PRACTICE QUESTIONS ON IAS 39

Classification

Q-1

(a) AB Co sells an investment in shares, but retains a call option to repurchase those shares at any time at a price equal to their current market value at the date of repurchase.

(b) CD Co sells an investment in shares and enters into a 'total return swap' with the buyer. Under a 'total return swap' arrangement, the buyer returns any increases in value to the seller, and the seller compensates the buyer for any decrease in value plus interest.

(c) EF Co enters into a stock lending agreement where an investment is lent to a third party for a fixed period of time for a fee.

(d) GH Co sells title to some of its receivables to a debt factor for an immediate cash payment of 90% of their value. The terms of the agreement are that GH Co has to compensate the factor for any amounts not recovered by the factor after six months.

Required: - Discuss whether the following financial instruments would be derecognized?

Q-2

Lulworth Co purchased a two year $20 million 6% debenture at par on 1 January 20X1 when the market rate of interest was 6%. Interest is paid annually on 31 December. The market rate of interest on debentures of equivalent term and risk changed to 7% on 31 December 20X1.

Required: - Show the charge or credit to the income statements for the two years to 31 December 20X2 if the debentures are held:

(a) at amortized cost

(b) at fair value through profit or loss

(c) at fair value as an available-for-sale financial asset.

Fair value is to be calculated using discounted cash flow techniques.

Q-3

Green Tree Co had the following financial instrument transactions affecting the year ended 31 December 20X2:

(1) Purchased 4% debentures in MT Co on 1 January 20X2 (their issue date) for $100,000 as an investment. Green Tree intends to hold them until their redemption after six years at a premium of 17%. Transaction costs of $2,000 were incurred on purchase. The internal rate of return of the bond is 6.0%.

(2) Entered into a speculative interest rate option costing $7,000 on 1 September 20X2 to borrow $5,000,000 from GF Bank commencing 31 March 20X3 for six months at 5.5%. Value of the option at 31 December 20X2 was $13,750.

(3) Purchased 25,000 shares in EG Co in 20X1 for $2.00 each as an investment. Transaction costs on purchase or sale are 1% purchase/sale price. The share price on 31 December 20X1 was $2.25 – $2.28. Green Tree sold the shares on 20 December 20X2 for $2.62 each.

(4) Sold some shares in BW Co 'short' (i.e. sold shares that were not yet owned) on 22 December 20X2 for $24,000 (the market price of the shares on that date) to be delivered on 10 January 20X3. The market price of the shares at 31 December 20X2 was $28,000.

Required: - Show the accounting treatment and relevant extracts from the financial statements for the year ended 31 December 20X2?

Q-4

The company issuing the 4% debentures in Lecture example 3 gets into financial trouble at the end of the first year (31.12.X2 – all interest has been paid up to this date). On this date the liquidator of the company that issued the bond informs you that no further interest will be paid and only 75% of the maturity value will be repaid, on the original repayment date. The market interest rate on similar bonds is 7% on that date.
Required: - How much is the impairment and how should it be reported in the financial statements?

Q-5

Bruntal is a manufacturer and retailer of gold jewellery. On 1 October 20X1, the cost of Bruntal's inventories of finished jewellery was $8.280 million with a gold content of 24,000 troy ounces. At that date their sales value was $9.938 million.

The selling price of gold jewellery is heavily dependent on the current market price of gold (plus a standard percentage for design and production costs).

Bruntal's management wished to reduce their business risk of fluctuations in future cash inflow from sale of the jewellery by hedging the value of the gold content of the jewellery. In the past this has proved to be an effective strategy.

Therefore it sold futures contracts for 24,000 troy ounces of gold at $388 per troy ounce at 1 October 20X1. The contracts mature on 30 September 20X2.

The jewellery was sold for $9.186m on 30 September 20X2 when the spot price of gold per troy ounce was $352.

Required: - Discuss how the above transaction would be treated in the financial statements for the year ended 30 September 20X2?

Q-6

Three Star Company on July 01, 2008, enters into an agreement with Million Star Bank to sell a group of its receivables without recourse. A total face value of $ 200,000 accounts receivables (against which a 5% allowance has also been created) is involved. The factor will charge 20% interest computed on the weighted average time to maturity of the receivables of 36 days plus a 3% fee.

Three Star's customers return for credit of $ 4,800 of inventory.

The customer return privilege period expires and the remaining holdback is paid to the transferor.

Required: - Pass necessary journal entries?

Q-7

An entity lends $ 1,000 to entity B for five years and classifies the asset under loans receivables. The loan carries no interest. Instead, entity expects other future economic benefits, such as an implicit right to receive goods on preferential terms.

On initial recognition, the market rate of interest for similar five year loan is 10% per annum.

Required: - Calculate the amortized cost of the loan?

CONTINUING INVOLVEMENT

Q-1

Entity A holds a portfolio of trade receivables with a carrying value of Rs. 500 million. Entity A enters into a factoring arrangement with entity B under which it transfers the portfolio to entity B in exchange for Rs. 490 million of cash. Entity A transfers the credit risk but retains the late payment risk up to a maximum of 180 days. After 180 days, the receivable is deemed to be in default and credit insurance takes effect. A charge is levied on the entity A for these late payments using a current rate of 6%.

The fair value of the guarantee of late payment is Rs. 2 million. Apart from late payment risk, entity A does not retain any credit risk or interest rate risk and does not carry out servicing of the portfolio. There is no active market for the receivables.

