THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB1 – Business Financial Reporting

June 2018

Answer 01

Relevant Learning Outcome/s:
1.1 Conceptual framework of SLFRS 1.3 Regulatory framework
Study text reference – Page 40, 14

(a) For financial information to be a faithful representation, it must be complete, neutral and free from errors.

The above property is used for both administrative purposes and to earn rental income. As per Sri Lanka Accounting Standards (LKAS 40), the part given out for rent should be recognised as investment property however, P Ltd has recognised the entire property as PPE. Therefore, it is not in compliance with Sri Lanka Accounting Standards and not free from errors. This also means that the information given in the financial statements is not complete.

(b) The Code of Best Practice on Corporate Governance requires every public company to hold board meetings at least once in every quarter of a financial year. Since, S PLC holds board meetings only twice a year, it is not in compliance with the said Code.

The board should include at least three non-executive directors or one third of the total as such, whichever is higher. If the constitution of the Board of Directors include only three non-executive directors, all three non-executive directors should be independent. In all other instances, three or two thirds of non-executive directors appointed to the Board, whichever is higher, should be independent. S PLC has not complied with these requirements since it has only one non-executive director out of a total of 07 directors.

Where the chairman and the CEO is the same person, majority of the board should be non-executive directors. S PLC has not complied with this requirement as well.

In the event the Chairman and CEO is the same person, the Board should appoint one of the independent Non-Executive Directors to be the "Senior Independent Director" (SID).

In the event of chairman and CEO is the same person, it should be justified and highlighted in the annual report.

(Total: 10 marks)

Answer 02

Relevant Learning Outcome/s: 2.2 (Level B)
Study text reference – Page 618, 626

(a) If the directors of Reliable (Pvt) Ltd shall make an assessment of the going concern. In making that assessment, the directors/management become aware of material uncertainties related to events or conditions that the management cast significant doubt on the entity's ability to continue as a going concern, the /management shall disclose such uncertainties relating to going concern of the entity in the financial statements for the year ended. This is a requirement in SLFRS for SMEs.

If the entity determines that the financial statements cannot be prepared on a going concern basis, it shall disclose that fact, together with the basis on which the financial statements were prepared and the reason why the entity is not regarded as a going concern.

(b) According to SLFRS for SMEs (Section 16), this property is an investment property.

Investment property whose fair value can be measured reliably without undue cost or effort shall be measured at fair value at each reporting date with changes in fair value recognized in the Statement of Profit or Loss.

Since the management has estimated the fair value in each year, it is clear that the fair value can be estimated without undue cost or effort.

Therefore, the property should be measured at fair value of Rs. 60 million as at 31 March 2018 and the Fair Value gain of Rs. 5 million shall be recognized in Statement of Profit or Loss.

Since, Plaza (Pvt) Ltd has incorrectly reflected this property in the financial statements which is a prior period error and therefore, should be corrected retrospectively.

(Total: 10 marks)

Answer 03

Relevant Learning Outcome/s: 2.1 (Level A) , 2.2 (Level B)
Study text reference – Page 434-449, 86-87

(a) (i)

1. Helen Holdings (Pvt) Ltd (HHL) (Parent)
2. Helan Plastics (Pvt) Ltd (Fellow Subsidiary))
3. Rathna (Pvt) Ltd (Affiliate)
4. Chairman (Key management personnel)

(ii) Related Party Disclosures
The parent entity of Helen PLC is Helen Holdings (Pvt.) Ltd.
Transactions and outstanding balances with related parties of Helen PLC are as follows:

Transactions		**outstanding balance as at 31.03.2018**
Fellow Subsidiary (Helan Plastics (Pvt) Ltd)		
Sale of goods	Rs. 23 million	Rs. 12 million (Dr)
Affiliate (Rathna (Pvt) Ltd)		
Providing of services	Rs. 10 million	Rs. 10 million (Dr)

As the consideration for settlement of the above transaction, Rathna (Pvt) Ltd will issue its shares to the company in 6 months' time.

(b) As per LKAS 1, when an entity applies an accounting policy retrospectively, and it has material effect on the information in the Statement of Financial Position at the beginning of the preceding period, the entity shall present a third Statement of Financial Position as at the beginning of the preceding period in addition to the minimum comparative financial statements.

