THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC 1 - Corporate Financial Reporting

December 2016

Answer 01

Relevant Learning Outcomes/s;1.1
Level A

Suggested Detail Answer:

(a) <u>Earnings per share</u>

Basic earnings per share computation is correct

<u>Diluted EPS</u>

Diluted EPS is not correct due to the following reasons.
According to paragraph 58 of LKAS 33, when an entity has issued a contract that may be settled in ordinary shares or cash at the entity's option, the entity shall presume that the contract will be settled in ordinary shares. Luxury Motors assuming that fact is therefore correct.

The outstanding ordinary shares = 10,000+(2000*10) =30,000

When such a contract is accounted as a compound financial instrument (i.e. liability component and equity component), an adjustment similar to the adjustments required by paragraph 33 of the standard is to be made for earnings (i.e. consider the whole instrument as an equity instrument).

Paragraph 33 requires <u>after tax effect</u> of any interest and other changes to income and expenses related to dilutive potential ordinary shares to be recognised.

Therefore,
Profit should be adjusted as follows.
The accretion of the liability because of the passage of time - Rs.14,762.96 (Rs. 184,537*8%)

After tax effect		Rs. 10,629.33 (14,762.96*(1-0.28))
Adjusted profit		Rs. 25,032+10,629.33 = 35,661.33
Diluted EPS	<u>35,661.33</u>	
	30,000	
	<u>Rs. 1.19</u>	

(7 marks)

Contract with DreamCars (Pvt) Ltd

As per LKAS 18, an entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or rendering of services.

Following factors provide evidence that the significant risks and rewards are retained by DreamCar. Therefore, Luxury Motors acts as an agent.

- DreamCars will decide the price of the car to be sold to the customer.
- DreamCars will have the responsibility of providing the car to the customer.
- Luxury Motors does not have to worry about bad debts.

- The amount earned by Luxury Motors is pre-determined as a % of the amount billed to the customer.

The revenue already recognised represents the amount collected on behalf of the principal. Therefore the revenue and the cost of sales recognized by luxury motors are incorrect. Revenue of Luxury Motors is therefore the commission of 10% (i.e.Rs.4 million).

Based on the information given there is no directly associated costs to be recognised as cost of sales. The vehicle costs recognised as cost of sales has to be removed.

(7 marks)

Credit Risks

For each risk from financial instruments an entity should make both quantitative and qualitative disclosures. Therefore, disclosures made relating to credit risk is not adequate

Qualitative disclosures required by paragraph 33 of SLFRS 7 has been adequately made (i.e. exposure to credit risk and how they arise and processes for managing the risk)

Quantitative disclosures

Maximum exposure to credit risk at the end of the year need to be disclosed without taking into account of any collateral held by the company. Therefore disclosing trade and other receivables net of collateral is not correct.

Further, following disclosures need to be made in the financial statements in relation to credit risk.

- A description of collateral held as security and other credit enhancements and their financial effect.
- Information on the credit quality of financial assets that are neither past due nor impaired.
- An analysis of age of financial assets that are past due but not impaired and an analysis of financial assets that are determined to be impaired.

(6 marks)

(b) As per SLFRS 15, when another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (i.e. the entity is a principal) or to arrange for the other party to provide those goods or services (i.e. the entity is an agent).

An entity is an agent if the entity's performance obligation is to arrange for the provision of goods or services by another party as in this case. When an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services.

Therefore, answer provided in (a) above will not be changed.

Therefore, Luxury motors is acting as an agent and revenue should be the amount of commission (10%) entitled for arranging the transaction.

(5 marks)

(Total: 25 marks)

Answer 02

Relevant Learning Outcome/s: 1.2
Level B

Suggested Detail Answer:

(a). i. When there is objective evidence that a financial asset is impaired, an entity shall determine the impairment loss (LKAS 39 para 58).

A significant and prolonged decline of market value of investment below its cost is an indication of objective evidence of impairment (LKAS 39 para 61) The decline in value from 2015 may be concluded as significant and prolonged.

The decline is 40% of the original cost and the duration is 2 years. Hence, the losses that have been recognized in Other comprehensive income must be transferred to the profit and loss account. Rs 40*100,000 has to be recorded as impairment in the P&L.

(5 marks)

ii. Significant accounting judgments, estimates and assumptions

The preparation of the financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities, and the accompanying disclosures, and the disclosure of contingent liabilities. Uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of assets or liabilities affected in future periods.

Estimates and Assumptions

Taxes

Deferred tax assets are recognised for unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilised. Significant management judgment is required to determine the amount of deferred tax assets that can be recognised, based upon the likely timing and the level of future taxable profits, together with future tax planning strategies.

The company has xxx of tax losses carried forward. These losses are a result of XXXX.

