CA

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

20404 – Advanced Financial Reporting

CA Professional (Strategic Level II) Examination
June 2014

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

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Answer No. 01

(a)

- Investment in Moon is a JV
- The decisions are made with unanimous agreement
- Proportionate consolidation is followed
- Alternatively, equity method of accounting can be applied

- Investment is net off against the share capital 400,000

- Investment in Star is a subsidiary
- Sun has the ability to appoint majority of the BOD members.

(b)

	Parent	J/V	Subsidiary	Adjustment at acquisition	JV – Proportionate	Current year Adjustments	Consolidated	JV- Equity accounted
	Sun	Moon	Star					Consolidate
Assets								
Non-current assets								
Property plant and equipment	610,000	1,300,000	400,000	150,000	650,000	5,000	1,815,000	1,165,000
Investment in JV								450,000
Investment	1,500,000	-	-	(1,100,000)	-	37,500	437,500	437,500
Goodwill	-	-	-	250,000	-	-	250,000	250,000
Intangible assets	-	-	-	50,000	-	(10,000)	40,000	40,000
	2,110,000	1,300,000	400,000	(650,000)	650,000	32,500	2,542,500	2,342,500
Non-current assets								
Inventory	300,000	100,000	80,000	-	50,000	(15,000)	415,000	365,000
Trade receivables	120,000	50,000	20,000	-	25,000	-	165,000	140,000
Cash and cash equivalents	10,000	10,000	50,000	-	5,000	-	65,000	60,000
	430,000	160,000	150,000	-	80,000	(15,000)	645,000	565,000
Total assets	**2,540,000**	**1,460,000**	**550,000**	**(650,000)**	**730,000**	**17,500**	**3,187,500**	**2,907,500**
Equity and Liabilities								
Equity								
Stated capital	1,200,000	800,000	200,000	(600,000)	400,000	-	1,200,000	1,200,000
Revaluation reserve	30,000	200,000	140,000	(125,000)	100,000	37,500	145,000	70,000
Retained earnings	500,000	150,000	150,000	(50,000)	75,000	(47,500)	665,000	615,000

Other components of equity	-	50,000	30,000	(30,000)	25,000	-	25,000	-
	1,730,000	1,200,000	520,000	(805,000)	600,000	(10,000)	2,035,500	1,885,000
NCI				155,000		17,500	172,500	172,500
Non-current liabilities								
Borrowings	510,000	230,000	10,000	-	115,000	10,000	645,000	530,000
Total non current liabilities	510,000	230,000	10,000	-	115,000	10,000	645,000	530,000
Current liabilities								
Trade and other payables	300,000	30,000	20,000	-	15,000	-	335,000	320,000
Total current liabilities	300,000	30,000	20,000	-	15,000	-	335,000	320,000
Total equity and liabilities	**2,540,000**	**1,460,000**	**550,000**	**(650,000)**	**730,000**	**17,500**	**3,187,500**	**2,907,500**

Workings:

1) **Goodwill**

Consideration paid	700,000
FV of NCI (250,000 * 600)	150,000
Less;	
FV of net assets	600,000
Goodwill	250,000

2) **FV of net assets**

CV of NA at acquisition	400,000
FV adjustment - PPE	150,000
FV of intangible asset - Customer list	50,000
	600,000

FV of employees not a recognisable intangible asset

3) **NCI as at 31/3/2014**

NCI as at 1/4/2013	155,000
Profit for the year	17,500
	172,500

4) **Consolidated retained earnings**

	Sun	Star	Consolidated
RE at 31/3/2014	500,000	-	500,000
Profit for the year - Star		52,500	52,500
			552,500

5) **Star post-acquisition profits**

RE at acquisition		50,000
RE at 31/3/2014		150,000
Profit for the year		100,000
Adjustments		
Additional depreciation on building		(5,000)
Amortisation of intangible assets		(10,000)
Unrealized profit on inventory in hand		(15,000)
		70,000
NCI	25%	(17,500)
Profit attributable to shareholders		52,500

6) **Borrowing cost**

Building under construction is considered as a qualifying asset. Hence borrowing cost is capitalised

Interest cost/long term loan	10,000
Borrowing cost (PPE)	10,000

7) **Interest income**

Only investment income (Interest income) arising from investing the amounts borrowed can be net off from the borrowing cost.

