CA | THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC 1 - Corporate Financial Reporting

June 2017

SECTION 1

Answer 01

Relevant Learning Outcomes/s:
1.1 Interpretation and application of Sri Lanka Accounting Standards (Level A)
Study text reference: Pages 25, 156, 335, 340

(a)

1. An instrument redeemable in cash only at the option of the issuer does not satisfy the definition of a financial liability per LKAS 32, because the issuer does not have a present or future obligation to transfer the financial assets to the holders. In this case, redemption of the shares is solely at the discretion of the issuer. Hence, there is no requirement to apply 'split accounting' and the entire amount may be classified as equity.

2. **Note A**

   When debtors are sold, but with full recourse to the entity for any default on the loan, the guarantee provided by the entity has the effect that it retains substantially all the risks and rewards of the loan, which is therefore not derecognised . Hence, the debtors will remain in the books.

   Note B

   With regard to impairment, the company needs to adopt a dual approach whereby significant debtors (e.g. A & B) are individually impaired. This requires the company to identify the existence of impairment indicators, and if any exist, future cash flows should be forecasted and discounted. The balance of other debtors can be subjected to collective impairment based on historical data.

3. This loan has been granted not at the market rate. Therefore, this loan should be recognised initially at the fair value, which is the present value of future payments of Rs. 1 million and interest using the market rate of 8%.

   Accordingly, the present value of the loan is as follows:

   Y1–Y5: 50,000 * 3.9927 = 199,635
   Y5 – 100,000 * .680583 = 680,583
   Total = 880,218

   The difference between Rs. 1 million and the above present value (i.e. Rs. 119,781) should be charged to the profit or loss as an expense.

   Subsequently, this loan should be measured at amortised cost.

(15 marks)

(b)

(i) "Highest and best use" is a valuation concept that considers how market participants would use a non-financial asset to maximise its benefit or value. The maximum value of a non-financial asset to market participants may come from its use:

- in combination with other assets or with other assets and liabilities, or
- on a stand-alone basis

In determining the highest and best use of a non-financial asset, you must consider uses that are physically possible, legally permissible and financially feasible.

As such, when assessing alternative uses, entities should consider:

- the physical characteristics of the asset
- any legal restrictions on its use, and
- whether the value generated provides an adequate investment return for market participants

(4 marks)

(ii) If the highest and best use of a non-financial asset differs from its current use, entities are required to:

- disclose this fact , and
- state why the non-financial asset is being used in a manner that differs from its highest and best use

(2 marks)

(c)

- An entity is related to a reporting entity if one entity is a joint venture of the other entity. Therefore, SCP and the joint venture are related parties.
- If a person is a key management personnel of the reporting entity, that person is a related party to the entity. Therefore Lokuge is a related party of SPC.
- The joint operation is not a related party of SCP.

(4 marks)

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s:
1.1 Interpretation and application of Sri Lanka Accounting Standards (Level A)
Study text reference: Pages 103, 105, 118, 158

(a)

(i) This land should be recognised as an investment property under LKAS 40 since on 1 April 2016 the use of the property was undecided. As the land was acquired in exchange for monetary assets (i.e. receivable balance), the cost of the land should be measured at fair value unless it lacks the commercial substance. If not, it should be measured at the carrying value of the receivable balance.

(2 marks)

(ii) The first 2 floors will be accounted for as PPE upon completion and the initial measurement will be at cost.

(3 marks)

(iii) The floors identified to be rented will be recorded as investment property and the initial measurement will be at cost.

(3 marks)

(iv) Borrowing costs can be capitalised if the asset meets the definition of a qualifying asset. Assuming the apartment complex will take a substantial period to complete, the borrowing cost will be capitalised during the construction period. Any borrowing costs incurred before or after the construction of the project will be expensed.

(4 marks)

(b)

In order to assess whether an impairment adjustment is necessary, the CGU's (Plaza Homes division) carrying amount including goodwill should be compared with the recoverable amount of the unit (para 90).

