KC 1 – Corporate Financial Reporting

Suggested Answers and Marking Guide

Section 1

(a) i.

To test the students' ability to apply LKAS 18 and IFRIC to a given scenario.

According to the LKAS 18 and IFRIC-13, If there is separately identifiable components of a single sale transaction, it is required to apply recognition criteria to each component separately.

Loyalty card scheme introduced for customers by a company is one example that above provision can be applied.

When an entity offers reward points, it shall recognize the consideration received for reward points as revenue only when reward points are redeemed by customers and it fulfills its obligation to reward points. Otherwise revenue should be differed. **1 mark**

Therefore, Hiru PLC can recognize revenue from loyalty cards only when customers use those cards to make purchases with in the expiration period of 36 months. **1 mark**

As a result, no revenue can be recognized for the month of March 2015 due to the fact that none of the customers have used this discount card in March 2015. Therefore revenue of the company should be reduced by Rs.30 Mn and it should be shown as differed revenue. **2 marks**

(a) ii.

To test the students' ability to apply LKAS-17 to a given scenario

Hiru PLC has leased out an existing plant. Leased period of the asset is five years and useful life time of the asset is also five years. Therefore this lease can be considered as a finance lease. **1 mark**

When company own asset is leased out under finance lease, lessor shall record the lower of fair value/carrying value of the property as receivable (net investment) and difference between gross investment and net investment as unearned finance income. Then, this unearned finance income should be allocated over the lease term reflecting constant periodic rate of return on a systematic and rational basis.

		Rs.Mn
Gross investment in lease(60x5+5)		305.0
Minimum Lease payment		
Lease rentals (60+60 x 3.170)	250.0	
Unguaranteed residual Value (5 x 0.683)	3.4	
Total	253.4	
Fair Value/Carrying Value	250.0	250.0
Unearned finance income		55.0

This transaction has resulted in an unearned finance income of Rs.55Mn. It should be recognized as an income over a period of five years. Income to be recognized in the first year is Rs.19 Mn.(Rs. 190Mn x 10%) **2 marks**

Gain on disposal amounting to Rs.70Mn should not be recognized in statement of comprehensive income for the year ended 31st March 2015. But, finance income of Rs.19 Mn shall be recognized. **1 mark**

a).iii

To test the student ability to identify the impairment indication in a given scenario.

According to the LKAS-36, significant decline in fair value of investment in equity instrument below its cost is an impairment indication. The term "significant" has not been defined in the standard but it means beyond the normal price volatility more than expected.

AFS investment is considered to be impaired when,

- Its fair value has declined to below cost.
- There is an objective evidence of impairment.

When there is objective evidence of impairment, recoverable value should be decided.

Generally, Changes in fair value of AFS investment is recorded in other comprehensive income.

According to the information given, market price has declined by 60%,which is a significant percentage.Therefore, Impairment loss of Rs.75 Mn should be recognized directly in P &L in the current year financial statements and carrying value shall be reduced to Rs.50 Mn. When it is sold on 20th April 2014, a profit of Rs 12.5Mn ((2.5 x25)-50Mn) can be recognized. **3 marks**

a).iv

To test the student ability to apply LKAS-36 for a given scenario.

This event is a post balance sheet event. Based on the information given Good Finance PLC was carrying on the business well up to 31 March 2015. The company has started experiencing liquidity problems only in May 2015.Therefore this condition did not prevail in the year ended 31 March 2015.As a result this event is a non-adjusting event and no adjustment is required in the financial statements in this regard. **2 marks**

Further this bond is a held to maturity financial asset and measured at amortised cost at the date of Statement of Financial Position. So interest income amounting to Rs.54 Mn should be recognized in the income statement. (Rs 360 Mn x 15%) **2 marks**

(15 marks)

b)

To test the students' ability to apply LKAS/SLFRS to a given scenario.

Computation of revised profit

	Rs.Mn	
Profit calculated already	300	
Reversal of loyalty card revenue	(30)	**1 mark**
Reversal of gain on disposal-Plant	(70)	**1 mark**
Interest income on lease	19	**1/2 mark**
Impairment-AFS investment	(75)	**1/2 mark**
Interest already recognized	(40)	**1/2mark**
Interest income on corporate Bond	54	**1/2 mark**
Revised profit for the year	158	
Number of Shares	50Mn	
Earnings per Share	Rs. 3.16	**1 mark**

(05 Marks)

c)

To test the students' ability to identify ethical issues and recommend relevant safeguard, if any.

