THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

No of pages: 12

Business Level

Business Financial Reporting

(Pilot Paper)

Instructions to candidates

(1) Time allowed: 3 hours.

(2) Section 1: 5 questions – **all questions are compulsory.**

Section 2: 2 questions – **both questions are compulsory.**

(3) Answers to questions should be in the answer booklet provided to you. Begin each answer on a separate page.

(4) All answers should be in **English.**

K

B

1

June 2015

SECTION 1

All five questions are compulsory.
Total marks for Section 1: 50 marks.
Recommended time for the Section is 90 minutes.

Question 01

A. "Business organizations need to assess the appropriateness of the going concern convention in preparing and presenting financial statements"

Required:

Explain the effect of the going concern convention not being held appropriate for an entity on its' financial statements.

(3 marks)

B. Tharu PLC issued a three year convertible bond with a face value of Rs. 6 Mn on 01/04/2013. The coupon rate of the bond is 10% payable annually in arrears. There were no issue costs in relation to the bond issue and the bond is redeemable on 01/04/2016 at par value for cash or can be exchanged for equity shares of Tharu PLC on the basis of 10 shares for each Rs. 1,000 of bond value. Tharu PLC would have been required to pay an interest rate of 15% on a similar bond without the conversion option. The directors believe that all the bond holders will opt for the conversion when the bond is due for redemption. Therefore, the directors are proposing to recognize the bond within equity in the statement of financial position when preparing the draft financial statements for the year ended 31/03/2014. They also intend to charge a finance cost of Rs. 600,000 (6 Mn x 10%) to the income statement for each year up to the date of conversion.

Required:

1. **Explain** whether above accounting treatment proposed by the directors of the Company can be accepted as per the applicable Sri Lanka Accounting Standards (LKAS/SLFRS).

(3 marks)

2. **Prepare** extracts to show how the above bond and the finance charge should be treated by Tharu PLC in its financial statements for the year ended 31/03/2014.

(4 marks)
(Total 10 marks)

Question 02

Miracle Creations (Pvt.) Limited (MCPL) is a company operating in the hospitality industry. MCPL has two main divisions. One division is a hospitality training academy which carries out a number of courses on food and catering for aspiring chefs. The other division is engaged in the import and sale of equipment to local bakeries. The sales are carried out directly by MCPL as well as through an agent.

The following issues have arisen in preparation of the draft financial statements of the Company for the year ended 31/03/2014.

MCPL charges Rs. 40,000 for a beginners course in cooking. The course consists of 30 classes conducted twice a week. The fees are charged at the commencement of the course and are non-refundable. The fee includes course material (booklets comprising local and international recipes) issued at the commencement of the course, which could be separately purchased at a price of Rs. 10,000. At the end of the financial year, MCPL had 20 students enrolled in this course who have paid the full course fee. The Company had completed 10 classes of the above course as of 31/03/2014.

MCPL sold bakery equipments with a value of Rs. 3 Mn to a customer opening up a new bakery, during the financial year 2013/14. Since the customer is a student who has passed out with a merit pass from the training academy, MCPL has agreed to defer the payment for the purchases for a period of 2 years.

A discount rate of 12% is to be used in any calculations.

Required:

1. **Assess** the revenue to be recognized by MCPL from the beginner's course in cooking for the year ended 31/03/ 2014.

   (5 marks)

2. **Discuss** how the sale of bakery equipment to the student needs to be treated by MCPL in the financial statements for the year ended 31st March 2014 and in the subsequent financial years.

   (5 marks)

(Total 10 marks)

Question 03

Hiru PLC is in the process of preparing its financial statements for the year ended 31st March 2014. The following special transactions which have taken place at Hiru PLC during the financial year 2013/3014 were brought to your attention.

Transaction 1

The Company has leased out a land from Ruwan for a period of 40 years on 1st April 2013. This land was used for the construction of a factory for the Company. The title of the property will remain with Ruwan at the end of the initial lease term. Hiru PLC has been given an option to renew the lease indefinitely at an immaterial rent at the expiry of the initial lease term of 40 years. Consideration of the initial lease term consists of two components: an up-front premium which equates to 75% of the market value of the land and an annual rental of 2% based on the market value of the land at the commencement of the lease.

