

CAP-III, Adv. Financial Reporting, June 2013
(Suggested)

Roll No.....

Maximum Marks - 100

Total No. of Questions - 6

Total No. of Printed Pages - 5

Time Allowed - 3 Hours

Marks

Attempt all questions. Working notes should form part of the answers.

1. The following condensed Balance Sheet of Company P and Company Q were prepared as on the Ashad end 2069.

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	Company P	Company Q
	Rs.	Rs.
<i>Assets</i>		
Goodwill	224,000	80,000
Plant and Machinery	190,000	100,800
Furniture	14,000	9,200
18,000 ordinary shares in Company Q	240,000	-
4,000 ordinary shares in Company P	-	48,000
Stock in trade	96,000	228,000
Sundry Debtors	140,000	90,000
Cash at Bank	34,000	26,000
	<u>938,000</u>	<u>582,000</u>
<i>Liabilities</i>		
Share Capital:		
Ordinary Shares of Rs. 10 each	360,000	200,000
7.5% Pref. Shares of Rs. 10 each	300,000	160,000
Premium on ordinary shares	72,000	-
Reserves	52,000	60,000
Sundry Creditors	34,000	122,000
Profit and Loss Account	120,000	40,000
	<u>938,000</u>	<u>582,000</u>

Sundry creditors of Company P included Rs. 30,000 due to Company Q for goods supplied since the acquisition of the shares. These goods are charged at 10% above cost. The stock of Company P as on Ashad end 2069 includes goods amounting Rs. 66,000 purchased from Company Q.

Company P acquired the share of Company Q on Magh 01, 2068. As at the date of the preceding Balance Sheet of Company Q, viz., on Ashad end 2068, the plant and machinery stood in the book at Rs. 112,000, the reserve at Rs. 60,000 and the profit and loss account at Rs. 16,000. The plant was revalued by Company P on the date of acquisition of the shares of Company Q at Rs. 120,000, but no adjustments were made in the books of Company Q.

Both the Companies have provided depreciation on all their fixed assets at 10% per annum.

YEO

P.T.O.

(2)

The reserve balance of company P as on the date of preceding Balance Sheet viz. on Ashad end 2068 was Rs. 52,000 and the balance in profit and loss A/c was nil.

You are required to prepare a consolidated Balance Sheet as at Ashad end 2069 and supporting schedules for major computations.

Answer No. 1

Consolidated Balance Sheet of P Ltd. and Its Subsidiary Q Ltd.
As on Ashad end 2069

<i>Liabilities</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
<i>Share Capital</i>			<i>Fixed Assets :</i>			
30,000 7 1/2% Preference shares of Rs. 10 each fully paid		300,000	Goodwill			
36,000 ordinary shares of Rs. 10 each fully paid	360,000		P		224,000	
Less 4,000 shares held by subsidiary Company Q	<u>40,000</u>	320,000	Q		<u>80,000</u>	
					304,000	
<i>Reserves & Surplus</i>			<i>Less Capital Reserve</i>		<u>46,794</u>	257,206
Share Premium	72,000		Plant and Machinery			
Less Loss on shares held by Subsidiary company Q	<u>8,000</u>	64,000	P		190,000	
			Q	100,800		
Reserves	52,000		<i>Add Appreciation</i>	<u>13,600</u>		
Less treated as capital profit	<u>23,060</u>	28,940		114,400		
			<i>Less Additional depreciation</i>	<u>680</u>	113,720	303,720
<i>Profit and Loss A/c</i>	120,000		Furniture			
Less Preference Dividend payable	<u>22,500</u>		P		14,000	
	97,500		Q		<u>9,200</u>	23,200
<i>Add Profit of Q</i>	<u>5,320</u>					
	102,820		<i>Current Assets</i>			
<i>Less Due to Minority Interest</i>	<u>1,193</u>		Stock :			
	101,627		P		96,000	
<i>Less Stock Reserve</i>	<u>5,340</u>	96,287	Q		<u>228,000</u>	
<i>Current Liabilities and Provisions</i>					324,000	
A. Current Liabilities			<i>Less Stock Reserve</i>		<u>5,340</u>	318,660
Sundry Creditors P	34,000		Sundry Debtors :			
Q	<u>122,000</u>		P		140,000	
	156,000		Q		<u>90,000</u>	
<i>Less Inter - Inter company indebtedness</i>	<u>30,000</u>	126,000			230,000	
			<i>Less Inter - Inter company indebtedness</i>		<u>30,000</u>	200,000
			Cash at Bank :			
B. Provisions :			P		34,000	
Provision for Pref. Dividend		22,500	Q		<u>26,000</u>	60,000

YEO

Minority Interest

205,059
<u>1,162,786</u>

<u>1,162,786</u>

Working Notes and Assumptions

- i) Shares were acquired by Company P in Company Q on Magh 01, 2068 – Date of acquisition of shares by Company Q in Company P is not given – it assumes that it was before Magh 01, 2068.
- ii) Since Company Q is entitled to a share of profits of holding Company P, the share of profit which Q could claim in Company P on Magh 01, 2068 (the date on which relationship of holding and subsidiary came into being) would be capital profit from the point of view of the group along with other pre-acquisition profits of Company Q. It is assumed that the balance in profit and loss A/c earned evenly during the fiscal year 2068/69.
- iii) Premium on ordinary shares has not been treated as capital (pre-acquisition) profit for allocation between the two companies. However, the converse treatment will not be wrong.
- iv) Taking into account 10% per annum depreciation (given) the book value of plant and machinery on the date of acquisition would be Rs. 112,000 – 5,600 (depreciation for six months on Rs. 112,000 @ 10% per annum) = Rs. 106,400. The holding Company P has revalued it at Rs. 120,000 on that date. Thus the valuation difference of Rs. 120,000 – 106,400 = Rs. 13,600 would constitute capital (pre-acquisition) profit.