Hence, interest income arising from USD fixed deposit (that is kept as security) cannot be net off against the interest expense on borrowing.

Option 2

Investment in JV - Equity method of accounting

Investment	400,000		
	50,000		
	450,000		

Net assets	**At acquisition**	**31/3/2014**	
RR	150,000	200,000	50,000
RE	100,000	150,000	50,000
Other components of equity	50,000	50,000	-
			100,000
	Holding	50%	50,000

Answer No. 02

(a) (i) Given that these bonds are planned to be held until maturity, they should be classified as held to maturity financial assets and held at amortised cost. This means that they are initially shown at their cost and their value is increased over time to the redemption value by applying the constant effective interest rate which takes into account not only the annual income due from coupon, but also the amortisation of the redemption premium. Their value is reduced by distributions received, i.e. coupon.

Consequently, the amortised cost valuation of these debentures at the year-end would be as follows.

	Rs
Cost	45.00 million
Effective Interest 15% (45mn x 15%)	6.75 million
Coupon received 12% (50mn x 12%)	6.00 million
Balance as at 31 March 2014	45.75 million

The above Rs. 6.75 million should be recognised as income in the income statement whereas the balance as at 31 March 2014 amounting to Rs. 45.75 million should be shown in the statement of financial position.

(ii) A foreign currency forward contract can be argued to be either a hedge of the future cash flow or a hedge of the fair value of the plant to be purchased. LKAS 39 allows foreign currency hedges of firm commitments to be classified as either a cash flow hedge or a fair value hedge.

If the contract is classified as a cash flow hedge, given that the machine is not yet recognised in the books, any gain or loss on the hedging instrument is split into two components.

1. The effective portion of the hedge is recognised initially in other comprehensive income. It is transferred out of reserves either when the asset is recognised or when the cash flow is recognised in the income statement as a reclassification adjustment.

2. The ineffective portion of the hedge is recognised in the income statement immediately as it has not hedged anything.

If the contract is classified as a fair value hedge, all gains and losses on the hedging instrument must be recognised immediately in the income statement. However, in order to match those against the asset hedged, the gain or loss on the fair value of the asset hedged is also recognised in the income statement, and as an asset or liability in the statement of financial position.

(b)

(1) This part of the grant is revenue in nature. Therefore, the entire amount received could be recognised as an income in the first year (year of receipt) itself. Income should be recognised over the period in which the related cost is recognised to the income statement.

(2) This could be recorded in two ways.

First method
The total amount could be deducted from the cost of the factory building, and the net cost of the factory building could be depreciated over the 40 year period.

Cost of the factory	200mn
(-) grant amount	(50mn)
Net investment in factory	150mn

Therefore, depreciation expense $\frac{150mn}{40\ years}$

= 3.75mn per year

Second method
The amount received could be credited to a separate grant account and it can be amortised over the 40 year period. Similarly, the cost of the factory building should also be depreciated over the 40 year period.

Deferred income 50mn

Amortisation per year (other income) $\frac{50mn}{40\ years}$

= 1.25mn per year

Cost of the factory 200mn

Depreciation expense $\frac{200mn}{40\ years}$

= 5mn per year

Net impact to the statement of comprehensive income = Depreciation expense – other income
= 5mn – 1.25mn
= 3.75mn per year

Accordingly, the net impact on the statement of comprehensive under both methods are equal.

(3) There is a performance obligation attached to this part of the grant. Therefore the grant received should initially be credited to a liability account. **Then the total liability could be charged to the income account on an yearly basis as and when the particular financial period is over and when the particular performance objective is met.** Therefore, as at 31 March 2014 the grant received amounting to Rs. 30 million should be shown as a liability in the statement of financial position.

(c) This transaction is a sale and lease back transaction. Further, since the fair value of the asset is equal to the selling price, and the asset's useful life is equal to the assets lease period, this should be classified as a sale and finance lease back transaction. Therefore, this transaction has resulted in a finance lease.

