# FINANCIAL & CORPORATE REPORTING

Time allowed – 3 hours
Total marks – 100

*[N.B. – Figures in the margin indicate full marks. Questions must be answered in English. Examiner will take account of the quality of language and the manner in which the answers are presented. Different parts, if any, of the same question must be answered in one place in order of sequence.]*

Marks

1. (a) The principle of recording the substance or economic reality of transactions rather than their legal form lies at the heart of the Framework for Preparation and Presentation of Financial Statements' and several International Financial Reporting Standards. The development of this principle was partly in reaction to a minority of public interest companies entering into certain complex transactions. These transactions sometimes led to accusations that company directors were involved in "creative accounting". Explain with relevant examples, what is meant by the term creative accounting. 6

(b) You are an accountant at Brothers Ltd., a newly formed company with plans to develop a national distribution network through investment in and agreement with local courier companies. Brothers is in its first year of trading and its majority investors have requested that it prepares its financial statements in accordance with BFRS.

During the year ended 31 December 2012 it formed its first two strategic partnerships that it intends to develop over a long-term period. Brothers has previously not owned any share investments. To show its commitment to these companies it invested in them as follows:

On 1 February 2012 Brothers subscribed for 10,000 Tk.10 ordinary shares in Millat Ltd. for Tk.12.00 each. Professional fees of Tk.30,000 were incurred on the transaction. Millat has 100,000 ordinary shares in issue. No dividends have been paid during the year. Millat is a start-up company which has yet to prepare any financial statements. It has not been possible to obtain a reliable fair value for the investment yet. It is anticipated that a reliable estimate of fair value will be available within one year.

On 1 January 2012 Brothers acquired 30,000 6% Tk.10 preference shares at par (their fair value) in Sohana Ltd. that are redeemable on 31 December 2015 at a premium of 4%. The preference dividend is paid annually on 31 December. Transaction costs were immaterial. The effective interest rate on the preference shares is 7%. The fair value of one preference share on 31 December 2012 is estimated as Tk.105.

The Managing Director of Brothers has called you and asked you to meet him to discuss the formulation of financial reporting treatments for these investments. He said,

'I'm concerned about how we account for these investments. We don't currently intend to sell them, we don't trade investments, and I think the directors want to hold them for the long-term. With this in mind I need to know whether any different financial reporting treatments are available to us. I've read the financial press and I'm aware about the increasing use of fair values with BAS 39. I'd prefer to use cost to simplify our financial statements.

**Required:**

Prepare notes for your meeting with the Managing Director which should

(i) Explain, using extracts from financial statements, the possible financial reporting treatments for the two investments identified above for the year ended 31 December 2012. 10

(ii) Discuss the financial reporting, ethical and other matters that you need to consider in formulating Brothers accounting policies for these investments. 4

[Please turn over]

2. You are financial advisor to Falgun Ltd. The directors of the company have asked you to identifying related party transactions for the year ended 31 December 2012.

Details of Falgun Ltd. and certain other companies are given blow:

**Falgun Ltd.**
A building construction company formed by Mr. Sohel Rahman and his brother Shafiq Rahman.

Falgun has issued share capital of 500 ordinary shares of Tk. 10 shares, owned as below:

| Name | No. of shares held | % of holding | Position |
|---|---|---|---|
| Sohel Rahman | 210 shares | 42% | Founder and director |
| Shafiq Rahman | 110 shares | 22% | Founder and director |
| Selima Rahman (Shafiq's wife) | 100 shares | 20% | Company Secretary |
| Ms. Helen | 20 shares | 4% | |
| Fazal Khan | 60 shares | 12%. | Director |

Fazal khan is a local businessman and a close friend of both Sohel and Shafiq. He gave the brothers advice when they set up the company and remains involved through his position on the board of directors. His own company, Fazal Design Ltd. supplies Falgun Ltd. with stationery and publicity materials.

Ms. Helen is Sohel Rahman's ex-wife. She was given her shares as part of the divorce settlement and has no active involvement in the management of the company. Alexander's friend, Ms. Jerin, is the company's solicitor. She is responsible for drawing up and reviewing all key building and other contracts and frequently attends board meetings so that she can explain the terms of a particular contract to the directors. Her personal involvement with Sohel Rahman started in December 2011 and, since that time, she has spent increasing amount of time at the company's premises.