The increase in the value of Plant and Machinery would necessitate provisions for additional depreciation on valuation difference (Rs. 13,600) for 6 months at the rate of 10% per annum i.e. Rs. 680.

- v) The profit earned by Company P during the FY 2068/069 was Rs. 120,000. After the provision for preference dividend of Rs. 22,500, the balance left would be Rs. 97,500. *(Balance of profit and loss account may be treated after provision of preference dividend and calculation will be different accordingly)*
- vi) The capital (pre-acquisition) and Revenue (post-acquisition) profits of Company P are as follows:

	Capital (Rs.)	Revenue (Rs.)
Reserves	52,000	-
Profit and Loss A/c as per note No. (v)	<u>48,750</u>	<u>48,750</u>
	<u>100,750</u>	<u>48,750</u>

- i) The profit earned by Company Q during FY 2068/069 is Rs. 24,000. After providing for preference dividend of Rs. 12,000 the balance left would be Rs. 12,000. *(Balance of profit and loss account may be treated after provision of preference dividend and calculation will be different accordingly)*
- ii) The capital (pre-acquisition) and Revenue (post-acquisition) profits of Company Q are as follows:

	Capital (Rs.)	Revenue (Rs.)
Reserves	60,000	-
P/L A/c credit balance on 01-04-2068	16,000	-
Profit earned during 068/069	6,000	6,000
Appreciation in the value of plant and machinery	<u>13,600</u>	<u>-</u>
	<u>95,600</u>	<u>6,000</u>
Less: additional depreciation as per note No. (iv)	<u>-</u>	<u>680</u>
	<u>95,600</u>	<u>5,320</u>

iii) Capital (Post-acq.) Profit for the Group

On account of inter-company holdings, the total capital profit of company P would be Rs. 100,750 plus its share in the capital (pre-acq.) profits of Company Q. Similarly the total capital profit of Company Q would be Rs. 95,600 plus its share in the capital (pre-acq.) profits of Company P. Thus, the two figures are inter-dependent and the difficulty can be overcome by the use of following algebraical equations:

Assume Capital profit of Company P to be X and Company Q to be Y,

Then, $X = 100,750 + 9/10 Y$; and

$$Y = 95,600 + 1/9 X$$

Therefore, $Y = 95,600 + 1/9 (100,750 + 9/10 Y)$ (substituting the value of X)

$$Y = 95,600 + 11,194.44 + 1/10 Y$$

$$10 Y = 1,067,944.4 + Y$$

$$9 Y = 1,067,944.4$$

$$Y = 118,660$$

Share of Minority Interest = $1/10 \times 118,660 = 11,866$.

Share of Company P on Capital (pre-acq.) profit for Group = $9/10 \times 118,660 = \text{Rs. } 106,794$.

Since the capital (Pre-acq.) profit in the Balance Sheet of Company Q is only Rs. 95,600 in all, Rs. 23,060 (to make it Rs. 118,660) will have to be transferred from the revenue (Post-acq.) reserves of Company P.

iv) Revenue (Post-acq.) Profits

Assume the Revenue Profit of Company P to be X and of Company Q to be Y.

Then, $X = 48,750 + 9/10 Y$

$$Y = 5,320 + 1/9 X$$

Therefore, $Y = 5,320 + 1/9 (48,750 + 9/10 Y)$ (substituting the value of X)

$$Y = 5,320 + 5,416.66 + 1/10 Y$$

$$10 Y = 107,366.6 + Y$$

$$9 Y = 107,366.6$$

$$Y = 11,930$$

Share of Minority Interest = $1/10 \times 11,930 = 1,193$

v) Unrealised Profit

Profit made by Company Q on Rs. 66,000 = $10/110 \times 66,000 = \text{Rs. } 6,000$.

a) Out of this profit of Rs. 6,000, Rs. 600 belong to Minority Interest and Rs. 5,400 to holding Company P.

b) Now, out of Rs. 5,400 belonging to Holding Company P as above, Rs. 600, i.e., $1/9$ of Rs. 5,400 belong to subsidiary company Q and therefore $1/10$ of Rs. 600 = 60 again belong to Minority Interest. Thus, the total profits from the point of view of Minority Interest is Rs. 600 + 60 = Rs. 660.

Therefore, reserve required for unrealized profit = Rs. 6000 – 660 = Rs. 5,340.