Transaction 2

On 1st April 2013 Hiru PLC leased out a plant from Tharu PLC on a four-year lease. The expected future economic life of the plant on 1st April 2013 was eight years. Under the terms of the lease, if the plant breaks down Tharu would be required to repair the plant or provide a replacement. Tharu PLC agreed to allow Hiru PLC to use the machine for four months of the lease period without payment of rental as an incentive to Hiru PLC to sign the lease agreement. After the first four months lease rentals are payable on a monthly basis at the end of each month at Rs. 1 Mn per month.

Required:

1. **Advise** the directors on how to account for the lease of land in the financial statements of the Company for the year ended 31/03/2014.

   (5 marks)

2. **Advise** the directors of the Company how to account for the lease of plant in the financial statements of the Company for the year ended 31st March 2014. Your answer should include relevant calculations where necessary. (Amounts to be shown in the statement of financial position and statement of comprehensive income).

   (5 marks)

(Total 10 marks)

Question 04

A. Some temporary differences arise when income or expenses are included in accounting profit in one period but are included in taxable profit in a different period. Such temporary differences are often described as timing differences.

Required:

State four situations that give rise to temporary differences other than timing differences.

(4 Marks)

B. You are the Finance Manager of XYZ PLC. You encountered the following matters in finalizing the deferred tax asset /liability to be included in the 2013/2014 financial statements of the Company. Income tax rate applicable to the Company is 25%

Situation A

An asset which cost Rs. 150 Mn has a carrying amount of Rs. 100 Mn. Cumulative depreciation of this asset for tax purposes is Rs. 90 Mn.

Situation B

The Company owns a land which was acquired in 2010/2011 at a cost of Rs. 100 Mn. During the financial year 2013/2014 it was identified that the value of this land is impaired by Rs. 20 Mn. The impairment loss is not allowed for tax purposes until the land is sold.

Situation C

The Company has recognized a liability of Rs. 100 Mn for accrued product warranty costs. For tax purposes, the product warranty costs will not be deductible until the Company pays claims.

Required:

Compute the deferred tax asset/ liability for each situation.

(6 marks)
(Total 10 marks)

Question 05

The following components of the financial statements of DAM PLC are available for your review.

Statement of Comprehensive Income for the year ended 31st March		
	2014	**2013**
	Rs'000	**Rs'000**
Revenue	106,000	69,000
Cost of sales	(62,000)	(41,000)
Gross profit	44,000	28,000
Distribution costs	(7,400)	(5,200)
Administrative expenses	(11,800)	(7,200)
Finance cost	(2,700)	(450)
Profit before taxation	22,100	15,150
Income tax expense	(6,900)	(3,850)
Profit for the year	15,200	11,300
Other comprehensive income	2,900	-
	18,100	11,300

Statement of Financial Position as at 31st March				
	2014		**2013**	
ASSETS	**Rs'000**	**Rs'000**	**Rs'000**	**Rs'000**
Non-current assets				
Property, plant & equipment		61,000		40,000
Intangibles		7,700		-
		68,700		40,000
Current assets				
Inventory	13,200		14,900	
Trade receivables	11,800		8,400	
Bank	-	25,000	5,100	28,400
Total Assets		93,700		68,400
EQUITY AND LIABILITIES				
Equity				
Equity shares Rs.10 each		30,000		30,000
Revaluation reserve		2,900		-
Retained earnings		11,800		7,200

		44,700		37,200
Non-current liabilities				
12% debentures	26,400		9,800	
Finance lease obligation	3,200	29,600	2,600	12,400
Current liabilities				
Finance lease obligation	1,800		1,600	
Trade payables	14,900		15,900	
Current tax payable	1,500		1,300	
Bank	1,200	19,400	-	18,800
Total Equity & Liabilities		93,700		68,400

Required:

Analyze the comparative financial performance and financial position of DAM PLC in terms of its return on capital employed, profit margins, asset utilization and gearing for the year ended 31/03/2014.

(Total 10 marks)

SECTION 2

Both questions are compulsory.
Total marks for Section 2 ; 50 marks.
Recommended time for the Section is 90 minutes.

Question 06

The following statements of financial position relate to Adem, Been and Cate as at 31st March 2014, all of which are public limited companies.