Accordingly, Horizon Finance PLC has to present 3 Statement of Financial Positions as at 1 January 2017, 31 December 2017 and 31 December 2018

(Total: 10 marks)

Answer 04

Relevant Learning Outcome/s: 2.2 (Level B)	
Study text reference – Page 273	

(a)

- Scheme 1 is a defined contribution plan because employees are entitled to a specified proportion of the plan assets and depend on the performance of the investment. Therefore, Peter & Co. PLC (PCP) does not have further obligation other than the amount contributed to the plan**.** The contribution paid by PCP should be recognized as an expense.

- Scheme 2 is a defined benefit plan since PCP has an obligation to fund the shortfall if the plan does not have sufficient fund to meet the pension liability*.* LKAS 19 requires defined benefit obligation (net of fair value of plan asset) to be recognized as a liability in the financial statements while the movements are recognized in profit or loss and other comprehensive income

(b)

i. In this case, MM (Pvt) Ltd has an option to require MAC (Pvt) Ltd to redeem preference share at par at any given time. This creates an obligation to MAC (Pvt) Ltd to transfer a financial asset (i.e. cash) to MM (Pvt) Ltd. Therefore, these preference shares should be classified as a financial liability in the financial statements of MAC (Pvt) Ltd .

ii. These preference shares are non-redeemable and a distribution to the holder is made at the discretion of the issuer (i.e. MAC). Since this does not create an obligation to MAC (Pvt) Ltd, these shares should be classified as equity instruments.

(Total: 10 marks)

Answer 05

Relevant Learning Outcome/s: 41 Financial statement analysis	
Study text reference – Page 634 -667	

(a) **Liquidity**

The current ratio has increased (2.1 – 1.82). The general norm of 2:1 is a healthy liquidity position. The quick ratio has dropped (1.09-0.83). Current Assets other than stocks have come down by 23.85% = (1.09-0.83)/1.09, comparatively the liquidity position has come down too. Stocks have increased, as indicated by the inventory turnover period ratio, to 109 days from 73 days (36 days, 49.3% = (109-73)/73) assuming other related variables were constant. In other words, the stock holding period was comparatively high. The debtors' collection period has increased from 25 days to 30 days. Therefore, we can assume that the debtors' value has also increased due to these additional 5 days. The creditors' payment period has decreased from 27 days to 25 days. Therefore, we can assume that the creditors' value has come down due to the reduction of these two days (assuming other related variables was constant)

Efficiency

Working capital requirement has increased/decreased.
Considering Debtors/Creditors period – 2018 (30-25)=5 days
2017 (25-27) =2 days
Considering Inventory turnover - 2018 (365/109) = 3.35 times
2017 (365/73) = 5 times
Company needs more working capital since the inventory holding period has increased.

(b)

- Reduce Inventory holding period, it has increased in comparison to last year.
- Reduce Working Capital requirement as it has also increased compared to last year. Increase Inventory Turnover period, since this may help to perform operations with a minimum stock level (Minimize absolute stocks, slow moving stocks etc.).
- Convert obsolete, unused, current/noncurrent assets into cash or equivalent mode.
- Introduce trade discounts/promotional methods to collect money within shorter period of time.
- Increase sales, especially cash sales (reduce bad debts).

(Total: 10 marks)

Answer 06

Relevant Learning Outcome/s: 3.1 Consolidated financial statements
Study text reference –Page 507-589

(a)

Maczilion PLC consolidated statement of financial position as at 31 March 2018

	Maczi	Haczi	Adjustments	Total Adjustment	Consolidated	Workings
Non-current assets:						
Property, plant & equipment	192,000	50,000	+3,200 (FV)	3,200	245,200	**W6**
Investments	83,000	27,000	– 58,000 – 25,000 +1,000 (FV)	(82,000)	28,000	**W6**
Investment in joint venture				26,200	26,200	**W5**
Goodwill				3,828	3,828	**W2**
					303,228	
Current assets:						
Inventories	46,000	23,000	– 600 (URP) -400 (URP)	68,000	68,000	**W7**
Receivables	32,000	14,000	– 2,200 (inter co.)	43,800	43,800	**W9**
Cash & bank	8,000	2,000			10,000	
					121,800	
Total assets					**425,028**	
Equity:						
Stated capital	175,000				175,000	
Retained earnings	132,000	16,000			136,125	**W3**
					311,125	
Non-controlling interest					9,345	**W4**
					320,470	