	Rs.
xii) Total Revenue Profit = Rs. 48,750 + 5,320	54,070
Less: Share of Minority Interest as per note No. (x)	<u>1,193</u>

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		52,877	
	<i>Less: Reserve for unrealised profit as per note No. (xi)</i>	5,340	
		<u>47,537</u>	
xiii)	Minority Interest		
		Rs.	Rs.
	Preference Shares		160,000
	Add Dividend payable		<u>12,000</u>
			172,000
	Ordinary Shares	20,000	
	Share of Capital Profits [note No. (ix)]	11,866	
	Share of Revenue Profits [note No. (x)]	<u>1,193</u>	<u>33,059</u>
			<u>205,059</u>
xiv)	Cost of Control or Goodwill		
		Rs.	Rs.
	Amount paid by Company P		240,000
	by Company Q		<u>48,000</u>
			288,000
	<i>Less Paid up value of shares held:</i>		
	4,000 shares in Company P	40,000	
	18,000 Shares in Company Q	180,000	
	Capital Profit for the Group	106,794	
	Share Premium paid by Company Q to be deducted from premium account	<u>8,000</u>	<u>334,794</u>
	Capital Reserve		<u>46,794</u>

Alternatively, if the Balance of Share Premium A/c of Rs. 72,000 is treated as capital profit, the capital reserve would increase by Rs. 8,000, *i.e.*, it would become Rs. 54,794.

- xv) Paid up value of share held by Company Q will be deducted from share capital of Company P and Rs. 8,000 being the amount of Share premium paid by Company Q on acquisition will be deducted from the balance on share premium account of Rs. 72,000.

2.

- a) The Balance Sheet of the Nepal Industries Limited as at 31st Ashadh 2069 is given below. The Company has two divisions namely Pokhara Division and Biratnagar Division. The assets and liabilities as on above date and the shares of the divisions are as follows,

(Amount in Million rupees)

Assets	Pokhara Division	Biratnagar Division	Total

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Fixed Assets:			
Cost	1,750	498	
<u>Less, Depreciation</u>	<u>(720)</u>	<u>(162)</u>	
WDV	1030	336	1,366
Investments	-	-	194
Net Current Assets:			
Current Assets	890	1,170	
<u>Less, Current Liabilities</u>	<u>(540)</u>	<u>(186)</u>	
	350	984	<u>1,334</u>
Total Assets			2,894
Liabilities			
Own funds:			
Equity shares @ 100 each	-	-	1,370
Reserve and Surplus	-	-	690
Loan funds	-	30	834
Total Liabilities			2,894

Loan funds included

- Bank loan – Biratnagar Division – Rs. 30.00 Million
- Debentures Paid up Value Rs. 250.00 Million (Redeemable at any time between 1st Magh 2068 to Poush end, 2069)

On 1st Shrawan 2069 the company sold all its investments for Rs. 204.00 Million and redeemed all the debentures at par, the cash transactions being recorded in the Bank account pertaining to Pokhara Division.

Then a new company called Himalayan Limited was incorporated with an authorized capital of Rs. 1,800.00 Million divided into shares of Rs. 100 each. All the assets and liabilities pertaining to Biratnagar Division were transferred to the newly formed company; Himalayan Ltd. allotting to Nepal Industries Limited's Shareholders its two fully paid equity shares each at par for every fully paid equity shares of Rs.100 each held in Nepal Industries Limited as discharge of consideration for the division taken over.

Himalayan Limited recorded in the books the fixed assets at Rs. 436.00 Million and all other assets and liabilities at the same values at which they appeared in the books of Nepal Industries Limited.

You are required to:

- i) Show the journal entries in the books of Nepal Industries Limited.
- ii) Prepare Balance sheets of Nepal Industries Limited immediately after demerger and the initial Balance sheet of Himalayan Limited.
- iii) Calculate the Intrinsic value of Nepal Industries Limited immediately before the demerger and immediately after demerger and of Himalayan Limited.

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(7)

- iv) Calculate the gain, if any, per share to the shareholders of Nepal Industries Limited arising out of Demerger
- b) Certain comparative figures for company A and Company B both belonging to the same industry are given below:

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Particulars	Company A	Company B
Net tangible assets backing for equity shares	300%	200%
Profit earned to profit distributed as dividend	200%	150%
Dividend per equity share	Rs 40	Rs 60

If the market value of a share in company A (considered representative of the industry) is Rs 200, what should, in your opinion, be the value placed on a share in Company B? Give reasons for your answer. Ignore Corporate Dividend Tax.