**Women's World Ltd.**
It is a beauty parlour of which 50% of the issued shares are owned by Ms. Helen and 50% by Mili Rahman, who is the daughter of Sohel and Helen. Women's World Ltd. operate from premises owned by Falgun, for which it pays rent at the normal market rate.

**Sheetal Construction Ltd.**
A construction company owned 60% by Falgun and 40% by R. Amin the Managing Director. Sheetal carries out regular work for Falgun Ltd. and also does other construction and repairing work for local customers. Sohel Rahman is director of Sheetal and Selima Rahman is the Company Secretary. All legal work is done by Ms. Jerin.

Required:

(i) Based on information given above write a memorandum to the Board identifying the potential related party relationships and any disclosable related party transactions for Falgun Ltd. for the year ending 31 December, 2012. Summarise, giving your reasons, what disclosure, if any, will be required in the full statutory accounts. 15

(ii) Comment, with examples, on the importance of related party transactions disclosures to the users of published accounts. 5

3. (a) The following are extracts from Brothers International's Balance Sheet as at 28 February 2013.

| | Tk | Note |
|---|---|---|
| Non-Current Assets | | |
| Land | 240,000 | (i) |
| Plant & equipment | 185,000 | (ii) |
| Buildings | 225,000 | (iii) |
| Current Assets | | |
| Financial instruments | 30,000 | (iv) |
| Trade receivables | 90,000 | (v) |
| Interest receivables | 5,000 | (vi) |
| Current Liabilities | | |
| Entertaining payable | 4,000 | (vii) |
| Interest payable | 2,000 | (vi) |

Notes:

(i) The land has been revalued during the year in accordance with IAS 16 Property, plant and equipment. It originally cost Tk 200,000. Land is not subject to depreciation under IAS nor under local tax rules. Revaluations are not allowed for tax purposes.

(ii) The plant and machinery had an original cost of Tk 240,000 and is stated after deducting accounting depreciation of Tk 55,000. The tax authorities have allowed tax depreciation of Tk 90,000 to date.

(iii) The buildings were acquired 5 years ago at a cost of Tk 250,000 and are being depreciated for accounting purposes over 50 years and for tax purposes over 25 years.

(iv) All of the financial instruments were acquired during the current year. They were acquired at a cost of Tk 24,000 and are stated at their fair value. Brother's Ltd has classified these financial statements as available for sale financial assets in accordance with IAS 39. The tax authorities only allow a deduction equal to the original cost of the financial instruments.

(v) The trade receivables balance in the accounts is made up of the following amounts.

| | |
|---|---|
| Gross trade receivables | Tk 105,000 |
| Less specific bad debt provision | (5,000) |
| Less general bad debt provision | (10,000) |
| | 90,000 |

The tax authorities only allow a deduction of bad debts when a court order has been received to write the debt off.

(vi) Interest is taxed on a cash basis.

(vii) The entertaining accrual relates to the staff party to celebrate the company's 5$^{th}$ anniversary. Staff entertaining costs are not allowed under the tax regime.

(viii) The applicable tax rate is 25%. The opening deferred tax liability was Tk 14,000.

**Required:**

(a) Describe the recognition criteria under IAS 12 Income taxes for a deferred tax liability and a deferred tax asset. 7

(b) Calculate the tax base and temporary differences for each of the balance sheet assets and liabilities in the above table. 7

(c) Calculate the deferred tax asset and liability at the balance sheet date and the amount that would be charged to the income statement for the year. 6

(b) Operating expenses in the draft accounts for Apex include Tk 405,000 relating to the company's defined benefit pension scheme. This figure represents the contributions paid into the scheme in the year. No other entries have been made relating to this scheme. The figures included on the draft statement of financial position represent opening balances as at 1 October 20X5:

| | |
|---|---|
| Pension scheme assets | Tk 2,160,000 |
| Pension scheme liabilities | (2,530,000) |
| | (370,000) |
| Deferred tax asset | 759,000 |
| | 389,000 |

