SUGGESTED SOLUTIONS

12306 – Financial Reporting Framework

CA Professional (Strategic Level I) Examination

December 2012

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

(a) (i) The property acquired falls within the definition of investment property in LKAS 40 (para 5) – Investment property. The asset was acquired with a view to earn rentals by Sigma PLC. Accordingly the value of property acquired should be shown in Sigma PLC accounts as investment property.

However in the consolidated financial statements of Sigma group 1/3 of this property should be recognized as property, plant and equipment (para 9c of LKAS 40) because from group point of view it falls within the category of owner occupied property.

(4 marks)

(ii) The asset should be initially recorded at cost, including transaction cost (para 20 of LKAS 40). Transaction cost includes directly attributable cost such as the tax on ownership transferring i.e. Rs. 24, 000(2.4mn*1%). Cost = purchase price + tax (Rs. 2,400,000 + Rs. 24,000) = Rs. 2,424, 000 (para 21 of LKAS 40).

(4 marks)

(iii)

Cost	Rs.	2,424,000
Addition	Rs.	500, 00
	Rs.	2,924,000
Fair value	Rs.	3,000,000
Recognized in P/L	Rs.	76,000

Fair value model should be used for measurement after initial recognition (para 33 of LKAS 40). Investment property accounted for under the fair value model is not depreciated. The investment property should be revalued to Rs. 3mn in the statement of financial position as at 31 March 2012 and the movement in the carrying amount should be recognized in profit and loss for the period.

(4 marks)

(iv) The property acquired is not a qualifying asset because extension work was completed during February (shorter period) therefore borrowing cost should be charged to profit and loss (para 22 and 24 of LKAS 23).

(2 marks)

(b) Sigma packing meets the definition of a disposal group within para 6 of SLFRS 5– Non Current Assets held for sale and Discontinued Operations because it is being disposed and it represents a major line of business.

But because it is to be closed down, rather than sold, it should not be classified as held for sale under SLFRS 05 but it should be classified as discontinued operation when it is closed (31 December 2012) and not when the decision to close down is taken. (31 March 2012).

- The closure intention is an indicative of impairment. Sigma PLC should consider whether any impairment charges required.

- The closure announcement on 31 March 2012 creates a constructive obligation in relation to the liabilities/employee etc. Sigma PLC must consider the need of recognizing provision/contingent liabilities in their financial statements.

It would be helpful to users of the financial statements if the details of these decision were disclosed in the notes to the financial statements.

(5 marks)

(c) No. According to the substance of this agreement rights/obligation incidental to the debtors have not been transferred to the Bank. Therefore the company should not derecognized its debtors. This should be treated as a secured loan. Rs. 0.4 mn (Rs. 4 – Rs. 3.6mn) should be recorded as the finance cost. The fact that the debtors have been pledged to obtain this loan must be disclosed in the notes.

(4 marks)

(d) Revenue should be recognized when the goods are delivered to the customer. Until then no revenue should be recognized and the advance should be carried forward as a deferred income. Therefore 500 x 10,000 x 10% = Rs. 500,000 should be recognized as a liability.

(4 marks)

(e) No. Definition of financial liability is a contractual obligation to deliver cash or another financial asset, or a contractual obligation to exchange financial assets or liabilities on potentially unfavourable terms. Hence this is a replacement of goods, no financial liabilities should be recognized.

(3 marks)
(Total 30 marks)

Answer No. 02

Total revenue of the company - Rs. 30,500,000

Combined profit of the company - Rs. 2,500,000

Total assets of the company - Rs. 68,500,000

Segment A - Satisfy the revenue test (36%)and the assets test (16%) Segment A is a reportable segment.

Segment B - Satisfy the revenue test (24.6%) and the assets test (22.6%). Segment B is a reportable segment.

Segment D - Satisfy the revenue test (11.5%) and the assets test (10.2%) . Segment D is a reportable segment.

Segment E - Satisfy the revenue test (13%) and the assets test (10.2%). Segment E is a reportable segment.

No need to consider the profits test in the above segments.

Segment C does not satisfy the revenue test (9.8%) but satisfy the assets test (15.3%) and hence there is no need to consider the profits test. Therefore it is a reportable segment.

