4,000	
	E Ltd. (Minority)		400	
	N Ltd. (Minority)		250	4,650
5.	Tangible assets			
	M Ltd.		21,800	
	E Ltd.	32,800		
	Less: Unrealized profit N Ltd.	(300)	32,500	
	N Ltd.		14,900	69,200

Workings Notes:

A. M Ltd.'s holding in E Ltd. is 1,60,000 shares out of 2,00,000 shares, i.e., $4/5^{th}$ or 80%; Minority holding $1/5^{th}$ or 20%.

B. M Ltd.'s holding in N Ltd. is 75,000 shares out of 1,00,000 shares, i.e., $3/4^{th}$ or 75%; Minority holding $1/4^{th}$ or 25%.

Analysis of Reserves and Profits of Subsidiary Companies

		E Ltd. (₹'000)	*N Ltd (₹ '000)*	*Minority interest in E Ltd. (1/5) (₹ '000)*	*Minority interest in N Ltd. (1/4) (₹ '000)*
1.	**Reserve (pre-acquisition reserves and profits)**				
	Reserves on 1.04.2012	800	750		
	Profit on 1.04.2012	2,000	800		
		2,800	1,550		
	Less: Minority interest	(560)	(387.5)	560	387.5
		2,240	1,162.5		

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2.	**Reserve (post-acquisition)**				
	Reserves as per Balance Sheet	1,000	900		
	Less: Reserve (pre-acquisition)	(800)	(750)		
		200	150		
	Less: Minority interest	(40)	(37.5)	40	37.5
		160	112.5		
3.	**Profit and Loss Account**				
	Profit for the year as per Balance Sheet	3,800	1,800		
	Less: Interest on Loan (5,000x8%)	(400)			
		3,400			
	Less: Minority Interest	(680)	(450)	680	450
		2,720	1,350		
	Less: Unrealised profit on stock transfer	-	(300*)		
		2,720	1,050		
4.	**Share Capital**				
	As per Balance sheet	20,000	10,000		
	Less: Minority interest	(4,000)	(2,500)	4,000	2,500
	Transferred for computation of Goodwill/Capital Reserve	16,000	7,500		
				5,280	3,375
	Less: Proposed dividend shown separately			(400)	(250)
	Transferred to Consolidated Balance Sheet			4,880	3,125
	Total			8,005	

5. **Computation of Cost of Control i.e. Goodwill/Capital Reserve on consolidation**

(₹ In thousand)

	E Ltd.	*N Ltd.*
Cost of Investments	18,000	8,000
Less: Paid up value of shares [Refer Note 4]	(16,000)	7,500

* As per para 17 of AS 21, 'Unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full.

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	2,000	500
Less: Pre-acquisition Reserve [Refer Note 1]	(2,240)	(1,162.5)
Capital reserve	(240)	(662.5)
Total Capital Reserve (₹ 240 + ₹662.5)	902.5	

3. (a) **Worth Limited**

Computation of Economic Value Added

	₹ in lakhs
Profit after Tax (Refer W.N. 5)	1,372.00
Add: Interest on Long-term Fund – net of tax (Refer W.N. 2)	28.00
Net Operating Profit after Tax	1,400.00
Less: Cost of Capital (₹ 6,400 lakhs × 15.77%) (Refer W.N. 3 and 4)	(1,009)
Economic Value Added	391.00

Working Notes:

(1) **Cost of Equity** = Risk free rate + Beta factor (Market rate – Risk free rate)

= 9% + 1.05 (16 – 9) = 9% + 7.35% = 16.35%

(2) **Cost of Debt**

	₹ in lakhs
Interest	40
Less: Tax @ 30%	(12)
Interest after Tax	28

$$\text{Cost of debt} = \frac{28}{400} \times 100 = 7\%$$

(3) **Weighted Average Cost of Capital**

		₹ in lakhs
Cost of Equity	₹ 6,000 lakhs × 16.35% (W.N.1)	981
Cost of Debt	₹ 400 lakhs × 7% (W.N.2)	28
	₹ 6,400 lakhs	1,009

$$\text{WACC} = \frac{1,009}{6,400} \times 100 = 15.77\% \quad \text{(approx.)}$$

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(4) **Capital Employed**

	₹ *in lakhs*
Share Capital	2,000
Reserves and Surplus	4,000
Long-term debts	400
	6,400

(5) **Profit after Tax**

	₹ *in lakhs*
Profit before Interest and Tax	2,000
Less: Interest	(40)
	1,960
Less: Tax (30% on ₹ 1,960 lakhs)	(588)
Profit after Tax	1,372