Fair value measurement of financial instruments

When the fair values of financial assets and financial liabilities recorded in the statement of financial position cannot be measured based on quoted prices in active markets, their fair value is measured using valuation techniques. The inputs to these models are taken from observable markets where possible, but where this is not feasible, a degree of judgment is required in establishing fair values. Judgments include considerations of inputs such as liquidity risk, credit risk and volatility. Changes in assumptions relating to these factors could affect the reported fair value of financial instruments.

(5 marks)

(b). As the issuer (HL) has an obligation to redeem the instrument when the holder exercises his right, there is a liability component for the fixed amount to be redeemed. As per AG 26 of LKAS 32 distributions are at the discretion of HL that part of the instrument creates an equity component. Accordingly, this instrument is a compound financial instrument.

The preference share herein therefore contains a financial liability & equity component, and requires split accounting under LKAS 32. In HL (Pvt) Ltd's financial statements:

on initial recognition of the instrument, the fair value of the liability component is calculated first and the equity component is treated as a residual;

on subsequent measurement the equity component is never re-measured after initial recognition and the liability component is measured at amortised cost

(5 marks)

(c). (1) KMP of MNC includes only the directors. However, the managing director may also be included as he is involved in planning, directing and controlling the activities of the entity, similar to the directors.

(2) In addition to the board of MNC PLC, the board members of A PLC will become related parties. (Parents' KMP)

As a result, the asset purchased by the spouse of P. Alwis will have to be disclosed.

(3) Compensation of AH Fernando & WK Perera that is paid by A PLC needs to be apportioned to MNC PLC and included in the KMP compensation disclosure note of MNC.

(4) With regards to the apartment given to the Managing Director, either a rental will have to be estimated and included with the compensation of KMP or a qualitative note will need to be disclosed in the financial statements that such apartment is used by the KMP.

(5 marks)

(Total: 25 marks)

Answer 03

Relevant Learning Outcome/s:
2.1/2.3/1.2/3.1/3.2/4.1/4.2/5.1

Suggested Detail Answer:

(a) **Memorandum**

To: Mahen
From: Sumith Ranawaka
Subject: Matters to be addressed before finalisation of year-end financial statements
Date: 24 December 2016

Investment in Ceylon Sugar Ltd - How should it be treated

First, it is required to identify whether the investment in Ceylon Sugar (Pvt) Ltd becomes a subsidiary. Ceylon Sugar (Pvt) Ltd becomes a subsidiary of Alpha (Pvt) Ltd; If Alpha (Pvt) Ltd has control over Ceylon Sugar (Pvt) Ltd. If all of the following are satisfied control can be established.

1. Power over Ceylon Sugar (Pvt) Ltd.

   Power exists if Alpha (Pvt) Ltd has the ability to direct relevant activities of Ceylon Sugar, which are the activities that significantly affect the investor's returns.

   As Ceylon Sugar (Pvt) Ltd's current utilisation of its production capacity is only 45% there is an opportunity to increase production by 55%. Researching and developing new processes to utilise full capacity and increase sugar production is a very significant activity over which Alpha (Pvt) Ltd has been given power due to holding a 49% stake. Furthermore, Ceylon Sugar (Pvt) Ltd is relying highly on debts, there is an urgency for the replacement of factory plant and machinery and buildings. There are serious governance issues which have a significant impact on proper business judgments and expansion strategies to reduce cost of production and increase revenue and these very important issues need to be resolved. Alpha (Pvt) Ltd had been given responsibility over these activities as well.

   Therefore, Alpha Ltd has power over Ceylon Sugar (Pvt) Ltd.

2. Exposure to, or rights to, variable returns from its involvement with Ceylon Sugar

   This is the case where investor's involvement has the potential to vary as a result of the investee's performance.

   It is obvious that involvement as explained above has a huge impact on the return of the company. This in turn will help to maximise investors' returns.

   Therefore, exposure to, or rights to, variable returns from its involvement with Ceylon Sugar can also be established.

3. Link between power and return

Alpha (Pvt) Ltd is able to use its power to affect its return (i.e. dividend) from its involvement with Ceylon Sugar (Pvt) Ltd, mainly because the power was given to direct most significant activities and Mahen being the CEO of Ceylon Sugar (Pvt) Ltd.

Therefore, Alpha (Pvt) Ltd has control over Ceylon Sugar (Pvt) Ltd and should be treated as a subsidiary of Alpha (Pvt) Ltd. Alpha (Pvt) Ltd should prepare its consolidated financial statements by consolidating the results of Ceylon Sugar.

In the separate financial statements of Alpha, investment in Ceylon Sugar should be reflected at cost or as per LKAS 39 (i.e. at fair value).

Accordingly, Alpha (Pvt) Ltd has to compute goodwill or a gain on the bargain purchase by deducting the fair value of assets acquired and liabilities assumed from the total of the fair value of consideration transferred and the fair value of non-controlling interest as given in the annexure.