Required: - Pass necessary journal entries if: -

a) If no default in late payment
b) The late payment occurs and Rs. 4 Million charged to entity A

Q-2

Entity A has a portfolio of high yielding corporate bonds with an amortized carrying value of Rs. 102 million. The bonds are not traded in the market place and are not readily obtainable. On January 01, 20x6, entity A sells the bonds to entity B for a consideration of Rs. 100 million, but retain a call option to buy the portfolio at Rs. 105 million on December 31, 20x6. On that date the amortized cost of the bonds will be Rs. 106 million. The fair value of the bonds at the date of transfer amounted to Rs. 104 million.

Required: -

Pass necessary entries?

Q-3

Entity A has 15% equity holding in entity B acquired few years back for Rs. 40 million. This holding is treated as an OCI Investment and current fair value is Rs. 104 million. There is no active market in entity B shares. On January 01, 20x6, the entity A sells its 15% investment in entity B to bank C for a consideration of Rs. 100 million, but retains a call option to purchase the investment for Rs. 105 million on December 31, 20x7.

Required: -

Pass necessary journal entries?

Continuing Involvement Questions

Q-4

On January 01, 20x0, an entity purchases 10% Rs. 10 million 10 year bonds with interest payable annually on December 31, each year. The bond's purchase price is Rs. 10,811,100, which results in a bond premium of Rs. 811,100 and an effective interest rate of 8.75%. The bonds were classified by the entity as held to maturity.

On December 31, 20x5, when the bonds amortized cost and fair value amounted to Rs. 10,407,192 and Rs. 10,749,395 respectively, the entity sells Rs. 1 million bonds and realizes a gain.

On January 01, 20x8 after the end of tainting period, the entity reclassifies the Rs. 9 million bonds as held to maturity. On that date, the fair value of bond was Rs. 9,488,165. The bonds new effective interest rate is 7%.

Required: - Provide extract to the financial statements for the years 20x5 to 20x9?

Q-5

On January 01, 20x6 bank A enters into an agreement to sell a portfolio of held for trading listed debt securities to an investment fund in exchange for a cash payment of Rs. 6 million. The securities are subject to a call option that allows the bank to repurchase the securities for a price of Rs. 6.7 million on December 31, 20x6. The securities fair value at the date of transfer is Rs. 6.5 million. The options fair value is Rs. 0.5 million. The investment fund has the practical ability to sell to a third party.

Assume that at December 31, 20x6, the fair value of the shares increases to Rs. 7 million and the bank exercises the option.

Required: - Provide accounting treatment on December 31, 20x5 and 20x6?

Q-5

Entity A has high yielding portfolio of corporate bonds with an amortized cost of Rs. 102 million. The bonds are not readily obtainable. On January 01, 20x6, entity A sells the bonds to entity B for a consideration of Rs. 100 million, but retains a call option to purchase the portfolio for Rs. 105 million on December 31, 20x6. On that date, the amortized cost of the bonds will be Rs. 106 million. The fair value of the bonds at the date of transfer amounted to Rs. 104 million.

Required: - discuss the accounting treatment of the above situation?

DERECOGNITION

Q-1

The directors of QN Limited owes $ 90,000 to MN Bank on 5% interest bearing non amortizing note payable in five years, plus accrued and unpaid interest , due immediately, of $ 4,500. MN Bank agrees to a restructuring to assist QN, which is suffering losses and is threatening to declare bankruptcy. The interest rate is reduced to 4%, the principal is reduced to $ 72,500 and the accrued interest is forgiven outright. Future payments will be normal term. However, given the QN current condition, the market rate of interest would have been 12%.

Required: - Discuss the implications of above restructuring and pass necessary journal entries?

Q-2

The directors of QN Limited owes $ 90,000 to MN Bank on 5% interest bearing non amortizing note payable in five years, plus accrued and unpaid interest , due immediately, of $ 4,500. MN Bank agrees to a restructuring to assist QN, which is suffering losses and is threatening to declare bankruptcy. The interest rate is reduced to 4.5%, the principal is reduced to $ 85,000. The loan term has been shortened to 3 years from 5 years in order to reduce the risk. QN Limited agreed to the new terms.

Required: - Discuss the implications of above restructuring and pass necessary journal entries?

Q-3

Hungry company on July 01, 2008 enters into an agreement with Rich Company to sell a group of its receivables without recourse. A total face value of $ 200,000 accounts receivables against which a 5% provision for doubt full debts has been created is involved. The factor will charge 20% interest computed on weighted average to maturity of the receivables of 36 days plus a fee of 3%. A 5% holdback will be retained.

Hungry customers return goods for the value of $ 4,800.

Required: - Discuss the implications of above restructuring and pass necessary journal entries?

Q-4

An entity has investment in mortgaged loans having amortized cost of $14.5 million is being sold to, but the right to service the loan retained. Servicing right requires monthly collections of principal and interest and forwarding these to the holders of investments.

a) The present value of future servicing is $ 1.2 while the investment without servicing can be sold for $ 13.6 million.

b) The present value of future servicing is $ 1.2 and the selling price of investment with servicing is $ 13.1 million
c) The present value of future servicing is $ (1.1) and the selling price of investment with servicing is $ 14.6 million.

Required: - Discuss the implications of above restructuring and pass necessary journal entries?