(b) Calculation of net assets as on 30.04.2013

	₹ *in lakhs*	₹ *in lakhs*
Opening bank balance [₹ (100- 90-7) lakhs]	3.00	
Add: Proceeds from sale of securities	40.00	
Dividend received	1.20	44.20
Less:		
Cost of securities	(28.20)	
Fund management expenses		
[₹ (4.50–0.25) lakhs]	(4.25)	
Capital gains distributed		
[75% of ₹ (40.00 – 38.00) lakhs]	(1.50)	
Dividends distributed (75% of ₹ 1.20 lakhs)	(0.90)	(34.85)
Closing bank balance		9.35
Add: Closing market value of portfolio		101.90
		111.25
Less: Arrears of expenses		(0.25)
Closing net assets as on 30.04.2013		111.00

Calculation of NAV per unit as on 30.04.2013

Closing net assets as on 30.04.2013	₹ 111.00 lakhs
Number of units	10 lakhs
Closing Net Assets Value (NAV) per unit	₹ 11.10

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4. (1) **Calculation of operational synergy expected to arise out of merger**

(₹ in crores)

Year	1	2	3	4	5
Projected cash flows of NRPL after merger with FIL	1,500	2,000	2,500	3,000	3,500
Less: Projected cash flows of NRPL Ltd. without merger	(1,000)	(1,500)	(2,000)	(2,500)	(3,000)
	500	500	500	5,00	500

(2) **Valuation of FIL in case of merger**

Year	Additional Cash Flows to NRPL from operations (₹ in crores)	Discount Factor	Discounted Cash Flow (₹ in crores)
1	500	0.870	435.00
2	500	0.756	378.00
3	500	0.658	329.00
4	500	0.572	286.00
5	500	0.497	248.50
			1,676.50

(3) **Maximum value to be quoted**

	₹ in crores	₹ in crores
Value as per discounted cash flows from operations		1,676.50
Add: Increase in goodwill of NRPL on acquisition of FIL		300
		1,976.50
Add: Cash to be collected immediately by disposal of assets:		
Fixed Assets	100	
Investments	1,500	
Stock	30	1,630.00
		3,606.50
Less: Current liabilities	1,000	
Compensations claim (510 – 102)	408	(1,408.00)
		2,198.50

So, NRPL can quote as high as ₹ 2,198.50 crores for taking over the business of FIL.

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(4) **Valuation of FIL ignoring merger (as a 'Stand Alone' entity)**

Year	Cash Flows	Discount Factor	Discounted Cash Flow
	(₹ in crores)		(₹ in crores)
1	400	0.870	348.00
2	400	0.756	302.40
3	600	0.658	394.80
4	800	0.572	457.60
5	1,000	0.497	497.00
			1,999.80

5. (a) **Misha Ltd.**

Balance Sheet as at 1st April, 2013

Particulars	Note No.	*(₹ in crores)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	125
(b) Reserves and Surplus	2	375
(2) **Non-Current Liabilities**		
Long-term borrowings	3	200
Total		700
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets	4	300
(2) **Current assets**	5	400
Total		700

Notes to Accounts

		(₹ in Crores)	*(₹ in Crores)*
1.	Share Capital		
	6.5 crores equity shares of ₹ 10 each	65	
	(of the above shares, 2.5 crores equity shares are allotted as fully paid-up for consideration other than cash)		

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	60 lakhs 10% Preference shares of ₹ 100 each	60	125
2.	Reserves and Surplus		
	As per last Balance Sheet	150	
	Capital Reserve (Refer W.N.)	225	375
3.	Long Term Borrowings		
	Secured Loans:		
	As per last Balance Sheet	100	
	Taken over on absorption of Nisha Ltd.	100	200
4.	Fixed Assets		
	As per last Balance Sheet	150	
	Taken over on absorption of Nisha Ltd.	150	300
5.	Current assets		
	As per last Balance Sheet	200	
	Taken over on absorption of Nisha Ltd.	200	400

(b) Valuation of shares on intrinsic value basis

(i)	Nisha Ltd.	Misha Ltd.
	(₹ in crores)	
Equity share capital	50	40
Reserves and Surplus	200	150
	250	190
Goodwill agreed upon	40	75
Increase in the value of fixed assets (Present worth less book value)	50	279
	340	544
(ii)	**Nisha Ltd.**	**Misha Ltd.**
Number of Equity shares	5 crores	4 crores
Intrinsic value per equity share	₹ 68	₹ 136
(iii) Ratio of intrinsic value of shares in the two companies	1 : 2	

Since the shares are to be issued at par, the number of equity shares of ₹ 10 each to be issued to maintain the intrinsic net worth = 5 crores /2 = 2.5 crores

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(iv) Statement to prove the accuracy of workings

		(₹ *in crores)*	
(1)	Equity share capital (after absorption)		65
	Reserves and Surplus (after absorption)		375
			440
	Add: Unrecorded value of goodwill ₹ (40 + 75)		115
	Add: Unrecorded incremental value of fixed assets ₹ (50+279)		329
			884
(2)	Number of equity shares	6.5 crores	
(3)	Intrinsic value of an equity share (884/6.5)	₹ 136	

Working Note:

Calculation of Capital Reserve on Absorption

	(₹ in crores)
Fixed Assets taken over	150
Net current assets taken over	200
	350
Less: Secured loans taken over	(100)
Net Assets taken over	250
Less: Purchase consideration	(25)
Capital Reserve	225

6. **(a)** In the given case, the length of the vesting period varies, depending on when the performance condition is satisfied. In such a situation, as per paragraph 14 of the text of the Guidance Note on 'Accounting for Employee Share-based Payments' the enterprise estimates the length of the expected vesting period, based on the most likely outcome of the performance condition, and revises that estimate, if necessary, if subsequent information indicates that the length of the vesting period is likely to differ from previous estimates.