	Adem	**Been**	**Cate**
	Rs'000	**Rs'000**	**Rs'000**
ASSETS			
Non-current assets			
Property, plant & equipment	59,200	48,100	59,400
Intangible assets	12,800	-	-
Investment in subsidiaries -Been	96,000		
Investment in associate - Cate	30,000		
Available-for-sale financial assets	3,900		
	201,900	48,100	59,400
Current assets			
Inventory	69,300	56,200	10,600
Trade receivables	11,100	28,200	9,200
Cash and cash equivalents	5,700	9,500	3,800
	86,100	93,900	23,600
Total Assets	288,000	142,000	83,000
EQUITY AND LIABILITIES			
Equity			
Equity shares of Rs.10 each	150,000	40,000	20,000
Other components of equity	15,000	16,000	8,000
Retained earnings	45,000	42,000	30,000
	210,000	98,000	58,000
Non-current liabilities			
Deferred tax	44,400	14,100	7,600
	44,400	14,100	7,600
Current liabilities			
Trade payables	33,600	29,900	17,400
	33,600	29,900	17,400
Total Equity & Liabilities	288,000	142,000	83,000

The following additional information is also available.

i. On 01/04/2012, Adem acquired 80% of the equity shares of Been. The purchase consideration comprised an immediate cash payment of Rs. 30 per share and a further payment of Rs. 9.68 Mn on 01/04/2014. Adem has recorded the immediate cash consideration paid as an investment. However, payment to be made on 01/04/2014 has not yet been recorded in the books of accounts of the Company. Adem's cost of capital is 10% per annum.
The following information with regard to the above transaction is also available.

- The fair value of the non-controlling interest in Been as at 01/04/2012 was Rs. 20 Mn.
- The fair value of the identifiable net assets recorded in the financial statements of Been as at 01/04/2012 was Rs. 84 Mn. However, this amount did not include the patent owned by the Company which was not reflected in the financial statements. The Company owned a patent which had a fair value of Rs. 3 Mn as at 01/04/2012. This had not been recognized in the financial statements of Been. The patent had a remaining life of three years as at 01/04/2012 and is not renewable.
- The retained earnings and other components of equity of Been as of 01/04/2012 were Rs. 30 Mn and Rs. 12 Mn respectively. The remaining excess in fair value is attributable to non-depreciable land.

ii. On 01/04/2013, Adem acquired 800,000 shares in Cate for a cash payment of Rs. 20 Mn. This enables Adam to exercise significant influence over Cate but not to control Cate. In its own financial statements Adem treated the investment in Cate as a financial asset and made an election to measure it at fair value through other comprehensive income. On 1st April 2013, the individual financial statements of Cate showed the following reserve balances.

Retained earnings	- Rs.25 Mn.
Other components in equity	- Rs. 5 Mn.

On 1st April 2013 there were no material differences between the carrying values of the net assets of Cate in the individual financial statements and the fair values of those net assets.
On 31st March 2014, the fair value of Adam's investment in Cate was estimated at Rs. 30 Mn and this is the balance recorded in Adam's individual financial statements. On 31st March 2014, Adam credited Rs. 10 Mn to other components in equity.

iii. Adem has sold goods to both Been and Cate during the year ended 31/03/2014. The sales value of the goods was Rs. 20 Mn and Rs. 10 Mn respectively. Adem sells goods at a gross profit margin of 20%. At the year-end, half of the goods sold to Been remained unsold whereas the entire goods sold to Cate had been sold to third parties.

iv. Been's current account balance with Adem as at 31/03/ 2014 was Rs. 4 Mn, which did not agree with Adem's equivalent receivable due to a payment of Rs. 1 Mn made by Been on 29/03/2014, which was not received by Adem until 02/04/2014.

v. Impairment tests were carried out on 31/03/2014 which concluded that the consolidated goodwill of Been was impaired by Rs. 5 Mn.

vi. On 01/04/2012, Adem purchased an equity instrument at its fair value of 31,000 dollars. The instrument was classified as available-for-sale. The subsequent relevant exchange rates and fair values were as follows:

	Rs. to Dollar	Fair value of instrument (Dollars 000)
01/04/2012	120	31
31/03/2013	130	30
31/03/2014	133	25

Adem has not recorded any change in the value of the instrument since 31/03/2013. The reduction in fair value as at 31/03/2014 is deemed to be as a result of impairment.