Answer No. 2

a)

I) Journal Entries in the Books of Nepal Industries Limited

Particulars		Amount in Rs 'millions'
a) Bank Account	Dr.	204
To Investment Account		194
To Reserves and Surplus Account		10
(Being Investment sold at a profit of Rs. 10 million)		
b) Debentures Account	Dr.	250
To, Bank Account		250
(Being debenture amount repaid at face value)		
c) Accumulated Depreciation Account	Dr.	162
Current Liabilities Account	Dr.	186
Loan Account	Dr.	30
Loss on reconstruction (balancing figure)	Dr.	1,290
To Fixed Assets Account		498
To Current Assets Account		1,170
(Being the assets and liabilities of Biratnagar Division being taken Out of books on transfer of the division to Himalayan Limited, the Consideration being allotment of members of the company two fully Paid equity shares each of Himalayan Ltd. at par for every fully paid share)		
d) Reserves and Surplus Account (690+10)	Dr.	700
To, Loss on reconstruction		700
(Being loss on reconstruction charged to reserve and surplus to the extent available)		

II) Balance Sheet of Nepal Industries Limited and Himalayan Limited as on 1st Shrawan 2069 (After demerger):

Particulars	Nepal Ind. Ltd.	Himalayan Ltd.
Fixed Assets:		
Cost	1,750	436
<u>Less, Depreciation</u>	<u>(720)</u>	-
WDV	1,030	436
Net Current Assets:		
Current Assets (working note 1)	844	1,170
<u>Less, Current Liabilities</u>	<u>(540)</u>	<u>(186)</u>
	<u>304</u>	<u>984</u>
Total Amounts	1,334	1,420
Liabilities		
Own funds:		
Equity shares @ 100 each	1,370	2,740
Reserve and Surplus (690+10-1290)	(590)	(1,350)*
Loan funds	554	30
Total Liabilities	1,334	1,420

* Balancing Figure

III) Calculation of Intrinsic Value:

	<u>Nepal Ind. Ltd</u>	<u>Nepal Ind. Ltd</u>	<u>Himalayan Ltd</u>
	<u>Before merger</u>	<u>After merger</u>	
Fixed Assets	1,366	1,030	436
Investment	204	-	-
Current Assets	2,060	844	1,170
Less, Current Liabilities	(726)	(540)	(186)
<u>Less, Loan Funds</u>	<u>(834)</u>	<u>(554)</u>	<u>(30)</u>
Net Assets	2,070	780	1,390
<u>÷ No of Shares</u>	<u>13.70</u>	<u>13.70</u>	<u>27.40</u>
Intrinsic Value/ Share	151.09	56.93	50.73

IV) Calculation of Gain per Share due to demerger:

Premerger Value per share = Rs.151.09

Less, Post merger Value(1 ×56.93+2×50.73) =Rs. 158.39

Gain= Rs. 7.30

Working Note

	<u>Rs. in million</u>
i) Current assets of Pokhara division before merger	890
Add: Proceeds of investment sold	204
Less: Payment to Debenture holders	<u>(250)</u>
Current assets after merger	<u>844</u>

Solution of question with correction of paid up capital and reserve and surplus of Nepal Industries Limited as Rs. 690 million and Rs. 1,370 million respectively.

I) Journal Entries in the Books of Nepal Industries Limited

Particulars	Amount in Rs 'millions'
a) Bank Account Dr.	204
To, Investment Account	194
To, Reserves and Surplus Account	10
(Being Investment sold)	
b) Debentures Account Dr.	250
To, Bank Account	250
(Being debenture amount repaid)	
c) Accumulated Depreciation Account Dr.	162
Current Liabilities Account Dr.	186
Loan Account Dr.	30
Loss on Demerger Account (Bal. fig.) Dr.	1,290
To, Fixed Assets Account	498
To, Current Assets Account	1,170
(Being Sundry assets and liabilities transferred)	
d) Reserves and Surplus Account Dr.	1,290
To, Loss on Demerger Account	1,290
(Being loss transfer)	

II) Balance Sheet of Nepal Industries Limited and Himalayan Limited as on 1st Shrawan 2069 (After demerger):

Particulars	Nepal Ind. Ltd.	Himalayan Ltd.
Fixed Assets:		
Cost	1,750	436
<u>Less, Depreciation</u>	<u>(720)</u>	<u>-</u>
WDV	1,030	436
Net Current Assets:		
Current Assets (working note 1)	844	1,170
<u>Less, Current Liabilities</u>	<u>(540)</u>	<u>(186)</u>
	<u>304</u>	<u>984</u>
Total Amounts	1,334	1,420
Liabilities		

Own funds:		
Equity shares @ 100 each	690	1,380
Reserve and Surplus (1,370+10-1290)	<u>90</u>	<u>10*</u>
	554	30
Loan funds		
Total Liabilities	1,334	1,420

Balancing Figure

III) Calculation of Intrinsic Value:

	<u>Nepal Ind. Ltd (Before)</u>	<u>Nepal Ind. Ltd (After)</u>	<u>Himalayan Ltd</u>
Fixed Assets	1,366	1,030	436
Current Assets	2,264	844	1,170
(2060+204)			
Less, Current Lia. (726)		(540)	(186)
<u>Less, Loan Funds (834)</u>		<u>(554)</u>	<u>(30)</u>
Net Assets	2,070	780	1,390
<u>÷No of Shares</u>	<u>6.90</u>	<u>6.90</u>	<u>13.80</u>
Intrinsic Value/ Share 300		113.04	100.72

IV) Calculation of Gain per Share due to demerger:

Premerger Value per share = Rs.300.00

Less, Post merger Value(1 ×113.04+2×100.72) =Rs. 314.48

Gain= Rs. 14.48

Working Note

	<u>Rs. in million</u>
ii) Current assets of Pokhara division before merger	890
Add: Proceeds of investment sold	204
Less: Payment to Debenture holders	<u>(250)</u>
Current assets after merger	<u>844</u>

