PAPER 6E: Global Financial Reporting Standards

CASE STUDY 4

You are Praveen an Assistant Manager in Finance and Accounts department of ABC Group (hereby referred as ABC, ABC Ltd. or group) headed by Director- Finance Aditya Goel. You assist and report to Sumit Bansal, Manager of your department. You have joined the organisation just a month ago.

Sumit Bansal is on vacation for 15 days and financial statements of ABC Limited needs to be finalized within a week. Therefore, Mr. Goel needs your assistance in finalization of consolidated as well as separate financial statements of ABC Limited for the year ended 31st March 2017.

He provided you with the following relevant information:

1. On 1st April, 2016, ABC acquired 90 million shares in PQR Limited by means of share exchange which has been classified as 'fair value through other comprehensive income' in separate financial statements of ABC Limited. The terms of the business combination were as follows:

   - ABC Limited issued eight shares for every, nine shares acquired in PQR Limited. On 1st April, 2016, the market value of ABC Limited's share was Rs.2.80 per share.
   - ABC Limited will make a further cash payment to the former shareholders of PQR Limited on 30th June 2019. This payment will be based on the adjusted profits of PQR Limited for the three-year period upto 31st March 2019. On 1st April 2016, the fair value of this additional payment was estimated at Rs.25 million. This estimate had increased to Rs. 28 million by 31st March 2017 due to changes in circumstances since the date of acquisition.

   Investment in PQR Limited has not been recorded in the draft financial statements of ABC Limited presented at later part of the study.

   It is the group policy to value the non-controlling interest in subsidiaries at the date of acquisition at fair value. The market value of an equity share in PQR Limited at 1 April 2016 can be used for this purpose. On 1 April 2016, the market value of a PQR Limited share was Rs.2.60 per share.

   On 1st April 2016, the individual financial statements of PQR Limited showed the following reserves balances:

   – Retained earnings Rs.86 million.

   – Other components of equity Rs.2·4 million.

   The directors of ABC Limited carried out a fair value exercise to measure the identifiable assets and liabilities of PQR Limited at 1 April 2016. The following matters emerged:

   - Property having a carrying value of Rs.140 million (including depreciable assets Rs.80 million) had an estimated market value of Rs.160 million (including depreciable

assets Rs. 92 million). The remaining estimated economic life of the depreciable assets at 1st April 2016 was 16 years.

- Plant and equipment having a carrying value of Rs.111 million had a market value of Rs.120 million. The estimated future economic life of the plant and equipment at 1st April 2016 was three years. PQR Limited has not disposed of any of this plant and equipment since 1st April 2016.
- Intangible assets with an estimated market value of Rs.8 million had not been recognised in the individual financial statements of PQR Limited. The estimated future economic lives of these intangible assets at 1st April 2016 was four years.

The fair value adjustments have not been reflected in the individual financial statements of PQR Limited. In the consolidated financial statements, the fair value adjustments will be regarded as temporary differences for the purposes of computing deferred tax. The rate of deferred tax to apply to temporary differences is 20%.

Impairment of the goodwill on acquisition of PQR Limited is not required since 1 April 2016.

Below are the separate financial statements of ABC and PQR Limited as on 31st March 2017:

	ABC Limited Rs.'000	PQR Limited Rs.'000
ASSETS		
Non-current assets:		
Property, plant and equipment	280,000	225,000
Investments	78,500	40,000
	358,500	265,000
Current assets:		
Inventories	85,000	56,000
Trade receivables	70,000	42,000
Cash and cash equivalents	14,000	11,000
	169,000	109,000
Total assets	527,500	374,000
EQUITY AND LIABILITIES		
Equity		
Share capital	160,000	120,000
Retained earnings	211,396	115,000

Other components of equity	5,604	4,000
Total equity	377,000	239,000
Non-current liabilities:		
Provision	1,500	Nil
Long-term borrowings	60,000	50,000
Deferred tax	22,000	25,000
Total non-current liabilities	83,500	75,000
Current liabilities:		
Trade and other payables	45,000	40,000
Short-term borrowings	22,000	20,000
Total current liabilities	67,000	60,000
Total equity and liabilities	527,500	374,000

2. On 1st April 2016, ABC has raised a long term loan from European investors. The investors subscribed for 50 million Foreign currency (FC) loan notes at par. ABC Ltd. incurred incremental issue costs of FC 1 million. Interest of FC 4 million is payable annually on 31st March, starting from 31st March 2017. The loan is repayable in FC on 31st March 2022 at a premium and the effective annual interest rate implicit in the loan is 10%. The appropriate measurement basis for this loan is amortised cost. Relevant exchange rates are as follows:

   – 1st April 2016 – FC 1 = Rs.1·40.

   – 31st March 2017 – FC 1 = Rs.1·45.

   – Average rate for the year ended 31st March 2017 – FC 1 = Rs.1·42.

   The functional currency of the group is Indian Rupee.

