THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

12306 – Financial Reporting Framework

CA Professional (Strategic Level I) Examination
June 2013

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

(a) Equity securities not held for trading are to be classified as available for sale and are to be measured at their fair value with the changes in fair value being taken to equity.

(b) Quoted Treasury Bills shall be classified either as held to maturity or available for sale. Held to maturity bills shall be measured at amortized cost using the effective interest rate while available for sale shall be measured at fair value through equity (fair value to be determined using bid prices).

(c) The company may have the option to account for investment in the subsidiary either at cost (which is the current practice), or at fair value.(either as FVTPL or AFS).

(d) Staff earns should be recognized as a financial asset and classified as loans and receivables and will be initially recognized at fair value adjusted for directly attributable and incremental administration fees. Initially they are measured at fair value plus transaction cost. The proceeds advanced may not be the initial fair value of the staff loan. To arrive at the fair value of the loan, the future cash inflows of the loan need to be discounted using the prevailing market rate for a similar loan (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. The difference between the proceeds advanced and the initial fair value on initial recognition is recognised with up-front loss under staff cost. If the effect of discounting is immaterial, the original amount advanced to staff may be considered as fair value

(e) Trade receivables are initially measured at fair value plus transaction cost. Under normal credit terms, the transaction price may be the initial fair value of the asset. For debtors to whom extensive credit terms are applicable, the future cash inflows of the debtor may need to be discounted using the prevailing market rate for a similar instrument with a similar credit rating. As far as short term receivables are concerned, the amounts receivable may be the fair value since the effect of discounting may be immaterial.

(f) Trade receivables should be recognized as financial liabilities and classified as other liabilities. Initially they are measured at fair value plus transaction cost. Usually the transaction price may be the initial fair value of the liability (creditor). Exceptionally, to arrive at the fair value, the future cash outflows of the creditor may need to be discounted using the prevailing market rate for a similar instrument with a similar credit rating. The difference between the original invoice value and the initial fair value on initial recognition is recognised with up-front gain. If the effect of discounting is immaterial, the original invoice value may be considered as the fair value.

(g) Fixed interest bearing loans and borrowings should be recognized as a financial liability and classified as other financial liabilities. Initially they are measured at fair value plus transaction cost (e.g. legal fees, documentary charges). The proceeds received from the bank may be the initial fair value of the loan.

(h) Joint and collective corporate guarantee is considered as an intra- group corporate financial guarantee contract. This should be initially measured at fair value. Since this is an intra- group financial guarantee contract, no premium is exchanged to determine the fair value. Hence, the fair value is to be estimated by applying a valuation model.

(i) Redeemable Preference Shares are recognised as financial liabilities and classified as other financial liabilities. Initially they are measured at fair value plus transaction cost. Usually the transaction price may be the initial fair value of the liability. In order to arrive at the fair value, the future cash outflows of the liability may need to be discounted using the prevailing market rate for a similar instrument with a similar credit rating.

(j) An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

(Total 30 marks)

Answer No. 02

(a)

i. 31 March 2013

ii. 15 January 2013

SLFRS requires the entity to recognize the services when received. The entity should estimate the grant date fair value of the equity instruments for the purposes of recognising the services received during the period between service commencement date and grant date.

(5 marks)

(b)

i. Equity - Alpha PLC has discretion over the payment of its dividends over preference shares and hence it should be classified as equity.

ii. Liability – Beta PLC management do not have the discretion to avoid the cash obligation and hence preference shares should be classified as a liability. The group as a whole has an obligation to deliver cash.

(5 marks)
(Total 10 marks)

Answer No. 03

(a) Entity C is obliged to disclose the name of B Ltd as the direct parent and Mr X as the ultimate controlling party, even if there are no transactions.

(5 marks)

(b)

i. The housing benefit should be disclosed .

ii. The depreciation charge does not meet the criteria of short term benefits and hence there is no requirement to disclose it. Market rental may be disclosed as narrative information outside the key management compensation table.

(5 marks)

(Total 10 marks)

Answer No. 04

The standard references given below are not required as part of the answer. Marks may be given for the principle that is underlined in the answer.

(a) Borrowing costs may include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Hence, exchange difference may have to be evaluated for the portion that is a result of interest costs, in order to identify the borrowing cost that can be capitalized.

(2 marks)

(b) The directly attributable costs of an item of PP&E include the costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any item produced while bringing the asset to that location and condition. (LKAS 16.17). The operation of the hotel that is partially completed is not an operation that occurs in connection with the construction or development of an item of property, plant and equipment, and is not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. Hence, income from the soft opening cannot be credited to PPE.

(2 marks)

(c) A class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date. (LKAS 16.38)

(2 marks)

(d) Although an appraisal is normally undertaken by professionally qualified valuers, an appraiser does not have to be independent of the reporting entity. Hence, if the employee is suitably qualified he/she may carry out the valuation.