Statement showing determination of the compensation expense to be recognised each year

Particulars	Year 1	Year 2	Year 3
Vesting condition (earnings)	18%	13% (avg.)	10% (avg.)
Actual earnings	14%	12% (avg.)	10.67% (avg.)
Length of the expected vesting period (at the end of the year)	2 years	3 years	3 years

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No. of employees expected to meet vesting conditions	440 employees	417 employees	419 employees
No. of options expected to vest	44,000	41,700	41,900
Fair value of options expected to vest @ ₹ 30 per option (₹)	13,20,000	12,51,000	12,57,000
Compensation expense accrued at the end of year (₹)	6,60,000 [13,20,000/2]	8,34,000 (12,51,000 × 2/3)	12,57,000
Compensation expense recognised till the end of previous year (₹)	Nil	6,60,000	8,34,000
Compensation expense to be recognized for the year (₹)	6,60,000	1,74,000	4,23,000

(b) Revised Schedule VI has come into force for the Balance Sheet and Profit and Loss Account prepared for the financial year commencing on or after 1st April, 2011. As per Part I of the Revised Schedule VI, a company shall, inter alia, disclose in notes to accounts for the period of 5 years immediately preceding the balance sheet date (31st March, 2013 in the instant case) the aggregate number and class of shares allotted as fully paid-up bonus shares. Revised Schedule VI does not require a company to disclose the source from which bonus shares have been issued. Therefore, non-disclosure of source from which bonus shares have been issued does not violate the Revised Schedule VI to the Companies Act, 1956.

7. (a) **Table showing differences among AS (applicable in India), IFRS and US GAAP**

Topic	Accounting Standard	IFRS	US GAAP
Inventories	Carried at lower of cost and net realizable value. FIFO or weighted average method is used to determine cost. LIFO method is however, prohibited.	Carried at lower of cost and net realizable value. For cost determination, FIFO or weighted average method is used. LIFO basis of valuation is prohibited. Reversal is required for subsequent increase in value of previous write-downs.	Similar to IFRS; however, use of LIFO is permitted. Reversal of write-down is prohibited.

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Earnings per share – diluted	Weighted average potential dilutive shares are used as denominator for diluted EPS except in certain circumstances where advance share application money received is treated as dilutive potential equity shares.	Weighted average potential dilutive shares are used as denominator for diluted EPS.	

(b) According to para 92 of AS 15 (Revised) "Employee Benefits", actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus of ₹ 6 lakhs in the pension scheme on its actuarial valuation is required to be credited to the profit and loss statement of the current year. Hence, Kumar Ltd. cannot spread the actuarial gain of ₹ 6 lakhs over the next 2 years by reducing the annual contributions to ₹ 2 lakhs instead of ₹ 5 lakhs. It has to contribute ₹ 5 lakhs annually for its pension schemes.

(c) Yes, both sales and gain of B Ltd. should be recognized. In accordance with AS 9, at the Balance Sheet date what was pending was merely a formality to register the deed. It is clear that significant risk and rewards of ownership had passed before the balance sheet date i.e. assets is in use by A Ltd. Further the registration of the property in the name of A Ltd. post the balance sheet date confirms the condition of sale which existed at the balance sheet date. Therefore, as per AS 4, it is an adjusting event and the sale will be recognised in the previous year.

(d) **Separation of Equity and Debt Portion**

	₹
Present value of the principal repayable in 4 years	
₹ 30,00,000 × 1.10 × 0.68 (10% Discount factor)	22,44,000
Present value of Interest 1,80,000 x 3.17	
(4 years cumulative 10% discount factor)	5,70,600
Total liability component (Debt Portion)	28,14,600
Equity Portion (Balance)	1,85,400
Proceeds of the issue	30,00,000

(e) **Calculation of possible value of brand under potential earning model**

	₹ *in lakhs*
Profit after tax (13 – 3)	10.00

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Less: Profit allocated to tangible fixed assets	(6.00)
Profit relating to intangible assets including brand	4.00
Capitalisation factor 25%	
Capitalised value of intangibles including brand $\left(\frac{4.00}{25}\times 100\right)$	16.00
Less: Identifiable intangibles other than brand	(10.00)
Brand value	6.00

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