As a result, first we should record the disposal of the asset. When the asset is disposed of, it will result in a profit of Rs. 50 million. This profit should be deferred and recognised in the income statement over the lease period.

∴ Rs. 50mn/4 years = Rs.12.5mn should be recognised in income statement over 4 year period.

Then the sale back plant should be recorded as a finance lease at Rs. 150mn.

Further, the revaluation surplus already shown in the revaluation surplus account amounting to Rs. 50 million can be transferred to retained earnings.

(d) Sale includes sale of machine and sale of service contract. Therefore, revenue from sale of good and sale of services should be separately identified and accounted for.

Fair value of individual components (under normal sale);

		Rs.
Sale of machine	=	90mn
Sale of service contract for 2 years (20mn per annum x 2 years)	=	40mn
		130mn
Actual selling price for special customer	=	99mn
∴ Amount of discount (130mn – 99mn)	=	31mn

$$\frac{31mn}{130mn} \times 100$$

23.85%

This means that the combined sale has been made at a discount of 23.85%

Therefore, the revenue that can be recognised this year (2013/14) is;

	Sale of good	Sale of services	Total revenue
Normal selling price	90.00mn	40.00mn	
Discount at 23.85%	(21.46mn)	(9.54mn)	
	68.54mn	30.46mn	
Recognition	100%	50%	
	68.54mn	15.23mn	83.77mn

The balance Rs. 15.23mn should be treated as deferred income and shown in the statement of financial position.

(e) An equity instrument is impaired when there is a significant and prolong decline in the fair value of the instrument below its cost.

The cost of the instrument at acquisition is Rs. 200 per share.

FV (31/3/2014) – Rs. 155

Avg. FV over 2013/14 year is Rs.140 - Rs.160 per share

This indicates that the FV of shares has always been below cost for a prolong period of 10-12 months. Decline in value is approximately 20%-30% which is a significant fall in value below the cost.

Even though subsequent to the balance sheet date the FV has improved, the FV is still below cost.

Hence, the instrument should be impaired.

Calculations

FV adjustment for 2012/13: Rs. 100 mn -105mn = Rs. 5 million gain recognised in OCI

FV loss for the year ended 31/3/2014 = Rs. 155 - Rs. 210 = Rs. 55 (per share)

		Rs.
Proceeds on disposal	[(500,000*20%)*160]	16,000,000
Cost	[(500,000*20%) *210]	21,000,000
		5,000,000
(-) gain already recognized in OCI relating to disposed shares		(1,000,000)
Realised loss on disposal		4,000,000

Impairment loss [(500,000*80%) *(210-155)] = Rs. 22,000,000

Extract of income statement

Realised loss on disposal of AFS shares	= Rs. 4,000,000
Impairment loss	= Rs. 22,000,000

Extract of OCI

Recycle the gain recognised in OCI as follows:

Attached to the remaining part of the investment	Rs. 4,000,000 Dr.
Transfer to disposal a/c	Rs. 1,000,000 Dr.
	Rs. 5,000,000 Dr.

(Transactions in 'T' account format are given below)

Investment (AFS Asset)

2012/13	Cash	100,000,000			
	AFS reserve	5,000,000	31/03/2013	Balance c/d	105,000,000
		105,000,000			105,000,000
01/04/2013	Balance b/f	105,000,000		Disposal	21,000,000 [500,000 x 20% x 210]
				Impairment	22,000,000 [(210-155) x 400,000]
			31/03/2014	Balance c/d	62,000,000
		105,000,000			105,000,000

AFS Reserve

		01/04/2014	Balance b/f	5,000,000
Investment disposal a/c	1,000,000			
Recycling of gain attached to remaining shares	4,000,000			
	5,000,000			5,000,000

Answer No. 03

(a)