- b) The dividend per share in company A being Rs.40 and the price per share being Rs.200, it is obvious that a 20% yield satisfies investors in these shares. Conditions in company B are different from those in company A; hence the yield will satisfy investors in shares of company B will also be different. The adjustments will be on the lines mentioned below:

Normal yield (for company A.)	20%
Add: For net tangible asset backing per share being only twice instead of 3 times	1.5%
For having a higher pay out ratio – company A distributes only 1/2 profits whereas company B distributes 2/3rds (rounded down)	1%
	22.5%
The dividend per share per share in company B being Rs. 60, the likely	Rs <u>60*100/22.5</u>

price of the share will be:	=Rs 266.67
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3. Tower Ltd is a small, profitable, owner-managed company which is seeking finance for a planned expansion. A local bank has indicated that it may be prepared to offer a loan of Rs. 100,000 at a fixed annual rate of 9%. Tower Ltd would repay Rs. 25,000 of the capital each year for the next four years. Annual interest would be calculated on the opening balance at the start of each year. Current financial information on Tower Ltd. is as follows:

- Current turnover: Rs. 210,000
- Net profit margin: 20%
- Annual taxation rate: 25%
- Average overdraft: Rs. 20,000
- Average interest on overdraft: 10% per year
- Dividend payout ratio: 50% of profit available for distribution
- Shareholders funds: Rs. 200,000
- Market value of fixed assets: Rs.180,000

As a result of the expansion, turnover would increase by Rs. 45,000 per year for each of the next four years, while net profit margin would remain unchanged. No capital allowances would arise from investment of the amount borrowed.

Tower Ltd currently has no other debt than the existing and continuing overdraft and has no cash or near-cash investments. The fixed assets consist largely of the building from which the company conducts its business. The current dividend payout ratio has been maintained for several years.

Required:

- a) Assuming that Tower Ltd is granted the loan, calculate the following ratios for Tower Ltd for each of the next four years:(i) interest cover;(ii) medium and long-term debt/equity ratio;(iii) return on equity;(iv) return on capital employed. **8**
- b) Comment on the financial implications for Tower Ltd of accepting the bank loan on the terms indicated above. **8**

Answer No. 3

a)

Profit and loss accounts for Tower Ltd for the four-year period

Year	Current	Year1	Year2	Year3	Year4
	Rs	Rs	Rs	Rs	Rs
Turnover	210,000	255,000	300,000	345,000	390,000
Expenses	<u>168,000</u>	<u>204,000</u>	<u>240,000</u>	<u>276,000</u>	<u>312,000</u>
Net profit (20% of turnover)	42,000	51,000	60,000	69,000	78,000
Tax (considering 25%)	14,000	17,000	20,000	23,000	26,000

Profit Before Tax	56,000	68,000	80,000	92,000	104,000
Interest on O/D	2,000	2,000	2,000	2,000	2,000
Interest on other Loan	0	9,000	6,750	4,500	2,250
Profit before Interest and tax	<u>58,000</u>	<u>79,000</u>	<u>88,750</u>	<u>98,500</u>	<u>108,250</u>
Dividend	<u>21,000</u>	<u>25,500</u>	<u>30,000</u>	<u>34,500</u>	<u>39,000</u>
Retained profit	<u>21,000</u>	<u>25,500</u>	<u>30,000</u>	<u>34,500</u>	<u>39,000</u>
Equity finance	200,000	221,000	246,500	276,500	311,000
Debt finance	nil	75,000	50,000	25,000	Nil
Interest cover (times)	29.00	7.18	10.14	15.15	25.47
Debt/equity (%)	nil	0.34	0.20	0.09	Nil
Return on equity (%)	21.00%	23.08%	24.34%	24.95%	25.08%
ROCE (%)*	22.00%	23.98%	25.15%	25.68%	25.72%
ROCE (%)**	20.00%	21.99%	23.26%	23.95%	24.17%

*Calculated only considering term loan in capital employed

**Including the existing and continuing overdraft in capital employed

Workings

Annual interest (assuming the continuing overdraft is maintained at the current level)

Year 1 interest payment = $100,000 \times 0.09 = 9,000 + 2,000 = \text{Rs. } 11,000$

Year 2 interest payment = $75,000 \times 0.09 = 6,750 + 2,000 = \text{Rs. } 8,750$

Year 3 interest payment = $50,000 \times 0.09 = 4,500 + 2,000 = \text{Rs. } 5,500$

Year 4 interest payment = $25,000 \times 0.09 = 2,250 + 2,000 = \text{Rs. } 4,250$

- b) Financial implications for Tower Ltd of accepting bank loan A key consideration is whether Tower Ltd will be able to meet the annual payments of interest and principle loan amount. It is assumed, in preparing a cash flow forecast, that there is no difference between profit and cash, and that inflation can be ignored. The annual cash surplus after meeting interest and tax payments is therefore assumed to be equal to retained profit.

Year	1	2	3	4
Retained profit	25,500	30,000	34,500	39,000
Capital Repayment (debt)	25000	25000	25000	25000
Net Cash Flow	500	5,000	9,500	14,000

Since Tower Ltd. Is able to meet the capital repayment from the very first year, it should accept the loan.