Non-current liabilities:						
Retirement benefit liability	12,000	7,000			19,000	
Deferred consideration					27,258	**W11**
					46,258	
Current liabilities:						
Trade & other payables	29,000	18,000	– 2,200 (inter co.)		44,800	**W9**
Dividends payable	13,000	5,000	– 4,500 (inter co)		13,500	**W10**
					58,300	
Total equity & liabilities					**425,028**	

W1 - Group structure

Maczilion PLC – Parent
Haczilion PLC – 90% subsidiary at reporting date therefore, include 100% of assets & liabilities.
Vaczi – 40% Joint Venture, significant influence exerted therefore, include under equity accounting method.

W2 – Goodwill

	Rs.'000	
Cost of investment:		
Immediate cash		58,000
Deferred cash (W11)		24,780
		82,780
Value of non-controlling interest at acquisition		9,200
Fair value of net assets at acquisition:		
Stated capital	70,000	
Retained earnings	10,600	
Fair Value adjustment (W6)	5,000	(85,600)
Goodwill		6,380
Impairment of Goodwill (6,380*40%)		(2,552)
Goodwill		3,828

W3 – Group Retained earnings at 31 March 2018

	Rs.'000	Rs.'000	Rs.'000
	Maczi	**Haczi**	**Vaczi**
Balance per SOFP	132,000	16,000	12,000
Less: balance at acquisition	-	(10,600)	(9,000)
Interest on deferred consideration (W11)	(2,478)	-	-
Depreciation on fair value adjustment (W6)	-	(800)	-
URP Inventory (W7)	-	(600)	-
URP on trade with Joint Venture (W8)	(400)		-
Dividend receivable (W10)	4,500		-
Impairment of Goodwill		(2,552)	-
Adjusted balances		1,448	3,000
Consolidate Haczi 1,448 * 90%	1,303		-
Consolidate Vaczi 3,000 * 40%	1,200		-
Total	136,125		-

W4 – Non-controlling interest

	Haczi
	Rs.'000
Balance at acquisition	9,200
Add: share of post-acquisition results (W3) (1,448* 10%)	145
	9,345

W5 – Investment in joint venture

	Vaczi
	Rs.'000
Balance at acquisition	25,000
Add: share of post-acquisition results W3 (3,000 * 40%)	1,200
	26,200

W6 – Fair value adjustments

	At acquisition	Movement	At Y/E
Plant	4,000	(800)	3,200
Investments	1,000	-	1,000
Total	5,000	(800)	4,200

Depreciation = (4,000/5) = 800

W7 – Intra group trading

Unrealised profit is eliminated from inventory and reserves of selling company.
Amount: 6,000 *50/150 * 30% = 600

W8 – Unrealised profit on trading with Joint Venture

Eliminate 40% of Vaczi's gain on goods remaining in group inventory.
Amount: 1,000 * 40% = 400 (reduce from inventory and group reserves)

W9 – Intra-group balances at Y/E

Eliminate 2,200 from receivables and payables

W10 – Intra-group dividend

Dividend receivable by Maczi from Haczi not recorded: 5,000 * 90% = 4,500
Increase Maczi's reserves and reduce Haczi's dividend payable.

W11 –Deferred consideration and interest

As the deferred consideration was measured at the acquisition date at its fair value, it was discounted for 2 years at the given discount rate of 10%.

This gave a present value of Rs. 24,780 (30,000 * 0.826).

As the reporting date is one year later, the discount is partially unwound. The unwinding is treated as an interest expense and an additional liability.

The amount is 24,780 * 10%= Rs. 2,478.
Deferred consideration =24,780+2,478 =Rs. 27,258

(b)

There are two types of joint arrangements. These are:

- Joint operation

- Joint Venture

Joint operation
Each venturer accounts for the elements (assets, liabilities, expenses and income) under its control on an individual basis, line by line.

Joint venture
The entity will prepare its own separate accounts and will be dealt with in the books of each venturer using equity accounting as done for associate companies.

