SUGGESTED SOLUTIONS

12306 – Financial Reporting Framework

CA Professional (Strategic Level I) Examination
DECEMBER 2013

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No 01

I. **Provision for bad and doubtful debts – LKAS 39 para 63**
The current practice on bad and doubtful debt provisioning to be replaced with impairment testing. Current practice is not correct.

The amount of impairment loss is measured at the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's initial effective interest rate or determined on a collective impairment test.

II. **Investment in Unit Trusts – LKAS 39 -** current practice is not correct.
This should be recognized as "financial asset". Then the Company may have the option to classify the investment as either

- "fair value through profit or loss (FVTPL)" [if they are held for trading or initially designated as FVTPL. A financial asset can be initially designated as FVTPL either if it reduces the accounting mismatch or the performance of the investment in unit trust is evaluated on fair value basis in accordance with documented risk management/ investment strategy] or

- "available-for-sale financial assets (AFS)" [if they are not classified as FVTPL].

III. **Property, plant and equipment (PPE) – LKAS 16 para 43**
Property, plant and equipment may have different useful life spans, and should be depreciated applying different depreciation rates based on the useful life of those assets, instead of applying a flat rate which is the current practice.

The company should identify the significant components in relation to the total cost of each item of property, plant and equipment and they should be depreciated separately. Therefore the company may allocate the amount recognised in respect of an item of PPE to its significant parts and depreciate separately each such part. Therefore, the current practice of using flat deprecation rates for all assets is not appropriate.

IV. **Investment in subsidiary – LKAS 27 para 38**
The company may account for investment in the subsidiary either:

- at cost(which is the current practice), or
- at fair value – in accordance with LKAS 39

V. **Loan to subsidiary – LKAS 39**
It may be considered to be an interest in subsidiaries (investment in subsidiaries) as a financial asset classified under "loans and receivables" in which initial measurement will be at fair value plus transaction cost and subsequent measurement basis would be the amortised cost.
Therefore, stating the loan to subsidiary at cost is not appropriate.

VI. **Trade payables – LKAS 39**
These should be recognized as "financial liabilities" and classified as "other financial liabilities".

Initially they are measured at fair value plus transaction cost. To arrive at the fair value, the future cash outflows need to be discounted using the prevailing market rate for a similar instrument. The transaction price may be considered as FV.

Subsequently they are measured at amortized cost. In the case, where the difference between the initial fair value and the maturity value is insignificant, the transaction price may be considered for subsequent measurement purposes as well. Current practice is not correct.

VII. **Loans and borrowings – LKAS 39**

These should be recognized under "financial liability" and classified as "other financial liabilities".

Initially they are measured at fair value plus transaction cost. The proceeds received from the bank may be the initial fair value of the loan.

Subsequently they are measured at amortized cost using the initial effective interest rate (EIR) minus impairment. Current practice is not correct.

VIII. **Corporate financial guarantee on behalf of the subsidiary**

They are considered to be financial guarantees covered by LKAS 39.They are initially measured at fair value and subsequently measured at higher of the amount determined in accordance with LKAS 37 and initial fair value less cumulative amortization. Current practice is not correct.

IX. **Stated capital- LKAS 32**

The redeemable preference shares should be classified as debt and included under liabilities. Current practice is not correct.

X. **Other assets – LKAS 39**

The interest free staff loans should be recognized as a "financial asset" and initially they are measured at fair value plus transaction cost.

Subsequently they are measured at amortized cost. Current practice of presenting staff loans as other assets is not correct.

(Candidates are not expected to comment on LKAS 1 requirements)

<u>Answer No. 02</u>

(a) (i) Sigma can apply SLFRS for SMEs in preparing its financial statements as it is not publically accountable as it is an unlisted company even though it is a subsidiary of a listed company

However for practical purposes of consolidation with the group it may require to use full SLFRs.

(ii) **Silva** is not a publically accountable entity. According to the given information Silva does not prepare financial statements for external users i.e. it doesn't publish general purpose financial statements. So that Silva is not necessarily required to prepare financial statements in accordance with SLFRS for SMEs.

(b)

(i) ***Accounting for associates***

SLFRS for SMEs- Section 14 - Option to use cost model, equity model and fair value through profit or loss is granted.

LKAS 28 – Cost and fair value models not allowed by LKAS 28.