It is useful to consider key financial information after the loan has been paid off, i.e. in year 5, assuming that no further turnover growth occurs after the fourth year:

Particulars	Year 5	Particulars	Year 5
Turnover	390,000	Tax	26,000
Total Expenses	312,000	Profit Before Tax	104,000
Net profit (20% of turnover)	78,000	Dividend	52,000
Interest	2,000	Retained Profit	52,000
Profit before Tax	104,000	Equity Finance	363,000

Debt Finance	Nil	Interest cover (times)	53
Debt/equity %	Nil	Return on equity (%)	21%
ROCE (%)*	19%		

*Including the existing and continuing overdraft in capital employed

The effect on financial risk of taking on the loan can be examined. If the interest and capital payments are kept up, financial risk will be lower than its current level at the end of four years, all things being equal. Interest cover increases from its current level after five years, from 29 times to 53 times, but is on the low side at the end of the first year (7.18 times), although an improved level is reached at the end of the second year (10.14 times), with further increases in subsequent years. The debt/equity ratio peaks at 33.94% at the end of the first year and falls rapidly thereafter, at no time looking dangerous, and Tower Ltd returns to its current ungeared position after five years. The bank, as provider of debt finance, would be interested in the trend in these ratios, as well as in the ongoing cash flow position.

Both return on equity (ROE) and return on capital employed (ROCE) improve with growth in turnover, but are lower than current levels in the first and second years following taking on the loan. At the end of five years ROE has improved to 25.08% from 21%.

Provided Tower Ltd can meet the interest and capital repayments, business expansion using debt finance may be financially feasible. However, this analysis has ignored any potential pressure for reduction or repayment of the overdraft. An average overdraft of Rs 20,000 is quite large for a company with an annual turnover of Rs 210,000 and therefore cannot be ignored in any assessment of financial risk. Tower Ltd may therefore consider asking for a longer repayment period, with lower annual capital repayments, if it plans to reduce the size of the overdraft or if it is concerned about future cash flow problems.

4.

- a) TQM Ltd. furnishes the following Profit and Loss A/c for the fiscal year ended Ashad 31, 2069:

Income	Notes	Rs. ('000)
Turnover	1	29,872
Other Income		<u>1,042</u>
		<u>30,914</u>
Expenditure		
Operating expenses	2	26,741
Interest on 8% Debenture		987
Interest on Cash Credit	3	151
Excise duty		<u>1,952</u>
		<u>29,831</u>
Profit before depreciation		1,083
Less: Depreciation		<u>342</u>
Profit before tax		741
Provision for tax	4	<u>376</u>
Profit after tax		365
Less: Transfer to Fixed Assets Replacement Reserve		<u>65</u>
		300

Less: Dividend paid	<u>125</u>
Retained Profit	<u>175</u>

Notes:

- i) Turnover is based on invoice value and net of sales tax.
- ii) Salaries, wages and other employee benefits amounting to Rs. 14,761,000 are included in operating expenses.
- iii) Cash Credit represents a temporary source of finance. It has not been considered as a part of capital.
- iv) Transfer of Rs. 54,000 to the credit of deferred tax account is included in provision for tax.

Prepare value added statement of TQM Ltd. for the fiscal year ended 31st Ashad 2069 and reconcile total value added with profit before taxation.

8

- b) From the following information compute Diluted Earnings Per Share (DEPS).
- Net profit for the year 2068-69: Rs.1,800,000
 - Weighted Average no. of equity shares outstanding during the year 2068-69 is 75,000
 - Average fair value of one equity share during the year: Rs. 200.
 - Weighted average no. of the shares under the options during the year is 15,000.
 - Exercise price per share under option during the year is Rs. 150.

4

- c) X Ltd. sold JCB Machine having WDV of 50 Lakhs to Y Ltd for 60 Lakhs and the same JCB was leased back by Y Ltd to X Ltd. The lease is operating lease.

4

Comment according to relevant Nepal Accounting Standard if

- (i) Sale price of Rs. 60 Lakhs is equal to fair value
- (ii) Fair Value is Rs. 50 Lakhs and sale price is Rs. 45 Lakhs.
- (iii) Fair value is Rs. 55 Lakhs and sale price is Rs. 62 lakhs
- (iv) Fair value is Rs. 45 Lakhs and sale price is Rs. 48 Lakhs.

