CA | THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

20404 – Advanced Financial Reporting

CA Professional (Strategic Level II) Examination

June 2013

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

(a)

	Rs.'000
Goodwill	
Cost of investment	150,000
Cash	30,000
Contingent consideration	50,000
Fair value of NCI -1/4/2012 (2,000,000 X Rs 25)	
	230,000
Fair value of net assets of M at acquisition **(W2)**	(156,000)
Goodwill on aqcuisition	74,000
	=======

(5 marks)

(b)

BIG PLC GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

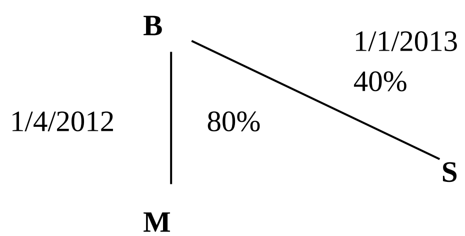
AS AT 31ST MARCH 2013

		Rs. '000
Assets		
Non Current Assets		
Goodwill (74,000 - 24,667) **(W 8)**		49,333
Property plant & equipment	(200,000+180,000+20,000+110,000-3,000-22,000-5,000)	480,000
Intangible assets	(50,000+15,000+10,000-1,000)	74,000
Investment in associates **(W 6)**		40,480
Available -for -sale financial assets **(W 7)**		30,000
Current Assets		
Inventories	(85,000+42,000)	127,000
Trade & other receivables	(38,000+28,000-25,000)	41,000
Cash & cash equivalents	(22,000+10,000)	32,000
		873,813
		======
Equity & Liabilities		
Equity		
Stated capital		200,000
Retained earnings **(W 5)**		134,146
Non-controlling Interest **(W 4)**		47,667
Non Current Liabilities		
Long term borrowings	(150,000+75,000+90,000)	315,000
Contingent consideration	(30,000+5,000)	35,000
Current Liabilities		
Trade & other payables	(41,000+30,000)	71,000
Short-term borrowings	(49,000+22,000)	71,000
		873,813

(Total 35 marks)

WORKINGS

(W1) Group Structure



(W2) Net assets of subsidiary (M)

	At date of acquisition	At reporting date
Stated Capital	100,000	100,000
Retained earnings	23,000	48,000
Fair value adjustments:		
Property	20,000	20,000
Inventory	3,000	-
Intangible	10,000	10,000
Additional depreciation on property (60Mn/20yrs)		(3,000)
Amortisation on intangible (10Mn/10yrs)	-	(1,000)
	156,000	174,000
	======	======

(W3) Goodwill (calculated at proportianate share of assets acquired)

Cost of investment	150,000
Cash	30,000
Contingent consideration	31,200
NCI -1/4/2012 (156,000 X 20%)	
	211,200
Fair value of net assets of M at acquisition (W2)	(156,000)
Goodwill on aqcuisition	55,200
Goodwill at fair value of NCI	74,000
NCI share of goodwill	18,800

(W4) Non controlling Interest

At the date of acquisition	50,000
20% of post acquisition profits (18,000x20%) (**W 5 (a))**	3,600
Impairment of CGU	(5,933)
	47,667

OR

20% of net assets at 31/3/2013 (20% X 174000) **(W-2)**	34,800
NCI share of goodwill (18800-1000) **(W 3)**	17,800
	52,600

(W5) Group retained earnings

100% parent	170,000
80% of M post-acquisition reserves (80% X 18,000**) (W 5(a)**	14,400
40% of S post-acquisition reserves (40% X 3/12 X 4800)	480
Impairement of CGU	(23,734)
Gain on ASF financial asset	5,000
Depreciation on leased plant	(22,000)
Lease interest	(5,000)
Increase in contingent consideration	(5,000)
	134,146
	======

(W 5 (a))

Post acquisition profit Medium PLC	
Profit for the year (48,000 – 23,000)	25,000
Additional depreciation	(3,000)
Amortisation – intangible asset	(1,000)
Pre acquisition – Inventory Fair Value	(3,000)
(W5) + (W 4)	18,000

(W6) Investment in associate

Cost	40,000
Share of post acquisition profit (4800 X 3/12 X 40%)	480
Carrying value 31.03.2013	40,480

(W7) Available for sale financial asset

At 1/1/2013	25,000
Change in FV	5,000
At reporting date	30,000

(W8) Impairment of CGU

Carrying amount of asset & Goodwill portion (70,000+24,667)	94,667
Recoverable amount	65,000
Impairment loss	29,667

as per LKAS 36, if an impairment loss arises in respect of a CGU, it is allocated among assets in the CGU in the following order:
1.any individual assets that are obviously impaired
2.goodwill
3.other assets pro rata to their carrying amounts

Accordingly, the impairment loss of Rs. 24,667 is set off against goodwill in full and the balance 5,000 is set off agaist the PPE.

(W 9) Lease arrangement

Determining whether the lease is a finance or an operating lease.

Lease term	5 yrs
Useful life of plant	8yrs
Lease term as a % of useful life	(5/8 X 100) = 62.5%

The lease term is for the major part of the economic life of the asset. Therefore, under LKAS 17 this lease is a finance lease and should be accounted for accordingly.