Segment F does not satisfy the revenue (4.9%) or the assets test (5.1%) but does satisfy the profit test (16%). This is because its profit of Rs. 400,000 is greater than 10% of the aggregate of the,

(i) absolute amount of losses of two segments (C & D) – Rs.1,500,000 (26%).
(ii) those which either break even or make of profit (including segment F, i.e. Rs. 400,000)

Therefore, segment F is also a reportable segment (para 13 IFRS 8).

If the management believes that information pertaining to a segment that does not meet the quantitative threshold, would be useful to the users of financial statements, such segments also could be included with other segments. (para 13 IFRS 8 – concluding section)

(Total 10 marks)

Answer No. 03

Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or the amount of the future expenditure required in settlement (para 11 LKAS 37) . There is also a relationship between provision and contingent liabilities (para 12 LKAS 37)

	Nature of the obligation	Provision	Other liabilities	Reason
(a)	Warranties given for goods sold	yes		Obligation expected due to past transaction. Uncertainty about amount and timing of payment.
(b)	Refunds to be given for goods sold	yes		Obligation expected due to past transaction. Uncertainty about amount and timing of payment.
(c)	Payments for damages connected with legal cases that are probable	yes		Obligation expected due to past transaction. Uncertainty about amount and timing of payment.
(d)	Dilapidations payable at the end of an operating lease	yes		Obligation expected due to past transaction. Uncertainty about amount and timing of payment.
(e)	Interest payments		yes	Accrual – The service has been received and the timing and amount of payment is known
(f)	Holiday pay earned by employees		yes	Accrual – short term compensated absences are recognised in LKAS 19
(g)	Property rentals		yes	Accrual – The service has been received and the timing and amount of payment is known
(h)	Ordinary dividend declared and appropriately authorised before the year end		yes	Recognise as a current financial liability

(Total 12 marks)

Answer No. 04

(a) No – Conditions in IFRIC 13 is that the entity should grant as part of a sales transaction <u>and</u> customer must meet “further qualifying conditions” (para 3 – scope). As the gift of an imported bottle of branded perfume has been given to the customer at the outset, there are no further conditions that must be met by the customer. Therefore, this is only a sales/trade discount. Hence the arrangement does not **<u>necessarily</u>** fall into the scope of IFRIC 13.

Note: Trade discounts are not recorded in books of account.

(5 marks)

(b) Yes – The customer earns points as he uses his broadband service. Using his broadband service is the “further qualifying condition” this is part of the sales transaction . Hence the arrangement falls into the scope of IFRIC 13

(5 marks)
(Total 10 marks)

Answer No. 05

No – A provision for restructuring should not be recognized. A constructive obligation arises only when an entity has both a detailed formal plan for restructuring and makes an announcement of the plan to those affected by it. The plan to-date does not provide sufficient details that would permit recognition of a constructive obligation (para 75 – LKAS 37) .

(6 marks)

Answer No. 06

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract (para 10 – LKAS 17).

(a) * Hence the lessor is liable for maintenance, BEE PLC is not holding substantial risk of the ownership.

* Because the lease is only for two years and the asset has a life of 5 years, BEE PLC is not holding substantial period of the life span of the asset.

* The present value of the minimum lease, payments does not amount to substantially all of the fair value of the asset at the inception of the lease.

* Accordingly, this lease is an operating lease hence the asset should not be capitalized and the lease liability should not be recognized.

(b) Comprehensive Income Statement

Operating Lease rental $\dfrac{\text{Rs. } 12{,}000 + (24 \times \text{Rs. } 4{,}000)}{2}$ = Rs. 54,000

Statement of financial position

Pre- paid rentals = Rs. 6,000

(Rs.12,000 x 12/24 = Rs. 6,000)

Recorded in the books of account as follows:

Dr. Income Statement	Rs.54,000	
Dr. pre-paid rentals	Rs. 6,000	
Cr. Cash		Rs. 60,000
(Rs.4,000 x 12 + 1 Rs. 12,000)		
(para 10 & 11 – LKAS 17)		

(Total 10 marks)

Answer No. 07

The initial carrying value of the loan is as follows:	Rs
Loan principal	1,000,000,000
Origination fees charged by the borrower	(12,500,000)
Origination fees incurred by the lender	25,000,000
Carrying value of the loan	1,012,500,000

Borrower will pay interest at the rate of 15% (Rs. 150 mn). At the end of the 5 year period borrower will pay Rs. 1,000 mn as capital. Hence the lender is to incur a loss of Rs. 12.5 mn as a result. Therefore this was of Rs. 12.5 mn has to be amortised over the 5 year period in other words annual receipt of Rs. 150 mn has to be split in to two parts,

(i) Interest income
(ii) Repayment of net expenses capitalized at the beginning.