The entity will have to disclose that an independent valuer was not involved in the valuation of the assets. (LKAS 16.77)

(4 marks)
(Total 10 marks)

Answer No. 05

(a) The impairment indicators and their analysis for the plastic household items:

External Indicators	Evaluation
Changes in the environment in which the entity operates.	1. Due to propaganda on use of environment friendly household items, the assets relating to the business line may be subjected to impairment, as a result of declining demand for the products. 2. Technological obsolescence of the plant, resulting in the deterioration of the value of the plant.
Change in the market interest rates	During the financial year, the change in the market rate did not affect the asset's value in use. (or any other appropriate response.)
Grater decline in the market value of the asset more than it would be from the normal use	Considering that required overhaul did not take place, and the plant is operating at 60% capacity, the market value of the asset may be affected. Another contributory factor may be the availability of machines with superior technology in the market.
Internal Indicators	
Restrictions on capital expenditure	Due to curtailment of capital expenditure the plant is not functioning at its optimum. This may also cause a significant increase in maintenance and other related costs of the plant.
Internal reporting	The following aspects indicate the possibility of impairment: - Decline in sales may affect the projected sales, and thereby affect profitability and cash flows - Increased costs due to heavy maintenance, etc. may affect expected profit margins
Based on the above analysis an impairment test will have to be carried out.	

(7 marks)

(b)
1. Price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset.

2. If there is no binding sale agreement but an asset is traded in an active market, fair value less costs to sell is the asset's market price less the costs of disposal.

3. If there is no binding sale agreement or active market for an asset, fair value less costs to sell is based on the best information available to reflect the amount that an entity could obtain, at the end of the reporting period, from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.

(3 marks)

(Total 10 marks)

Answer No. 06

(a)

Direct ownership in KT	10%
Ownership through Quitex	5%
Total holding in KT	15%

(3 Marks)

Ownership through BT Hotels is not considered as it is an associate. (LKAS 28 Para 21)

(b) The recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate because the <u>distributions received may bear little relation to the performance of the associate</u>. Because the investor has <u>significant influence</u> over the associate, the investor has an interest in the associate's performance and, as a result, the return on its investment. The investor accounts for this interest by extending the scope of its financial statements to <u>include its share of profits or losses of such an associate</u>. As a result, application of the <u>equity method provides more informative reporting of the net assets and profit or loss of the investor</u>.

(The principles underlined above are sufficient)

(5 marks)
(Total 8 marks)

Answer No. 07

(a) i. GEL does not have to consolidate the subsidiary.
Parent need not consolidate if it has no subsidiaries other than one that was acquired with the intention of selling or disposing of it within one year.

ii. <u>Yes</u>. This section applies to <u>a first-time adopter</u> of the SLFRS for SMEs, <u>regardless of whether its previous accounting framework was full SLFRSs</u>.

iii. Under SLFRS for SMEs an entity shall recognise all borrowing costs <u>as an expense</u> in profit or loss <u>in the period in which they are incurred.</u>

(8 marks)

(b) i. Segment 1 and Segment 2 cannot be combined for external reporting purposes.

<u>Reasons</u>

Operating segments that meet either of the following quantitative thresholds shall be reported separately.

- Revenue is 10% or more of the combined revenue, internal and external, of all operating segments
- Its assets are 10% or more of the combined assets of all operating segments

ii. Segment 3 and Segment 4 cannot be combined for external reporting purposes.

The operating segments do not seem to have similar economic characteristics.

- The long term gross margin is very dissimilar.
- The type of customers that segments 3 and 4 serve are dissimilar.

(6 marks)
(Total 14 marks)

Answer No. 08

(a)

(i) Yes. As per the Corporate Governance requirements a board shall include at least two non executive directors, or such number of non- executive directors equivalent to 1/3 of the total number of directors whichever is higher.

(2 marks)

(ii) No. At least 2 independent non-executive directors should be present in the remuneration committee. **or** the Committee should not have any executive director.

(2 marks)

(iii) No. Mr. Y. De Saram has significant shareholding in the company, hence he is not independent.

(2 marks)

(b) Interest on preference shares will not be considered, as the interest falls due only if the board authorizes such payment.

(2 marks)

(Total 8 marks)

Notice of Disclaimer

The answers given are entirely by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) and you accept the answers on an "as is" basis.

They are not intended as "Model answers', but rather as suggested solutions.

The answers have two fundamental purposes, namely:

1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) makes no warranties with respect to the suggested solutions and as such there should be no reason for you to bring any grievance against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka). However, if you do bring any action, claim, suit, threat or demand against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka), and you do not substantially prevail, you shall pay the Institute of Chartered Accountants of Sri Lanka's (CA Sri Lanka's) entire legal fees and costs attached to such action. In the same token, if the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) is forced to take legal action to enforce this right or any of its rights described herein or under the laws of Sri Lanka, you will pay the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) legal fees and costs.