vii. The group policy is to measure non-controlling interest at fair value.

viii. The intangible assets of Adem represent expenditure incurred during the financial year 2013/2014 on a project to increase energy efficiency in the production process of the Company. The project was started on 1st August 2013 and is expected to be completed by 31st July 2014. The Company incurred an expenditure of Rs. 1.6 Mn per month from 1st August 2013 and total expenditure incurred on project as of 31st March 2014 is being capitalized and included under intangible assets in the statement of financial position. On 1st January 2014, the directors of the Company were able to assess the technical feasibility and commercial viability of the project with reasonable certainty. At this date they also received assurance that the economic benefits that the project is likely to bring to the Company exceed the projected cost.

Required:

1. **Compute** the goodwill on acquisition of Been.

(6 marks)

2. **Compute** the other components of equity to be shown in the consolidated statement of financial position as at 31st March 2014.

(3 marks)

3. **Prepare** the consolidated statement of financial position as at 31st March 2014

(16 marks)

(Total 25 marks)

Question 07

Rich (Pvt.) Limited is in the business of real estate development and sale. The Company has the following portfolio of properties.

Property A

This is the newly constructed head office premises, construction of which was completed during the current year at a cost of Rs. 8 Mn. Rich (Pvt.) Limited issued debentures valued at Rs. 8 Mn with a coupon interest rate of 12% on 01/04/2013, to finance the construction of this property. The debentures were issued at a discount and are redeemable at a premium which translates to an effective finance cost of 15% per annum. Construction commenced on 01/06/2013 and was completed and ready for use as the head office building from 28/02/2014. On this date, it was estimated that the property has a useful life of 50 years. The building was vacant until 01/04/2014 as it took one month to shift from the old premises to the new building. Due to a shortage of imported material, the construction of the new building was suspended during the month of August 2013. The construction was also delayed for one month during December 2013 due to technical obstacles that are a typical part of the construction process. The proceeds of the debenture were temporarily invested and earned an interest income of Rs. 300,000 until construction was completed. Out of such interest earned, Rs. 80,000 was earned before the commencement of construction and a further Rs. 40,000 was earned during the months of August and December (Rs. 20,000 each) when the construction activity was suspended.

Property B

This is a building which is a surplus to the requirements of the company. This was sub-let to a subsidiary of Rich (Pvt.) Limited. As at 01/04/2013, the building had a remaining life of 30 years and a fair value of Rs. 8.6 Mn. With the expansion of commercial operations, the property was taken back by Rich (Pvt.) Limited on 01/01/2014 to provide housing to low income employees in the area at below market rental. The maintenance cost of the property is covered by the rent paid by the employees. On 01/01/2014, the property had a fair value of Rs. 8.775 Mn which had increased to Rs. 9.1 Mn as at 31/03/2014.

Property C

This represents plots of land owned by the Company. Some of the land is held for capital appreciation whilst the other plots of land have no current purpose since Rich has not determined whether it will use the land to construct properties to earn rental income or for short-term sale in the ordinary course of operations. These plots of lands were acquired two years ago at a cost of Rs. 13 Mn. On 01/04/2013 these plots of land had a fair value of Rs. 15.2 Mn, which had increased to Rs. 16.1 Mn as at 31/03/2014. Rich (Pvt.) Limited uses the fair value model for investment properties. The fair value of the investment properties was determined by an in-house valuer, using number of complex calculations.

Required:

1.

I. **Contrast** how the accounting treatment of an investment property carried under the fair value model differs from owner occupied property carried under the revaluation model.

(3 marks)

II. **Discuss** the circumstances under which borrowing costs should be capitalized in accordance with LKAS 23.

(2 marks)

2. **Calculate** the net borrowing cost that should be capitalized as part of the cost of Property A and the finance cost that should be expensed in the Income Statement for the year ended 31 March 2014.

(5 marks)

3. **Prepare** extracts of Rich (Pvt.) Limited's Income Statement and Other Comprehensive Income for the year ended 31st March 2014 and Statement of Financial Position as at 31 March 2014 in respect of the above properties. In the case of Property C only, state how it would be classified in Rich (Pvt.) Limited's Consolidated Statement of Financial Position.

(15 marks)

(Total 25 marks)