Recoverable amount

Fair value less costs of disposal

Estimated value of the CGU	Rs. 760 million
Costs of disposal	Rs. 5 million
FV less costs of disposal	Rs. 755 million

Termination benefits of Rs. 10 million (as defined in LKAS 19) are not part of the direct incremental costs to dispose the unit.

Value in use

Present value of future cash flows	Rs. 646 million

Add:	
Future restructuring cost	Rs. 70 million
Finance cost	Rs. 7 million
Value in use	Rs. 723 million

Future cash flows should be estimated for assets in its current conditions. Therefore, future restructuring costs that are not yet committed are not part of the estimated cash flows (para 44).

Estimates of future cash flows shall not include financing cash flows.

The fair value less costs of disposal of Rs. 755 million is higher.

Carrying amount

It was assumed that the above recoverable amount was determined considering the liabilities reflected in the net carrying amount of the CGU, and the receivables directly attributable to the CGU.

If the candidate assumes payables and receivables are not part of the carrying amount using a proper basis, such amounts should be excluded from the carrying amount.

The recoverable amount is lower than the carrying amount. Therefore, the impairment adjustment is necessary.

Accordingly, the impairment is Rs. 135 million (i.e. Rs. 890 million – Rs. 755 million).

Allocation of this impairment should first be to goodwill and then to the other non-monetary assets on a pro-rata basis:

Property	650 – 80 [(105/855) * 650]	570
Equipment	205 – 25 [(105/855) * 205]	180
Allocated goodwill	30 – 30	0

(13 marks)

(Total: 25 marks)

SECTION 2

Answer 03

Relevant Learning Outcomes/s:
2.2 Joint ventures
2.3 Investment in an Associate
4.1 Corporate governance and sustainability reports including integrated reporting
5.1 Recent ethical issues
3.2 Internal financial statement analysis
Study text references: Pages 17, 41, 528, 535, 736

(a)

Option 1

According to the contractual terms, the new entity (separate vehicle) will have a separate legal form and the assets and liabilities of the separate vehicle are considered to be the assets and liabilities of the separate vehicle.

Further, the parties to the arrangement do not have the right to the assets of the arrangement. Their obligation for the liabilities will be limited to the unpaid capital.

The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.

Accordingly, the arrangement is a joint venture.

The parties recognise their rights to the net assets of the new entity as an investment and account for them using the equity method.

In this case, each party's investment will be Rs. 250 million (each). For SSPL, this will be the cost of the investment for initial recognition. Thereafter the carrying amount is increased or decreased to recognise SSPL's share of the profit or loss of the new entity.

Option 2

SSPL gets the majority of the voting rights of the new entity by holding 60% of the ordinary shares. In the absence of any other factors that could alter decision-making, SSPL will control the new entity. However, SFP(HK) would be responsible for major operating and capital decisions of the instant noodles division including budgets. Further, SFP(HK) can appoint or approve the majority of the key management personnel of the new entity who have the ability to direct relevant activities. This will alter the decision-making power. Obviously, such decisions made by SFP(HK) will significantly affect each party's return.

Therefore, SFP(HK) will get control over the new entity.

The investment made by SSPL in the new entity can be considered as an investment in an associate based on the ownership and ability to participate in policy-making processes by appointing a director to the board. This investment should be accounted for using the equity method.

The investment should be initially recognised at cost. Thereafter, the carrying amount should be increased or decreased to recognise SSPL's share of the profit or loss of the new entity.

The cost of the investment is as follows:

Initial cash payment (Rs. 330 million * 50%)	Rs. 165 million
Deferred cash (Rs. 120 miilion/1.13)	Rs. 106.2 million
Contingent cash (Rs. 50 million/1.13^2)	Rs. 39.15 million
Total consideration	Rs. 310.35million

(25 marks)

(b)

Currently all the directors of the company are family members and therefore not independent.