(ii) ***Accounting for property, plant and equipment***

SLFRS for SMEs- Section 17 – No revaluation model is allowed only historical cost method is allowed.

LKAS 16 – Allows revaluation of PPE through equity

(iii) ***Accounting for intangibles other than goodwill***

SLFRS for SMEs- Section 18 – Does not recognize internally generated intangible assets. Acquired intangible assets to be measured at cost less amortization.

LKAS 38 – Requires capitalization of development costs incurred if, and only if, an entity can demonstrate the 6 criteria given in para 57 of LKAS 38.

LKAS 38 - Acquired intangible assets to be measured using cost model or revaluation model.

(iv) ***Goodwill generated though business combinations***

SLFRS for SMEs- Section 19 – Goodwill should be amortized. If unable to estimate useful life, goodwill should be amortized over 10 years.

LKAS 38 – Goodwill amortization is prohibited by LKAS 38.

Answer No. 03

(a)

- A lease is a contract in which one party (the owner of the property) transfers the right to use the property to another party (lessee) in exchange for some form of payment.
- In accounting for an operating lease, the lessee recognises lease rentals as expenses when incurred and does not recognise the leased property as an asset, nor does it recognize a liability for its obligation under the lease.

  The distinguishing feature of a finance lease is that it transfers substantially all the risk and rewards incidental to the ownership of an asset. An operating lease is a lease other than a finance lease.

  According to conceptual framework, an asset is a resource controlled by the entity as a result of a past event and from which future economic benefits are expected to flow to the entity.

For an asset to be recognized the definition and recognition criteria to be met are as follows:

- probability of future economic benefit
- the item has a cost that can be measured reliably.

One of the weaknesses of this model is the difficulty of determining whether substantially all of the risks and rewards of ownership have been transferred. In other words, should the lessee's accounting for a lease depend on whether substantially all the risks and rewards of ownership have been transferred to the lessee? Or should it be determined by whether the lease gives the right of control over resources that are expected to provide future economic benefits to the entity and to an obligation that is expected to be settled by the outflow of resources embodying future economic benefits, or by whether the recognition criteria for resulting asset and liability are satisfied?

Accordingly, one could argue that a lease can be accounted under operating lease as per LKAS 17, if the lease is structured to meet the criteria of recognizing an operating lease. However, according to recognition criteria given under conceptual framework, one could argue for capitalizing asset and recognizing liability.

(b) If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognized as income by a seller-lessee. Instead it shall be deferred and amortised over the lease term**.**

	Rs. Mn	Treatment
Profit - Excess of sale price over carrying value (90-60)	30	Deferred and amortised

In the financial year ended 31 March 2013 an amount of Rs(30*1/38)=Rs 789, 474 should be released and credited to IS.

The balance of deferred revenue as at 31 March 2013 is 30, 000,000 – 789, 474 = 29, 210, 526

Answer No. 04

(a) (i) The market capitalization of SEA PLC as at the recent reporting date i.e. Rs. 150 million exceeds the carrying amount of net assets as at the same date i.e. 140 million. It is an indication that the net assets of the company have not impaired. Accordingly formal estimation of the recoverable amount of companies assets is not required.

(ii) Although WE PLC was not directly affected by the natural disaster, many of its suppliers have ceased operations. As a result WE PLC's plant operates at only half capacity. The assets of WE PLC may potentially be impaired as a result of this change because economic performance of the plant will be significantly lower than the expected. Accordingly WE PLC should make a formal estimate of the recoverable amount of its assets.

(b) (i) This is a non- adjusting event, as it relates to an event that does not reflect conditions existing at the end of the reporting period. Accordingly, investments will not be adjusted in the statement of financial position, but nature of the event and its financial effect should be disclosed in the notes to the financial statements.

(i) This is a non – adjusting event and should not result in adjustments of items in the financial statement, but details of the nature and financial effect of the event should be disclosed.

Answer No. 05

(a) A disclosure exemption is outlined in para 92 of LKAS 37. In extremely rare cases, disclosure of some or all of the information required by paragraphs 84-89 can be expected to seriously prejudice the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. This exemption is only applicable in extremely rare circumstances.

The alternative disclosure is that the general nature of the dispute, together with the fact and reason why information has not been disclosed, must be stated.

(b)
- Future operating losses do not satisfy the definition of liabilities
- There is no present obligation
- The mere intention to make future sacrifice of economic benefits is not sufficient to give rise to a present obligation
- The entity has the ability to avoid incurring future operating losses by either disposing of or restructuring the operation
- The amount of the losses cannot be measured reliably.