		2010	2011	2012	2013
Profitability ratios					
Profit margin	PAT/Revenue*100	2.88%	3.96%	5.33%	2.22%
GP margin	GP/Revenue*100	20.00%	21.33%	21.33%	18.06%
Market ratios					
EPS	PAT/# shares	2.88	4.75	8.00	2.00
P/E ratio	Market price/EPS	34.72	23.15	11.88	45.00
DPS	Dividend/# shares	2.00	2.00	2.00	1.00
Dividend yield	DPS/Market price	0.020	0.018	0.021	0.011
Dividend cover	EPS/DPS	1.44	2.38	4.00	2.00
Liquidity ratios					
Current ratio	CA/CL	2.00	0.84	0.72	1.09
Collection period	T. receivable/Turnover*365	73	73	63	85
Inventory turnover period	Inventory/COS*365	46	46	40	35
Asset utilisation					
ROCE	PBIT/Capital (D+E)	6.5%	9.8%	12.9%	5.0%
Return on Biological Assets	Revenue/BA	33%	43%	60%	55%
Trend analysis					
Sales growth					
Increase in sales in LKR			20%	25%	20%
Real sales in USD		8,929	10,526	11,538	15,000
Increase in sales USD (volumes)			18%	10%	30%
Increase in wage rate			20%	0%	88%
Increase in GP			28%	25%	1.6%

(b)

To: The board of directors
From: Accountant
Subject: Financial performance analysis and suggestions for improvement

Performance

In the evaluation it is observable that up to 2012 the performance has an increasing trend. 2013 indicates a downward turn in the performance in terms of NPAT and GP margins.

Even though the revenue has increased by 30% in 2013, in real terms (USD), the GP has only increased by 1.6%. This could be due to the higher percentage increase in wages (15% wage increase in 2013 when compared to 8% in 2012). Sales has increased and at the same time the trade receivable collection period has also increased in 2013, with inventory having a lower turnover time. This could be due to forced sales or over trading.

Investor information

EPS and the market price in 2013 are the lowest during the last 4 years. Decrease in DPS and dividend cover in 2013 would indicate lower confidence in the company.

Increase in PE is not due to increase in prices but due to low EPS. However, the market prices has decreased considerably.

Decrease in return to shareholders could be due to higher interest payable on borrowings

Return on assets

It is observed that in 2013 the company has increased its investment in the plantation. There is no immediate effect on the investment made during the year as the returns are expected in the long term.

Asset utilisation has increased from 2010 to 2012, however, it has declined in 2013. The return on plantation is approximately 55% in 2013 compared to 60% in 2012.

Improvement suggestion

Consider increasing sales prices to cover increase in cost. However, consider market conditions.

Increase in price or decrease on cost of production is required to avoid drop in gross profit margin and net profit margin.

Increased profit is required to provide adequate return to shareholders after deduction of interest.

Recommend to maintain steady dividend ratio to avoid any investor dissatisfaction.

Need to evaluate reasons for higher debtor collection period in 2013.

Increase in return on asset could be due to the depreciated value of plantation. Need to evaluate the quality of the plantation.

Answer No. 04

There are threats to integrity and objectivity arising from the managing director wanting to consider this lease as a sale and operating lease back. As a Chartered Accountant, I should consider the code of ethics in formulating a way of resolving ethical conflict that seems to be developing. It is essential I do not succumb to pressure from non-financial managers so that financial reporting information is prepared in a misleading manner. A Chartered Accountant should present information fairly, honestly and in accordance with relevant professional standards.

Further information about the transactions and the facts must be sought. Establishing the full facts surrounding the situation is essential. If this does not resolve the issue or identifies further concerns, then the parties affected by the conflict, including the managing director, other directors, employees and users of financial statements, should be identified. Then the risk arising from the proposed transaction should be discussed with the managing director of the company. If the matter cannot be resolved, then further discussion should be held with non-executive directors. I should take other actions indicated in the internal whistle blowing policy of the company.

During the resolution process it may be helpful to document my involvement, the substance of the discussions held, who else was involved and what decisions were made and why.

Answer No. 05

(a)
- quality
- delivery time
- lead time
- number of customer complaints

(b) External benchmarking involves comparing the performance of an organisation with that of a direct competitor, ideally one that is acknowledged to be the best in class.

Performance measures, when done correctly, helps everyone in the company to focus on the right things in the right place at the right time.

Further, this will help to achieve a competitive advantage by learning from others' experiences and mistakes, finding best practices and translating these best practices into use in the organisation.

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