Annexure

Financial Impact - in Rs. Million

Goodwill computation

Fair value of consideration transferred		
Cash	50	
Debentures	20	
Non-controlling interest	30	
	100	
Fair value of net assets acquired		
Net assets as per FSs (pre-seen)	(2,127)	
FV decrease in Building	(10)	(30 – 20)
Impairment of factory plant and machinery	(65)	
Intangible asset arising from favorable lease terms	282	(611-329)
FV increase in Molasses	145	(500-355)
Deferred tax liability (-10-65+282+145)*28%	(99)	
Deferred tax asset on c/f tax losses	76	
	(1,798)	
Goodwill	1,898	

Acquisition costs and debenture issue costs are <u>not part of the consideration</u>.
Legal costs of Rs. 1.5 million are expensed as incurred.

Debenture issue cost Rs. 1 million

This is a transaction cost and should be treated as per LKAS 39, and <u>therefore should be written off against the carrying amount of debentures and amortised over the maturity period of the debentures using the effective interest rate.</u>

Intangible asset arising from favourable lease terms

SLFRS 3 para B29 - the acquirer shall recognise an intangible asset if the terms of an operating lease are favourable relative to market terms as in this case.

Deferred tax asset on c/f tax losses

Carry forward of tax losses that exist at the acquisition date should be accounted as per LKAS 12. LKAS 12 requires the deferred tax asset on unused tax losses to be recognised to the extent that it is probable that future taxable temporary deference will be available against which the unused tax losses can be utilised.

Based on the cash flow projections (pre-seen) of Ceylon Sugar (Pvt) Ltd, profit is expected to increase significantly. Provided these projections are reasonable, reversal of the deferred tax asset on tax losses can be expected.

(b) IFRS 16 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments. A lessee measures right-of-use assets similarly to other non-financial assets (such as property, plant and equipment) and lease liabilities similarly to other financial liabilities. As a consequence, a lessee recognises depreciation of the right-of-use asset and interest on the lease liability.

As Ceylon Sugar (Pvt) Ltd already recognised the right to use land and is amortised over the lease period, it is unlikely there will be an impact due to application of the new SLFRS.

(c)

1. Ceylon Sugar (Pvt) Ltd should be headed by an effective board, which should direct, lead and control the company as currently the company is headed by a dysfunctional board which lacks clear objectives.

2. The current board has only 2 non-executive directors. If that is the case, both such non-executive directors should be independent. However, T.Sally is not independent as he has served in the board of Ceylon Sugar (Pvt) Ltd for a period exceeding 9 years.

4. Currently, Ceylon Sugar (Pvt) Ltd's nomination process of board members is not effective. Therefore, the company should have a nomination committee to make recommendations on all new board appointments. This will help to have a formal and transparent procedure for appointment of new directors.

5. Ceylon Sugar (Pvt) Ltd's salaries are lower than market salaries and has an adverse impact on the results of the company due to lack of performance based contracts. Therefore, the company needs to have a remuneration committee in order to establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration package for individual directors.

6. Currently Ceylon Sugar has an internal audit function. However, that is not independent. Therefore, the company needs to have a sound internal audit function as well as a processes for risk management.

(d) When an individual's private interest interferes in any way with business interests of the company as a whole, conflict of interest occurs. When there is excessive ministerial intervention in company's affairs, the directors or key management personnel may be faced with conflicting situations where it is difficult to perform his or her duties objectively and effectively. Conflict situations also arise when a director/KMP receives improper personal benefits from the ministry concerned. The company should have a policy prohibiting such conflicts of interest and providing a means for directors and KMPs to communicate potential conflicts to the company.

(e)

Liquidity Position

	After restructuring	Before restructuring
Current ratio (CA/CL)	1.15	0.35
Quick ratio (CA-Inventory)/CL	0.75	0.23

Current liabilities (after restructure)	
Trade and other payable	62
Interest bearing borrowings	967
Finance lease obligation	16
Bank OD	88
	1133
Current Assets	1306
Inventory	450

The company's liquidity position has improved with the restructuring of debts showing a better short term position. Current Assets are now sufficient to meet all the current liabilities. When the company's least liquid asset, inventory is removed from the current ratio, it gives a better liquidity position than before restructuring.

Changing terms of related party payables of Rs. 375 million which was a current liability before has resulted in this liability being classified as an equity instrument. Therefore, the company has a better short term and long term position as this is not considered as a liability. It is now the residual of the company which will require to be considered at the time of liquidation. Further, the company had to pay a very high interest rate on these payables earlier which is not required now due to restructuring.

Overdraft is payable on demand even though it is permanent. Converting this to a long term loan results in strengthening the short term position of the company. It is important to note that the company has to meet the current portion of this long term loan in the next year when it becomes due together with interest.

Restructuring of Rs. 2,000 million of current interest bearing borrowings as payable in the long term also improves the company's liquidity position. However, in the next year the company needs to have sufficient funds to meet the current portion of the loan together with the interest.

Even though this restructuring results in a better short term position for the company, in the long term it is not a good position. Having long term loans increases the gearing ratio which might impact the company's going concern. Therefore the company needs to earn enough profits or to introduce new equity capital to mitigate this issue.

(Total: 50 marks)

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