As the entity expects the borrower not to pre pay, the amortization period is equal to the instrument's full term. In calculating the effective interest rate that will apply over the term of the loan at a constant rate on the carrying amount, the discount rate necessary to equate five annual payments of Rs 150 mn and a final payment at maturity of Rs 1 billion to the initial carrying amount of Rs 1,012,500,000 is approximately 14.632%.

Date	Cash inflows (coupon)	Interest Income at 14.623%	Amortization of net fees	Carrying amount
	Rs'000	Rs'000	Rs'000	Rs'000
1-Jan-10				1,012,500.00
31-Dec-10	150,000.00	148,146.06	1,853.94	1,010,646.06
31-Dec-11	150,000.00	147,874.79	2,125.21	1,008,520.85
31-Dec-12	150,000.00	147,563.838	2,436.16	1,006,084.68
31-Dec-13	150,000.00	147,207.385	2,792.61	1,003,292.07
31-Dec-14	150,000.00	146,798.778	3,201.22	1,000,090.85

As can be seen from the above, the effective interest income for the period is calculated by applying the effective interest rate of 14.632% to the loan's amortised cost at the end of the previous reporting period.

The annual interest income decreases each year to reflect the decrease in the assets carrying value as the initial net fee is amortised. Thus the difference between the calculated effective income for a given reporting period and the loan's coupon is the amortization of net fees during the reporting period. The loan's amortised cost at the end of the previous period plus amortization in the current reporting period gives the loan's amortised cost at the end of the current period.

By maturity date, the net fees received are fully amortised and the loan's carrying amount is equal to the face amount, which is then repaid in full. (IAS 39 para 9 AG 6)

(Total 12 marks)

Answers No. 08

(a) No. If CEO of the company participate for remuneration committee meetings, it implies that CEO participate for the decision making of his own salary. And also remuneration committee should be an independent committee. If CEO participates for remuneration committee meetings its independence get diluted. According to the Code of Best Practice on Corporate Governance Principle B.1.1, Board should void potential conflict of interest, when setting up a remuneration committee. According to principle B.1.2 remuneration committee consists of exclusively of non-executive directors.

(3 marks)

(b) No. According to code of best practice on corporate governance, principle A.5.1, the board should include at least two non-executive directors or such number of non-executive directors equivalent to one third of total number of directors whichever is higher. Accordingly NED should have minimum of 3 non-executive directors.

(3 marks)

(c) According to the code of Best Practice on Corporate Governance Principle A.5.5, a director would not be independent if he/ she:

- has been employed by the Company during the period of two years immediately preceding appointment as director;
- currently has/had during the period of two years immediately preceding appointment as director, a Material Business Relationship with the Company, whether directly or indirectly;
- has a close family member who is a director, chief executive officer (and / or an equivalent position) in the Company;
- has a Significant Shareholding in the Company;
- has served on the Board of the Company continuously for a period exceeding nine years from the date of the first appointment;
- is employed in another company or business;
  - in which a majority of the other directors of the Company are employed or are directors; or
  - in which a majority of the other directors of the Company have a Significant Shareholding or Material Business Relationship; or
  - that has a Significant Shareholding in the Company or with which the Company has a Business Connection;
- is a director of another company;
  - in which a majority of the other directors of the company are employed or are directors; or
  - that has a Business Connection in the Company or Significant Shareholding;
- has a Material Business relationship or a Significant Shareholding in another company or business.;
  - in which a majority of the other directors of the Company are employed or are directors; and/or
  - which has a Business Connection with the Company or Significant Shareholding in the same.

(4 marks)

(Total 10 marks)

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