3. Trade receivables of ABC Ltd. include Rs. 2 million lent to a supplier on 1st April 2016, in order to assist them with their expansion plans. The cost incurred to arrange the loan is Rs. 100,000. Mr. Goel opined to recognise Rs. 100,000 as a cost in the current year. However, he had not charged interest on this loan since the loan was given to help supplier's short-term cash flow. The supplier was expected to repay Rs. 2.4 million on 31st March 2018. Mr. Goel believe that no profit will accrue this year but there will be a nice bonus next year when the repayment will be received. The finance department informed him that the effective annual rate of interest on this loan is 6·9%. However, Mr. Goel did not find any relevance of this information as no interest is payable according to him.

   Just before the year ending on 31st March 2017, ABC Ltd. came to know that the supplier is facing poor economic conditions which has caused significant problems to him. In order to

help him, ABC Ltd. agreed to reduce the amount repayable by him on 31st March 2018 to Rs.2.2 million. Mr. Goel feels that still ABC Ltd. will report profit next year on it.

4. Mr. Goel also mentioned that during the year ended 31st March 2017, ABC Ltd. provided consultancy services to a customer regarding the installation of a new production system. The system has caused the customer considerable problems, so the customer has taken legal action against ABC Ltd. for the loss that has arisen as a result of the problems with the system installation. The legal department of the group felt that there is 25% chance to successfully defend the claim. However, at the same time it also felt that 75% chance is that ABC Ltd. may require to pay damages of Rs.1.6 million. Mr. Goel believes that ABC Ltd. should not suffer any overall loss because the legal department informed that the company is covered by insurance against such types of losses. Mr. Goel feels that ABC Ltd. will make a claim immediately if the outcome of the case is against the company. According to him no provision shall be made for it because ABC Ltd. is covered by insurance. However, disclosure by way of a note shall be given for it.

5. ABC Ltd. provides consultancy advice to other firms as well. On 1st October 2016, ABC Ltd. signed a contract to supply 50 days of consultancy advice to a customer over the two-year period ending on 30th September 2018. The contract required ABC Ltd. to submit to six-monthly audits of the firm to ensure that the performance conditions in the contract had been adhered to in the immediately preceding six months. The first six-monthly audit was carried out shortly after 31st March, 2017 wherein the firm confirmed that ABC Ltd. had satisfactorily supplied 15 days of consultancy in the six-month. The total contract price was Rs.1·5 million payable on 30th September 2018 even though if the service of 50 days is rendered in the initial period of the service contract . ABC Ltd. has strong budgetary control systems in place and is able to accurately forecast the costs incurred in delivering the consultancy. An appropriate rate of interest to impute to this project would be 15% for the required period.

Besides above issues Praveen has some more doubts for which he requires your assistance.

I. Objective Type Questions

[Select the most appropriate answer from the options given for each question. **(2 Marks each)]**

1. Property, plant and equipment (PPE) of ABC Ltd. includes factory and head office PPE among other PPE. Factory and head office PPE have the carrying value of Rs. 16,000 thousand and Rs. 22,000 thousand respectively as on 1st April 2016. The remaining useful lives of both the PPE are 10 years and 20 years respectively. Company carried out an impairment testing on 31 March 2017 and noted that recoverable amount of factory and head office PPE as on that date is Rs. 15,000 thousand and Rs. 20,000 thousand respectively.

At what amount factory and head office PPE shall be recorded on 31 March 2017?

(a) Factory- Rs. 15,000 thousand and Head office- Rs.20,900 thousand

(b) Factory- Rs. 15,000 thousand and Head office- Rs.20,000 thousand

(c) Factory- Rs. 14,400 thousand and Head office- Rs.20,000 thousand

(d) Factory- Rs. 14,400 thousand and Head office- Rs. 20,900 thousand

2. ABC Ltd. factored Rs. 2 million of its trade receivables to a bank during the year. The Bank paid Rs. 1.8 million to ABC Ltd. Bank charged ABC Ltd. Rs. 1 lac fee for this. All responsibility of receivables will be returned to ABC Ltd. if the debts are left unpaid after 6 months.

(i) Rs. 1.8 million shall be considered as loan and accounted for as financial liability

(ii) Rs. 1 lac fee should be deducted as transaction cost from financial liability

(iii) A loss of Rs. 2 lac should be recorded in the statement of profit and loss

(iv) The receivable should be derecognised from the statement of financial position

State which two of the above treatment represents the correct accounting treatment.

(a) (i) and (ii)

(b) (i) & (iii)

(c) (i) & (iv)

(d) All of the above

3. ABC Ltd. has uncertainty over two items of inventory on 31 March 2017.

Item A relates to raw material purchased for Rs. 5 lacs for a large profitable contract with supermarket. Since then, the purchase cost of these raw material has fallen to Rs. 4 lacs. **Item B** cost Rs. 2.5 lacs. It was damaged on 15 March 2017. After performing repairing work of Rs 30,000, it was sold for Rs. 2.6 lacs on 15 April 2017.

. Determine the value at which items A & B shall be recorded on 31st March, 2017.