Accounting entries:
Date of inception

Leased plant	Dr	110,000	
Interest in suspense	Dr	15,000	
Lease creditor			125,000

Subsequent measurement

1. Depreciation on plant	Dr	22,000	
Leased plant			22,000
2. Lease creditor	Dr	25,000	
Trade & other receivables			25,000
3. Lease interest	Dr	5,000	
Interest in suspense			5,000

Note:
Sum of the digits method is used to compute lease interest

$$15000 \quad X \quad \frac{5}{15}$$

Alternative answer

Calculation of PV of minimum lease payment

Year	rental (mn)	Pv (mn)
0	25	25
1	25/1.14	21.929
2	25/(1.14^2)	19.236
3	25/ (1.14^3)	16.874
4	25/ (1.14)^4	14.802
		97.841

By calculating Pv of minimum lease payment, answers can be changed accordingly and marks are also awarded.

Answer No. 02

(a)

Unrecognized actuarial losses	Rs. 3,000,000
Unrecognized past service cost	Rs. 1,000,000
PV of available reduction in future contribution	Rs. 5,000,000
Max ceiling	Rs. 9,000,000

(b) This arrangement contains a lease due to existence of following conditions

- A specific asset is identified to fulfill the production requirement
- Sell Fashion has the right to use the asset
  - Majority of the output is taken by Sell Fashion
  - Payments are fixed and not dependent on the number of units produced
- The lease should be classified and accounted as finance lease
  - Sell fashion has substantially all of the risk and rewards incidental to the ownership of the asset
  - Lease term is for major part of the economic life. Insignificant residual value.
  - PV of minimum lease payments amounts to substantially fair value of the asset at the inception of the lease

(Total 15 marks)

Answer No. 03

(a)

$$\frac{\text{EPS}}{\text{Market price per share}} = \frac{15}{120}$$

$$= \underline{\underline{\mathbf{0.125}}}$$

ii) Price Earnings Ratio

$$= \frac{\text{Market price per Share}}{\text{EPS}} = \frac{120}{15}$$

$$= \underline{\underline{\mathbf{8\ times}}}$$

iii) Asset turnover ratio

$$= \frac{\text{Revenue}}{\text{Non Current assets}}$$

$$= \frac{1{,}200\ \text{Mn}}{530\ \text{Mn}}$$

$$= \underline{\underline{\mathbf{2.26\ Times}}}$$

iv) ROCE

$$= \frac{\text{PBIT}}{\text{Capital Employed}} \times 100 = \frac{225}{600} \times 100$$

$$= \underline{\underline{\mathbf{37.5}}}$$

v) Dividend Cover

$$= \frac{\text{EPS}}{\text{DPS}}$$

$$= \frac{15}{5}$$

$$= \underline{\underline{\mathbf{3\ Times}}}$$

(5 marks)

(b)

To :- Director Finance
From :- Mr. X

<u>FINANCIAL PERFORMANCE</u>

The financial performance of the Target company can be evaluated using the ratios provided. These ratios include the following,

- Gross profit ratio
- Net profit ratio
- ROCE
- Assets turnover ratio

The company's Gross profit ratio (GP) has dropped compared to the previous year & it remains below the industry average over the period under consideration. However, the net profit ratio has remained above the industry average but has seen a drop over the years. The drop in GP ratio could be due to higher direct costs. Another possible reason is that the company may be facing low demand & due to this the sales may be low. This is also highlighted by the low asset turnover ratio. Below –industry assets turnover ratio suggest that the assets are under utilized. This could be due to low demand.

The Return on Capital Employed (ROCE) was on the drop & also remained below the industry average one possible reason could be recent injection of capital.

The foregoing analysis suggests that the financial performance of the company is deteriorating & below the industry performance.

<u>LIQUIDITY</u>

Liquidity is the availability of cash (& Cash equivalents) to settle its short term debts. The liquidity position of an entity can be analysed using following ratios.

- Current ratio
- Quick ratio
- Inventory holding period
- Debt collection period
- Creditor's payment period

Both current & quick ratios indicate the availability of liquid funds to settle short term obligations. The quick ratio removes the less liquid inventory from the current assets. Both ratios remained at the same level over the years but remained below industry average. This could be due to higher short term obligations such as creditors & bank overdrafts.

Both inventory holding & debt collection periods have remained unfavorable compared to the industry norms. The higher ratios suggest that the money is tied up in inventory & debtors over a considerable period. As a result, the company has taken substantial time to settle its creditors as suggested by the creditors' settlement period. This could result in suppliers refusing to provide goods & services on credit terms.

The above analysis indicates adverse liquidity position and if appropriate measures are not taken this could lead to further financial distress.

SOLVENCY

The solvency is the ability to meet obligations as they become due. The long term solvency is measured by the debt/ equity (gearing) ratios.

The company is high geared compared to the industry norm. Further, the gearing ratio is on the rise over the period under consideration.