Answer No. 4**a)****TQM Ltd.****Value Added Statement for the year ended 31st Ashad, 2069**

	Rs.('000)	Rs.('000)	%
Turnover		29,872	
Less: Cost of bought in materials and services:			
Operating expenses (26,741 –14,761)	11,980		
Excise duty*	1,952		
Interest on Cash Credit	<u>151</u>	<u>14,083</u>	
Value added by manufacturing and trading activities		15,789	

(15)

Add: Other income		<u>1,042</u>	
Total value added		<u>16,831</u>	
Application of value added:			
To Pay to employees:			
Salaries, wages and other employee benefits	14,761		87.70
To Pay to Government: *			
Corporation tax (376 – 54)	322		1.91
To Pay to providers of capital:			
Interest on 8% Debentures	987		
Dividends	<u>125</u>	1,112	6.61
To Provide for maintenance and expansion of the company:			
Depreciation	342		
Fixed Assets Replacement Reserve	65		
Deferred Tax Account	54		
Retained Profit	<u>175</u>	<u>636</u>	<u>3.78</u>
		<u>16,831</u>	<u>100</u>

Reconciliation between total value added and profit before taxation

	Rs.('000)	Rs.('000)
Profit before tax		741
Add back:		
Depreciation	342	
Wages, salaries and other benefits	14,761	
Debenture interest	<u>987</u>	<u>16,090</u>
Total Value Added		<u>16,831</u>

*Excise duty could alternatively be shown as an item 'To pay to government' without deducting from Value Addition. Excise duty is contribution to government net of refund claimed by entity.

b) Working note 1: Calculation of Basic Earnings Per Share

Basic EPS: Earnings for Equity Share holders/ W.avg. no of shares
=1,800,000/75,000= Rs.24.00 Per share

Calculation of Diluted Earnings per share:

- Identify Potential equity share: (ESOP)
= ESOP- (ESOP× Exercise price/Fair Value)
= 15,000-(15,000×150/200)
=3,750 Shares

(16)

- Incremental EPS: $= 0/3,750 = 0$ per share

- Test of Dilution:

<u>Particulars</u>	<u>Numerator</u>	<u>De-numerator</u>	<u>Ratio</u>
BEPS-COO	1,800,000	75,000	24.00
+ ESOP	-	3,750	
	1,800,000	78,750	22.86

- Diluted Earnings Per Share = $(1,800,000/78,750) = \text{Rs.} 22.86$ Per share.

c) According to NAS 15 para 62, 63 and 64, following will be the treatment in the given situations:

- (i) When sales price of Rs. 60 lakhs is equal to fair value, X Ltd. should immediately recognize the profit of Rs. 10 lakhs (i.e. 60 - 50) in its books.
- (ii) When fair value of leased JCB machine is Rs. 50 lakhs & sales price is Rs. 45 lakhs, then loss of Rs. 5 lakhs (50 - 45) to be immediately recognized by X Ltd. in its books provided loss is not compensated by future lease payments.
- (iii) When fair value is Rs. 55 lakhs & sales price is Rs. 62 lakhs, profit of Rs. 5 lakhs (55 - 50) to be immediately recognized by X Ltd. in its books and balance profit of Rs. 7 lakhs (62-55) is to be amortised/deferred over lease period.
- (iv) When fair value is Rs. 45 lakhs & sales price is Rs. 48 lakhs, then the loss of Rs. 5 lakhs (50-45) to be immediately recognized by X Ltd. in its books and profit of Rs. 3 lakhs (48-45) should be amortised/deferred over lease period.

5. Explain the followings with reference to the provision of Nepal Accounting Standards:

- a) A company is in dispute involving allegation of infringement of patents by a competitor company who is seeking damages of huge sum of Rs. 50 Million. The directors are in opinion that the claim can be successfully resisted by the company. How would you deal with the same in the annual accounts of the company? 4
- b) Cashier of A Limited embezzled cash amounting to Rs. 600,000 during Ashad, 2069. However, the same comes to the notice of Company management during Shrawan, 2069 only, financial statements of the company is not yet approved by the Board of Directors of the company. Whether the embezzlement of cash should be adjusted in the books of accounts for the fiscal year ending on Ashad end, 2069? 4
- c) A company undertook a contract for building a crane for Rs. 10 lakhs. As on 31.03.2069 it incurred a cost of Rs. 1.5 lakhs and expects that there will be Rs. 9 lakhs more for completing the crane. It has received so far Rs. 1 lakh as progress payment. How the revenue should be recognized in the financial statement for the fiscal year 2068/69. 4
- d) A private limited company manufacturing fancy terry towels had valued its closing stock of inventories of finished goods at the realisable value, inclusive of profit and the export cash incentives. Firm contracts had been received and goods were packed for export, but the ownership in these goods had not been transferred to the foreign buyers. Comment on valuation of stocks hold by the company. 4

Answer No. 5

- a) As per the provisions of Para 14 of the NAS-12 "Provisions, Contingent Liabilities and Contingent Assets", provisions should be recognized only when,
- An enterprise has a present obligation as a result of Past Event,
 - It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
 - A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provisions should be recognized.

In the given situation, the directors are of the opinion that the claim can be successfully resisted by the company, therefore there will be no outflow of the resources. Here as per the provision of Para 86 of above NAS the company will disclose the same as contingent liability by way of the following note: "Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of Rs. 50.00 Million. However, the directors are of the opinion that the claim can be successfully resisted by the company."

- b) As per para 3 of NAS 05, Events after the balance sheet date are those events, favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorized for issue. Two types of events can be identified:
- a) those that provide evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); and
 - b) those that are indicative of conditions that arose after the balance sheet date (non-adjusting events after the balance sheet date).