Here, two key management personnel (MD and CFO) hold 25% of company shares which can be considered as significant percentage. <u>So, it has created a financial interest with the company and, as a result of that, there is a self-interest threat to objectivity and confidentiality</u>. Further the company has received a bid from a rival company which says the value of consideration is based on the company earnings reported as at 31st March 2015. This may trigger the issue. Because, there is a high possibility that financial information presented may not be reliable and disclosure may not be complete. **3 marks**

Committee should ensure that company is in compliance with financial reporting requirement and may consider getting additional services from external auditors /expert regarding the special areas concern and get financial statements prepared in compliance with Sri Lanka Accounting standards. Further chairman should consider informing all members of the board and other stake holders if any, about the errors identified. **2 marks**

(05 Marks)

Question 2

a).

To tests the student ability to identify the importance of related party transaction in financial statement analysis.

When related party transaction do not occur in an arm's length basis, reported financial information in the set of financial statements may not give the true picture because reported transactions and balances do not represent the real transaction value. It may understate or overstate the true financial position. **1 mark**

On the other hand, size of the related party transaction is another important factor, because company may have performed well not because of anything else but because of intercompany sales as the given case of Hifi Bakers. **1 mark**

Further valuation of related party payable and receivable may have an impact on financial performance and position as the case of Hifi Bakers where related party loan has not been measured at amortized cost and interest cost has not been charged to income statement. **1 mark**

If ratios are calculated without considering the impact of those transactions, results of the financial statements analysis may not show true picture of the company. This analysis should consider financial and non financial disclosures as well. **1 mark**

On the other hand there may be some off balance sheet items which are related party transactions. Example includes guarantee issued for subsidiary company, some terms and conditions included in agreements with related parties. **1 mark**

Other related party Transaction may include sales, purchases, expenses for services, finance income and expenses and balance includes intercompany loans, investments, related party receivable and payable.

(05 Marks)

b)

To test the students ability to analyze the given financial information and write a report.

To: Managing Director, Tasty Bakers (Pvt) Ltd

From: Accountant of Tasty Bakers (Pvt) Ltd

Subject: Analysis of Financial Statements of HIFI Bakers (Pvt) Ltd

At your request I have analyzed the financial statements and other information of Hifi Bakers (Pvt) Ltd provided to me. My analysis of profitability & liquidity of the company is given below.

Return on capital employed

Overall performance of the 'Hifi Bakers' which is measured by ROCE has improved from 39.6% to 80.9% which is almost doubled compared with previous year. Looking at the composition of ROCE, Gross margin has increased from 19.5% to 26.4% which is increase of 35%. This is supported by one reason given in the question which says that there was an increase in price of bakery products sold by the company to out siders by 10%. But, outside sales represent only 42% of total sales (Previous year-36%).This, alone may not justify the reason for the increase in sales. On the other hand, the product launch made has also been not success. So it can be assumed that some fictitious sales may be included in the total sales. Further, there is no increase in cost of sales in proportion to increase in sales. Total sales has increased by 36% whereas cost of sales has gone up only by 24%. Most probably this may have been the other reason for improvement in GP margin. But, this argument cannot be supported due to the fact that it says the raw material prices increased during the year under review. Sometimes this may be due to intercompany purchases at a lower price than fair values. Operating margins has improved from 5.5% to 17.8% by 223%. In one hand, this can be attributed to increase in gross margin by 35%. Other main reason is significant decrease in selling & distribution cost by 50%Compared to previous year. Further management fees have also come down by 50%which is a related party transaction. As a whole operating expenses has come down from 14% to 9.8% from 2014 to 2015 and selling and distribution cost has come down whereas it does not justify the increase in sales. **8 marks**

Asset Utilization

This ratio shows that company has not performed well during the year 2015.It has come down from 3.6 times to 2.6 times. It shows sales per rupee invested has come down by 28%. This may be due to increase in PPE & trade & other receivables. There is new machine purchased during the previous year but it has not performed well. On the other hand there is a substantial increase in PPE during the year. This may be due to capitalization of interest and some other expenses. Purchase of low Performance asset to inflate assets may be the other reason. **5 marks**

Further, increase in trade and other receivable may be due to poor internal controls over credit management and long outstanding debts.