(Total 10 Marks)

Answer 07

Relevant Learning Outcome/s: 2.1(Level A),2.2 (Level B)
Study text reference – Page 154-159, 258-266, 272-274, 194-202

(a) There is a present obligation in this case even though there is no proof of the number of repairs required.

The obligation is established by the past event of selling the products with the warranty promise. The promise is the obligation.

Past experience shows us that it is probable that an outflow of resources will be required to settle this obligation (as 2% of goods have been faulty in the past and there is no reason to believe this will be any different this year. Further, it is part of the sales contract which makes it legally enforceable).

A reliable estimate of the cost of repair can be made.

Therefore, the three conditions are met, and a provision for repair of defective goods sold and qualifying for warranty at the reporting date must be set up.

The amount of the provision is based on the best available estimate at the reporting date. The amount would be 1.5mn * 2% * 15,000/- = Rs. 450 million.

This should be charged to expenses and credited to current liabilities.

(b) An adjusting event is an event which provides further evidence of a condition existing at the reporting date.

Rock PLC has obtained the best estimate for the warranty provision for repair of defective goods before signing off and it is significantly different (i.e. double the existing provision) from the provision already made in the financial statements. Therefore, this is an adjusting event.

Hence, the revised amount of provision would be 1.5mn * 3% * 20,000/- = Rs. 900 million.

This should be charged to expenses and credited to current liabilities.

(c) As the licence was acquired individually, it is capitalised at its cost of Rs. 150 million initially.

Subsequently, this could be valued based on either the revaluation or the cost model.

However, the question does not provide any evidence for the existence of an active market for the asset therefore, subsequent measurement should be at cost.

The licence should be amortised over its useful economic life, which is 6 years.
Amortisation amount: Rs. 150 million / 6 years = Rs. 25 million per annum.

Since the recoverable value of the licence is Rs. 100 million, which is lower than the carrying value of Rs. 125 million an <u>impairment</u> of Rs. 25 million should be provided.

The balance of the license as at 31 March 2018 = (Rs. 150 million - Rs. 25 million - Rs. 25 million) = Rs. 100 million

(d) Under LKAS 17, the land and buildings element would be <u>dealt with separately</u>.

The lease of the land is an operating lease, since land has an indefinite useful economic life.

The lease on the buildings is assessed on its own merits.
Here, it seems like a finance lease since the useful economic life of the building is entirely taken up by the lease term. (OR the building seems like a finance lease since the present value of minimum lease payment is equal to the fair value of building).

The lease payments are split in proportion to the fair values of the respective assets.

Fair value of building= Rs. 160 million – Rs. 16 million = Rs.144 million

Buildings: (144 million/160 million) x 12 million = Rs. 10.8 million

Land: (Rs. 12 million – Rs. 10.8 million) = Rs. 1.2 million

Fair value of the building Rs. 144 million should be recognised as a finance lease and the respective <u>leasehold asset</u> and <u>lease creditor</u> should be recognized at Rs. 144 million.

Leasehold asset should be depreciated over its useful life of 50 years and hence net carrying value of the asset as at 31 March 2018 is Rs. 141.12 million (Rs. 144 million – Rs. 2.88 million).

Since the lease payment has been made in advance, Rs. 10.8 million paid on leasehold building, it is treated as a repayment of lease creditor. Hence, lease creditor as at 31 March 2018 is Rs. 133.2 million (Rs. 144 million – Rs. 10.8 million).

Finance lease interest of Rs. 10.6 million (Rs. 133.2 million * 8%) should be charged to profit or loss as an expense & respective liability should be added to lease creditor.

Further, Rs. 1.2 million paid for the land component would be treated as an operating lease rental and expensed to the profit or loss.

(e) There is an offer for the asset of Rs. 50 million. However, this amount represents the realizable value which is not the fair value of the asset and hence <u>not recognized at Rs. 50 million</u>.

A normal sale in present condition would be expected to realize at Rs. 75 million. This figure is arrived at after analyzing transactions in similar assets at quoted prices. Therefore, this would seem to qualify as a level 2 input, and would seem reasonable to be use as the basis of valuation.

The valuation models are level 3, as they are unobservable. Therefore, they are inferior to level 2 inputs.

Hence, the <u>best estimate of fair value</u> in this situation would be Rs. 75 million.

(Total: 25 marks)

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