Though the theft, by the cashier Rs. 600,000, was detected after the balance sheet date (before approval of financial statements) but it is an additional information materially affecting the determination of the cash amount relating to conditions existing at the balance sheet date. Therefore, it is necessary to make the necessary adjustments in the financial statements of the company for the year ended 31st Ashad, 2069 for recognition of the loss amounting Rs. 600,000.

- c) NAS 13 'Construction Contracts' provides that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively with reference to the stage of completion of the contract activity at the reporting date.

As per NAS 13, during the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognized only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognised. NAS 13 further states that when it is probable that the total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. Thus the foreseeable loss of Rs. 50,000 (expected cost Rs. 10.5 lakhs less contract revenue Rs. 10 lakhs) should be recognized as an expense in the year..

- d) The provision of Para a of NAS 04 'Inventories' states that inventories shall be measured at the lower of cost and net realizable value. The provision of Para 4 of

above NAS further states that at certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted and when sale is assured under a forward contract or a government guarantee or when homogenous market exists and there is a negligible risk of failure to sell, the goods invoiced are often valued at Net-realizable value."

Terry Towels do not fall in the category of agricultural crops or mineral ores. Accordingly, taking into account the facts stated, the closing stock of finished goods (Fancy terry towel) should have been valued at lower of cost and net-realizable value and not at net realizable value. Further, export incentives are recorded only in the year the export sale takes place. Therefore, the policy adopted by the company for valuing its closing stock of inventories of finished goods is not correct as per the provision of above NAS.

6. Write short note on:

(4×4=16)

- a) Market Value Added
- b) Accommodation Bill
- c) CAPM and Beta
- d) Materiality

Answer No. 6

a) Market Value Added:

Market value added is the market value of the capital employed in the firm less book value of the Capital Employed. Market value added is calculated by summing up the paid up value of equity and preference share capital, Retained earnings, Long term- Short term debts and subtracting this sum from the market value of the equity and debt. Market value added measures cumulatively the performance of corporate entity.

A high market value added means the company has created substantial wealth for shareholders. On the other hand, negative MVA means the value of management's actions and investments are less than the value of capital contributed to the company by the capital market or that the wealth and value has been destroyed.

b) **Accommodation bill**

Bill of exchange are usually drawn to facilitate trade transmission, that is, bills are meant to finance actual purchase and sale of goods. But the mechanism of bill can be utilized to raise finance also. Therefore, an accommodation bill is one which is drawn, accepted or endorsed for the purpose of arranging financial accommodation for one or more interested parties. Suppose Ram needs finance for three months. In that case he may persuade his friend Hari to accept his drafted bill. The bill of exchange may then be taken by Ram to his bank and discounted there. Thus Ram will be able to make use of funds. When the three months period draws to a close Ram will send the requisite amount to Hari and Hari will meet the bill. Thus Ram is able to raise money for his use. If both Ram and Hari need money, the same device can be used. Either Ram accepts a bill of exchange or Hari does. In either case, the bill will be discounted with the bank and the proceeds divided between the two parties according to mutual agreement. The discounting charges must also be borne by the two parties in the same ratio in which the proceeds are divided. On the due date the acceptor will receive from the party his share.

The bill will then be met. When bills are used for such a purpose, they are known as accommodation bills.

Entries are passed in the books of two parties exactly in the same way as for ordinary bills. The only additional entry to be passed is for sending the remittance to the other party and also debiting the other party with the requisite amount of discount.

c) Capital Asset Pricing Model

Capital Asset Pricing Model (CAPM) is the most widely used method of calculating the Cost of Equity Capital. Under CAPM cost of Equity Capital is expressed as

$$\text{Risk Free Rate} + \text{Specific Risk Premium} = \text{Risk Free Rate} + \text{Beta} \times \text{Equity Risk Premium} \\ \text{Premium} = \text{Risk Free Rate} + \text{Beta} \times (\text{Market Rate} - \text{Risk Free Rate})$$

Specific Risk Premium is a multiple of Beta and Equity Risk Premium.

Beta :

Beta is a relative measure of volatility that is determined by comparing the return on a share to the return on the stock market. In simple terms, the greater the volatility, the more risky the share and the higher the Beta. For the companies, which are not listed in stock exchanges, beta of the similar industry may be considered after transforming it to un-gear beta and then re-gearing it according to the debt equity ratio of the company. The formula for un-gearing and gearing beta is shown below.

$$\text{Un-gear Beta} = \text{Industry Beta} / [1 + (1 - \text{Tax Rate}) (\text{Industry Debt Equity Ratio})] \\ \text{Geared Beta} = \text{Un-gear Beta} / [1 + (1 - \text{tax rate}) (\text{Debt Equity Ratio})]$$

d) **Materiality**

Financial statements should disclose all 'material items, i.e. the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases quantitative limits of materiality is specified. A few of such cases are given below:

(a) In giving break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break-up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10% or more of the total value of purchases, stocks or turnover as the case may be, are shown as separate and distinct items with quantities thereof in the break-up.

(b) Any item under which the expenses exceed 1 per cent of total revenue of the company or Rs. 5,000, whichever is higher, are shown as a separate and distinct item against appropriate account head in the Profit & Loss Account and are not combined with any other item shown under 'Miscellaneous Expenses'.