Profit Margins

Net profit margin of Hifi Bakers has increased by 321% (from 2.8% to 11.8%) which is significant due to several factors outlined as above. This has been both by the effect of increase in GP margin as well as decrease in overall operating expenses. Further it appears that interest has not been calculated using EIR for the related party loan. If EIR is higher than the flat rate that is 10% then profit has been overstated by taking lower interest cost to the financial statements. Further it requires to analyze and see whether adequate depreciation has been charged for the year and provision has been made for debtors outstanding. **3 marks**

Liquidity

Liquidity position of the company doesn't seem to be good but compared with the previous year it has improved due to increase in debtors. But it is still below the norm. Further this severe liquidity problem is evidenced by increase in current liability not paid yet. 60% of the current assets represents trade receivables. It appears that most of these receivables are due from parent company. If the parent company will not pay debt on time the company might not be able to continue as a going concern. Further suppliers might stop further supplies due to not paying their payments on time. **4 marks**

Ratio	**2013**	**2012**
Return on Capital Employed [(32,000+50,000)/(50,000-43,000)]*100	80.90%	39.62%
Operation Profit Margin (37,000/207,300)*100	17.80%	5.50%
Gross Profit Margin (54,800/207,300)*100	26.40%	19.50%
Operating expenses (20,300/207,300)*100	9.80%	14%
Net Profit Margin (24,500/207,300)*100	11.80%	2.80%
Interest cover (37,000/5,000)	7.40	3.36
Effective tax rate (7,500/32,000)*100	23.40%	27.10%
Asset Turnover (207,300/79,100)	2.60	3.60
Gearing (28,400+50,000)/0)	-	-
Current Ratio	0.91: 1	0.77: 1
Liquidity Ratio	0.75 : 1	0.55 : 1

(20 marks)

Section 2

Question 3

(i)

To test the student's ability to compute goodwill on consolidation.

(a) Total comprehensive income cannot be added to the retained earnings. Out of the total comprehensive income of Rs.144.53Mn, Profit for the year amounting to Rs.91.11 Mn can only be added to retained earnings. Fair value gain on AFS amounting to Rs.28.42 Mn and Revaluation Surplus amounting to Rs.25 Mn should be shown as separate components with in equity. Therefore this adjustment would result in reduction in retained earnings by Rs.53.42 Mn.

1 mark

(b) Milanka Waltiles (Pvt) Ltd has become a subsidiary of Migaya Ceramics since 1st October 2014. Therefore financial statements of Milanka Waltiles should be consolidated in preparing the 2014/2015 consolidated financial statements of Migaya Group.

The acquicision of Milanka Waltiles would result in a goodwill of PRs. 83.490 Mn.

			Rs. "000"	
1	**Goodwill On Consolidation**			
	Fair value of 15% equity shares already acquired		52,500	**1 mark**
	(10,000 x 15% x 35)			
	Consideration for 40%			
	Cash	100,000		
	Contingent consideration(40,000/(1.08) 1/2	38,490	138,490	**1 mark**
	(10,000 x 45% x 35) Non-controlling interest		157,500	**1 mark**
			348,490	
	Less: Fair value identifiable of net assets acquired:			
	Stated Capital	(160,000)		
	Retained earnings	(104,750)		

Fair value adjustment- Land	(250)		**1 mark**
		(265,000)	
Goodwill on acquisition		83,490	**1 mark**

Financial results of Milanka Waltiles (Pvt) Ltd for the period 1st October 2014 to 31st March 2015 should be consolidated. This would result in increase in consolidated profit of Migaya group.

(c) This investment is designed as available for sale financial assets. AFS financial assets should be measured at fair value in subsequent measurement. The fair value of investment in Milanka Tiles (PLC) as at 31st March 2015 was Rs.30 Mn. Therefore the resulting gain on fair value measurement of AFS financial assets amounting to Rs.10 Mn should be recognized as other comprehensive income. This will result in increase in total comprehensive income of Migaya group by Rs.10 Mn. **1 mark**

(d) This plant is sold and taken it back on lease. The new lease arrangement is a finance lease. Because the lease period is equal to the remaining life time of the plant. Therefore this asset should be taken out from free hold asset and classify it under leasehold asset at its fair value. Further corresponding liability should also be recognize in the financial statements. **1 mark** **1 mark**

Further the asset is being sold at a price higher than the fair value of the plant. Therefore the difference between the selling price and the carrying value should be taken as an income over the lease period which is four years. Therefore Rs.2.5 Mn (10 Mn / 4) should be recognized as income in preparation of 2014/2015 consolidated financial statements. Installment already paid amounting to Rs.15 Mn recognized as an asset should be derecognized. It should be split among repayment of capital and interest, and adjust accordingly. **1 mark**

e) This is a financial instrument. It has liability component as well as equity component.