(a) Item A- Rs. 4 lac and Item B- Rs. 2.30 Lac

(b) Item A- Rs.5 lac and item B- Rs. 2.60 Lac

(c) Item A- Rs. 5 lac and Item B- Rs. 2.30 Lac

(d) Item A – Rs. 4 lac and Item B- Rs.2.60 Lac

4. ABC Ltd. uses first in first out method to measure its inventory for many years. On 1st April 2016, ABC Ltd. shifted to weighted average cost. This increased the inventory value at that date by Rs. 2 lacs. Which one of the following is NOT the correct accounting treatment for the financial statements for the year ended 31st March 2017?

(a) Increase only opening retained earnings in the statement of changes in equity by Rs. 2 lacs on 31st March, 2017.

(b) Increase inventory by Rs 2 lacs in the prior year comparative statement of financial position alongwith the opening retained earnings.

(c) Increase the cost of sales of the current year by Rs. 2 lacs.

(d) Reduce the profits in prior year comparative statement of profit and loss by Rs. 2 lacs.

5. ABC Ltd. has introduced a profit sharing plan from 1st April, 2016 for its employees who serve the company through out the year. If no employees leave during the year, total profit sharing payments for the year will be 2% of profit. ABC Ltd. estimates that the employee turnover will be there and their profit share would be limited to 1.5%.

Determine the accounting treatment for this profit sharing plan.

(a) ABC Ltd. recognises a liability and an expense of 1.5% of profit.

(b) ABC Ltd. recognises a liability of 2% of profit.

(c) No liability will be recognised.

(d) Only expenses will be recognised on actual basis.

6. ABC Ltd. offered a customer interest free credit for two years on a sale of goods for Rs. 2 lacs that was made on 1st April 2016. ABC Ltd. has cost of capital of 8% and has recorded Rs. 2 lacs as revenue. How much should be reclassified from revenue into finance income for the year ended 31 March 2017?

(a) Rs. 13,717

(b) Rs. 14,815

(c) Rs. 16,000

(d) Rs. 28,532

7. On 1st March 2017, ABC Ltd. began construction to build an asset for a customer. ABC Ltd. has spent Rs. 10,000 so far and believes that the construction may cost total Rs. 8 lacs to complete. The total price of the construction contract is Rs. 1 million. ABC Ltd. uses an output method to measure progress, but as the contract has only just begun, Mr. Goel is unable to measure the progress made towards completion at 31st March 2017. How much revenue should ABC Ltd. recognize for the year ending 31st March 2017?

(a) Nil

(b) Rs. 10,000

(c) Rs. 12, 500

(d) Rs. 16,700

8. Following issues have arisen in ABC Ltd. for which Mr. Goel is unsure how to account for:

i ABC Ltd. operates number of machines requiring a regular overhaul to pass safety inspection. Many of these overhauling are due within next 12 months.

ii. ABC Ltd. has caused environmental damage during construction of new factory. There is no legislation requiring ABC Ltd. to repair the ground. ABC Ltd. has a well-documented, strong environmental policy and record of honouring it.

Provision should be created for which of the following issues.

(a) i and ii both

(b) i only

(c) ii only

(d) None of the above

9. On 15th April 2017, the following events were noted by ABC Ltd.:

(i) A major customer went into liquidation and

(ii) Inventory was damaged in flood. This was sold at loss on 20th April 2017.

Which of the event should be considered as an adjusting event in the financial statements for the year ended 31st March 2017?

(a) Liquidation of the major customer

(b) Damaged inventory

(c) Neither of the event events are adjusting events

(d) Both the events are adjusting events

10. During the year, ABC Ltd. sold some items to PQR Ltd. The year end balances were reconciled with ABC Ltd. showing receivable of Rs. 8,000. This does not agree with payable recorded by PQR Ltd., with a difference being due to Rs. 1,000 cash in transit. Select the

correct options for adjustment of such inter-company transaction as on 31st March, 2017in the consolidated balance sheet.

(a) Deduct consolidated trade receivable and trade payable by Rs. 8,000.

(b) Deduct consolidated trade receivable and trade payable by Rs. 7,000

(c) Deduct consolidated trade receivable and trade payable by Rs. 1,000

(d) Deduct consolidated trade receivable by Rs. 8,000, consolidated trade payable by Rs. 7,000 and add consolidated cash & cash equivalent by Rs. 1,000.

II. Descriptive Questions

1. Compute the amount of 'Goodwill' and 'Non- controlling interest' to be shown in the Consolidated financial statements of ABC Limited as on 31st March 2017 on acquisition of PQR Ltd. **(10 Marks)**

2. Advise the appropriate accounting treatment for the Foreign Currency loan to be made by ABC Ltd. in the books. **(5 Marks)**

3. Do you agree with Mr. Goel that in case of loan given to a supplier, no interest shall be shown in current year's profit and loss. If not, suggest the correct accounting treatment with impact, if any on current year's profit and loss. Also, do you think any adjustment is required in current year's financial statements due to the financial problem being faced by the supplier? Also comment on the classification of such loan under the heading 'trade receivables'. **(5 Marks)**

4. Do you agree with the views of Mr. Goel on the legal action taken by the customer and the treatment suggested by him? State your answer with reasons **(5 Marks)**

5. How much revenue should ABC Ltd. recognize for the year ended 31st March 2017 for the contract entered with the firm for providing the consultancy service for 24 months? **(5 Marks)**