After the year end, a report was obtained from an independent actuary. This gave valuations as at 30 September 20X6 of

| | |
|---|---|
| Pension scheme assets | Tk 2,090,000 |
| Pension scheme liabilities | (2,625,000) |

Other information in the report included:

| | |
|---|---|
| Expected rate of return on assets | 12% |
| Discount rate for liabilities | 10% |
| Current service cost | Tk 374,000 |
| Payment out of scheme relating to employees transferring out | Tk 400,000 |
| Reduction in liabilities relating to transfers | Tk 350,000 |
| Pensions paid | Tk 220,000 |

All receipts and payments into and out of the scheme can be assumed to have occurred on 30 September 20X6.

Apex's accounting policy is to recognize any actuarial gains and losses on defined benefit pension plans directly in other comprehensive income. This is consistent with the group policy.
In the tax regime in which Apex operates, tax deduction is allowed on payment of pension benefits. No tax deduction is allowed for contributions made to the scheme. Gains and losses on pension scheme assets are tax exempt.
Assume that the rate of tax applicable to 20X5, 20X6 and announced for 20X7 is 30%.

**Required:**

(i) Explain how each of the above transactions should be treated in the financial statements for the year ended 30 September 20X6. 8

(ii) Prepare an extract from the statement of comprehensive income showing other comprehensive income for the year ended 30 September 20X6. 8

**4.** Novotel Ltd acquired, from the licensing authority, a ten year license to operate a unique, ten channel satellite television network at a cost of Tk. 3.7 million on January 2012. The license commence on that date. The license purchase was funded by the issue of five million Tk. 1 ordinary shares at a premium of 20p. Professional fees of Tk. 500,000 were incurred of which Tk. 300,000 related to the issue of the ordinary shares. The remainder related to the legal negotiations for the network operating license. All of the professional fees are deductible for tax. The current tax rate is 30%. Sateast Ltd. subscribed for 10% of the shares issued. It also paid Tk 500,000 for five million warrants. Each warrant entitles Sateast Ltd to subscribe for one new ordinary share in Novotel Ltd from 1 April 2014 for Tk. 2 per share. The market value of one Novotel warrant at 31 December 2012 has been estimated at 11p. Novotel Ltd has signed a four year agreement with Stars Ltd. to utilize its satellite network for the delivery of its television channel. That agreement commenced on 1 April 2012. Novotel Ltd. Paid Stars Ltd Tk. 1 million on 1 April 2012. Three further annual payments of Tk. 600,000 are payable commencing on 1 April 2013. Novotel utilizes approximately 10% of the operating capacity of Star Ltd's network, which has an estimated useful life of eight years. Star has agreed a minimum level of service that will be provided.

Novotel operates a simple business model involving only one customer package. Each customer pays Novotel Tk. 45 per month for television services and commits to an initial 12 month contract. After that initial period the customer may cancel the contract. Once the initial contract is signed each customer receives free receiver equipment and free equipment installation. These have a retail value of Tk. 90 and Tk. 30 if purchased without the contracts. Stars Ltd. offers customers a similar television package without receive equipment and installation for Tk. 40 per month. Novotel signed up 20,000 customers during 2012. The average unexpired term of a customer contract is eight month. Novotel business plan includes ambitious growth targets. The customer take up has been disappointing. The business plan target number of customers who were needed to have subscribed to the service by 31 December 2012 in order to achieve eventual break even has been calculated at 75,000. Sateast ltd. Who wishes to break into this market, has made an indicative offer of Tk. 3.2 million for Novotel Ltd.'s operating license. The net selling price of the other intangible and tangible assets is believed to approximate to their carrying amount.

**Required:**

Discuss the financial reporting treatment in the 31 December 2012 financial statements of Novotel Ltd. for the issues arising from the establishment of the satellite television network business, particularly relating to: 24

a. Intangible assets; b. Equity issues; c. Agreement with Star Ltd.; d. Revenue recognition;

e. Impairment; and f. Going concern.

Your answer should effect on the 31 December 2012 financial statements.

*– The End –*