However, if the company is listed, the board should have a balance of executive and non-executive directors and the board should include at least 2 non-executive directors or such number of directors equivalent to one third of the total number of directors, whichever is higher. Then no individual or small group of individuals can dominate the board decision taking.

<u>Appointments to the board</u>

Currently, directors join the company due to the family relationships that they have with the founder. For example, Edward joined the board at the request of the CEO who is a brother of the founder.

If the company is listed there should be a formal and transparent procedure for the appointment of new directors to the board. A Nomination Committee should be established to make recommendations to the board on all new board appointments..

(4 marks)

(c) The group finance director is a chartered accountant. As such, he:

- should be aware of the requirements of SLFRS and apply those requirements in order to achieve fairly presented financial statements
- is bound by CA Sri Lanka Code of Ethics

SLFRS 10 clearly states that a parent is exempt from preparing consolidated financial statements if it meets all the following conditions:

- It is a wholly or partially owned subsidiary and all its other shareholders have been informed about and do not object to the parent not preparing consolidated financial statements.
- Its debt or equity are not traded in a public market.
- It did not file, nor is it in the process of filing its financial statements with a securities commission or other regulatory organisations for the purpose of issuing such instruments in a public market, and
- Its ultimate or intermediate parent produces consolidated financial statements that are available for public use.

But in this case, all the above are not met and SSPL is required to prepare consolidated financial statements.

If the group finance director were to accept the CEO's statement, this would be a clear breach of integrity (integrity → the group finance director is honest in his professional conduct). It also displays a lack of objectivity (i.e. requirement that an accountant should not allow bias, conflict of interest or the influence of others to override professional judgment).

The group finance director must behave professionally and display professional competence and due care by complying with professional standards and regulations to avoid any act that will discredit the profession.

The group finance director must explain to the CEO the requirements of accounting standards in respect of preparation of consolidated financial statements. If the CEO insists on not preparing consolidated financial statements, the finance director should bring this to the attention of the internal and external auditors.

(6 marks)

(d) **<u>Profitability assessment</u>**

Revenue

Revenue of SSPL in 2017 has decreased by 3% compared to 2016. This was disappointing when the company had budgeted revenue to increase by 4%. The main reasons for this reduction can be identified as follows:

- Reduction in food products revenue, which is the main revenue stream (2017: 61%) by 2%, and fuel and lubricants revenue by 8%.
- SSPL operates in a highly competitive market and the threat from substitutes is very high. Therefore, there is a difficultly in increasing prices to be in line with the increase in the cost of production.
- Slight movements in some of the food products revenue from high-priced products to low-priced products.

Gross profit margin

GP margin has come down to 21% in 2017 from 24% in 2016. This was mainly due to the increase in cost of sales by 2% when compared to 2017. Further, there were changes to the composition of revenue from food products. Reduction of the

GP margin can occur if a product with a higher GP margin has reduced during the year.

Reasons for the increase in cost of sales:

- Cost of production is higher than competitors (by 10% – 20%) due to the issues in the supply chain
- Coffee powder → reduction in the supply from farmers and the use of old machinery have caused high cost of production, which reduces the GP margin.

Operating profit margin

Operating profit margin has also decreased from 6% in 2016 to 4% in 2017.

This reduction has occurred due to the reduction in revenue and GP margin.

There was an increase in administrative expenses by 4% compared to 2016, but this had no big impact on the OP margin as distribution expenses had decreased by 7% in 2017. However, the company needs to ensure that adequate impairment for debtors has been recognised in the financial statements to reflect the delay in recoveries (currently there is a significant amount of trade debtors that are outstanding for more than 90 days).

Net profit margin

NP margin has reduced significantly to 3% in 2017 from 5% in 2016. Reduction in revenue and the GP margin are the main reasons for the reduced NP margin.

(15 marks)

(Total: 50 marks)

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