(c) There is no present obligation in this situation as the plan has not been communicated to employees; the firm can still put off the decision to restructure, that is, there is no current obligation for the entity to proceed with the restructuring.

As per LKAS 37, constructive obligation to close down arises only when the entity has a detailed formal plan, identifying at least,

* business concerned (gents garment division)
* principal locations affected (the said division)
* location, function & no. of employees affected
* expenditure to be undertaken.
* date of implementation (not yet decided)

Answer No. 06

(a) Cost is Rs 100 million and has a useful life of 20 years. Hence annual depreciation charge over the first five years is Rs 5 million.

Accumulated depreciation at the end of year 5 is Rs 5 million @ 5 years = Rs 25 million

Carrying value at the end of year 5 = Rs 100 million – Rs 25 million = Rs 75 million

Annual depreciation charge from year 6 to year 10 = Rs 75 million / 5 years = Rs 15 million
Depreciation charge in Year 9 = Rs 15 million

(b)

	2012 (Rs. mn)	**2011 (Rs. mn)**
Net profit before dividends	550	450
Preference dividends	(5)	(5)
Net profit after dividends	545	445
Weighted average no. of ordinary shares	**No. (000)**	**No. (000)**
Shares in issue for full year	10	10
Issued on 1 October 2012 (4,000,000 @ 3/12)	1	-
Number of shares	11	10
Earnings per ordinary share (Rs)	545/11	445/10
	49.54	**44.5**

Answer No. 07

Net assets acquired	**Book values (Rs. mn)**	**Tax written down values (Rs. mn)**	**Fair values (Rs. mn)**
Total assets	1,230	1,080	1,330
Total liabilities	(260)	(160)	(260)
Net assets before deferred tax liability	970	920	1,070
Deferred tax liability (970-920=50) @ 40%)	(20)	-	-
Net assets at acquisition	950	920	1,070

			Rs. mn
Fair values of S's identifiable assets and liabilities excluding deferred tax			1,070
Less: tax written down value			(920)
Temporary difference on acquisition **(Note below)**			150
Net deferred tax liability on acquisition of entity S(Rs. 150 mn @40%)			60
Purchase consideration			1,500
Fair values of S's identifiable assets and liabilities excluding deferred tax		1,070	
Deferred tax		(60)	1,010
Goodwill arising on acquisition			**490**

Note – Alternate Method

H
↓ 100% on 1/1/12 for Rs. 1.5bn
S

	Amount recognized at acquisition	Tax base	Temporary differed
Land & building	700	500	200
Plant & machinery	270	200	70
Inventory	80	100	(20)
Retirement benefit obligation	(100)	-	(100)
			150
Deffered tax @ 40%			60

Answer No. 08

(a) **Audit committee**

- Overseeing of the preparation, presentation and adequacy of disclosures in the financial statements of a listed entity, in accordance with Sri Lanka Accounting Standards.
- Overseeing of the entity's compliance with financial reporting requirements, information requirements of the Companies Act and other relevant financial reporting related regulations and requirements.
- Overseeing the process to ensure that the entity's internal control and risk management are adequate, to meet the requirement of the Sri Lanka Auditing Standards.
- Assessment of the independence and performance of the entity's external auditor.

- To make recommendations to the board pertaining to appointment, re-appointment and removal of external auditors and to approve the remuneration and term of engagement of the external auditor.

Remuneration committee

The remuneration committee shall recommend the remuneration payable to the executive directors and CEO of listed companies and/ or equivalent position thereof, to the board of the listed entity which will make the final determination upon consideration of such recommendations.

(b) One of the key requirements of non-executive directors is that they should be independent.

Non- executive directors are often appointed through business or social contact with the executive directors though the majority should be independent of the management and free from any business or other relationship which could interfere with the exercise of their independent judgment. This level of independence can often be difficult to obtain.

Finding adequate number of non- executive directors, potentially to make up half of the board, who have the knowledge and expertise to contribute in the required manner to running of the company also becomes a problem.

Another problem is that non- executive directors are only part time and have no operational responsibilities. This has often meant in practice that individuals have taken on a number of non-executive directorships and may therefore not have the time or motivation to fully carry out their roles within each company in which they are non-executive directors.

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