A high geared Company could indicate both a healthy position as well as a weak position. A company may have borrowed to finance its growth. This normally indicates a healthy position with the expectation of future profits. Similarly, a company in financial distress may also involve in borrowing to finance its activities. Therefore, it is vital to consider the objective of borrowing before commenting on the solvency.

CONCLUSION

Based on the foregoing analysis, the Chairman's comments are not substantiated.

(Total 25 marks)

Answer No. 04

(a) Instrument in and active quoted market cannot be classified as loans and receivable. Hence it shall be classified as available for sale

(b) Instrument classified as AFS cannot be reclassified as FVTPL. However, on disposal of the instrument, the gain/loss that was recognized in equity shall be recycled to P/L.

(c) These instruments can be designated as FVTPL as they are managed on FV basis

(d) This is a hybrid instrument with an embedded derivative. The option embedded into the debenture is not closely related to host contract. Therefore the option should be separated from the host contact as separate derivative. Should be fair valued. The debenture can be classified as LR. Alternatively, the entire instrument can be designated as FVTPL

(Total 10 marks)

Answer No. 05

(a) (i) Challenges faced by the practitioners

- Extensive requirements to exercise judgment. It is not the judgment of the accountant or the CFO.
- The judgments shall be made by the operational staff with the knowledge of the business. The accountant/CFO would not have the required knowledge and expertise.
  - Judgment on impairment
  - Estimation of fair value
  - Understanding of products and business promotional activities
  - Unbundling of products
- Understanding the purpose and nature of the business should be supported by the executive levels. Any business decision could have accounting consequences.
  - Business acquisition and accounting for SPV
  - Understanding of contracts and purpose of the contract (Eg. Lease/ derivatives)
- Buying sponsorship from the senior executive level and other operational units are challenging
- Obtaining required information and marinating reliability of the information could be challenging .

(ii) Quality and reliability of information

- The businesses are reported as how they managed. Provides for proper count of stewardship of the management.
- Eg.
  - Risk management disclosures made under IFRS 7 would improved the usefulness of the information presented related to financial instruments and how they are managed
  - Segmental reporting disclosures are made as how the CODM (the Executive management) manage the business
  - Many transactions are brought in as on balance sheet items. Eg. Derivative contracts. The fair values of the contract are accounted depicting the worthiness of the contract entered into by the management.
  - Fair value of the assets and liabilities (financial instruments) and how they are derived (with assumptions) are disclosed increasing the relevance and reliability of the information.

(iii) Sri Lanka’s readiness

- IFRSs are in a fast changing regime in order to face;
  - the dynamic business environment
  - To cater for increasing demand for information by business and users
- Sri Lanka needs significant change in the entire financial reporting systems. Some of the crucial elements are listed.
  - Standard setting and monitoring by the regulators
  - Enhancement of knowledge and skill levels of practitioners
  - Alliance and coordination with other related regulators
    - CBSL/ IBSL/ Business associations
    - Tax authority
    - Stock exchange
  - Education of users such as;
    - Banks
    - Researchers
    - Investors
    - Government etc.
  - Experts
    - Real estate valuers
    - Financial instrument valuers
    - Actuaries
- It is also vital to gage the readiness of the money and capital markets to react on the IFRS related information

- Preparers readiness and availability of the information. The prepared systems and procedures may not yet be read to produce required IFRS related information for disclosure purpose. Such information also may not be reliable for decision making purposes.

(b) What is sustainability reporting.

Sustainability reporting refers to reporting about the business organizations environmental, social and governance performance. It is a method to internalize and improve an organizations commitment to sustainable development in a way that can be demonstrated to both internal and external stake holders.It provides additional information to the stake holders as to how the business organization discharge its responsibilities towards environment , social and governance perspectives.Present stake holders of the business organizations evaluate the businesses not purely based on the financial numbers.They evaluate and see the contribution of the business organizations towards environment and social aspects as well.Therefore sustainability reporting is very important.

The business organizations will have to consider the following principals in reporting on sustainable reporting.

- Transparency
- Traceability
- Compliance

(c) " The management....................................."

Comment on the above statement ?

Shareholders are the owners of the business organizations (Limited liability companies).They appoint board of directors to manage the business in the best interest of share holders.In this process share holders assign the responsibility with the management to manage the assets of the business in the best interest of them.Therefore management appointed by the share holders has no moral right to dispose the business assets on non business objectives.As a result it can be concluded that managements primary responsibility is to use the assets owned by the business to maximize share holders wealth.

Society at large can also be benefitted when management peruse this objective of share holders wealth maximization , as follows.

1. Maximizing wealth has the effect of increasing the tax revenue available to the government to distribute on socially desirable objectives.

2. Maximizing wealth for a few people some times held to have a "tickle down" effect on the disadvantaged members of the society.

   However business organizations at large are benefitted using the public resources , may pollute the environment etc.Therefore the business organizations have social responsibilities as well.

Further the following will also have to be considered in evaluating the above.

1. Organizations are rarely controlled effectively by the Share holders.Most of the share holders are not active.In this context is it really necessary to work only towards their wealt maximization.

2. Strategic decisions by business always have wider social consequences.Therefore the business organizations have some social responsibility as well.

(Total 15 marks)

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