Fair value of non- convertible debt = 100Mn/ $(1.12)^3$

= 71.18 Mn

Present value of interest = 33.1 Mn/ $(1.12)^3$

= 23.56

Fair value of debt = 94.74 Mn

Therefore this liability should be shown in the financial statements at Rs. 94.74 Mn. **1 mark**

Equitry component of the financial instrument is Rs.5.26 Mn.(Rs.100Mn- Rs.94.74Mn) **1 mark**

As at 31 st March 2015, this liability should be measured at amortised cost and should be shown at Rs. 106.10 Mn in the SOFP and difference between Rs.106.10 and Rs.94.74 amounting to Rs.11.36 Mn should be shown as finance cost in SOCI. **1 mark**

f) This asset should be reclassified into asset held for sale and shown under current assets. Because the management has already decided to sell this and appropriate steps have also been taken such as advertising to sell this asset. Therefore carrying value of this asset which is Rs. 113.968Mn should be derecognize from PPE. Further recoverable value of this asset is lower than the carring value by Rs.6.968 Mn. Therefore this difference should be recognized as an impairment loss in the Financial Statements. **2 marks**

(ii)

To test the student's ability to prepare consolidated financial statements.

Migaya Group

Revised Consolidated Statement of Comprehensive Income

For the year ended 31st March 2013

Turnover (4,106,015 + 422,560 x 6/12 - 50,000)	4,267,295	**1/2 mark**
Cost of sale (3,026,511 + 245,200 x 6/12)	(3,149,111)	**1/2 mark**
Gross profit	1,118,184	
Other income Gains (W1)	40,352	**4 marks**
Investment income	14,422	
Distribution expenses (462,450 + 82,040 x 6/12)	(503,470)	**1/2 mark**
Administrative expenses (W2)	(285,975)	**1/2 mark**
Finance Cost (W3)	(280,558)	**1/2 mark**
Profit / (Loss) before tax	102,955	

Income tax (39,047 + 6,830x 6/12)	(42,462)	1/2 mark
Net profit for the year	60,493	
Other Comprehensive Income		
Gain on revaluation	25,000	
Increase in fair value of AFS investment(W8)	25,920	1/2 mark
Total comprehensive income	111,413	1/2 mark
Profit attributable to parent Company	58,355	
Profit attributable to NCI	2,138	
	60,493	
Total comprehensive income attributable to parent company	109,275	
Total comprehensive income attributable to NCI	2,138	
	111,413	

(iii)

To test the student's ability to prepare consolidated financial statements.

Migaya Group

Revised Consolidated Statement of Financial Position

As At 31st March 2013

Assets		
Non Current Assets		
Property plant & equipment (W5)	3,145,986	2.5 mark
Available for sale investment(W6)	10,495	1 mark
Goodwill	83,490	
Total Non Current assets	**3,239,971**	
Current Assets		
Inventories (1,919,980 + 115,000)	2,034,980	
Trade & other receivables (978,845 + 92,100)	1,070,945	
Other financial assets (318,859 + 22,690)	341,549	
Asset held for sale (W12)	107,000	1 mark
Cash and cash equivalents (35,272 + 30,100)	65,372	
Total Current Assets	**3,619,846**	
Total Assets	**6,859,817**	
Equity and Liabilities		
Equity		
Stated capital(W13)	2,295,012	1 mark
Revaluation reserve	75,000	
Reserve	27,850	
AFS reserve (W8)	25,920	1 mark
Retained earnings(W7)	502,294	1 1/2
Non controlling interest(W14)	159,638	1 mark
Total equity	**3,085,714**	

Non Current Liabilities

Contingent consideration	30,000	
Differed revenue on lease	7,500	
Interest bearing loan - at amortized cost.(W11)	902,495	1.5 mark
Differed tax liability (W9)	40,023	
Lease creditor(W10)	33,600	1.5 mark
Retirement benefit obligation (104,276 + 9,500)	113,776	
Total Noncurrent Liabilities	**1,127,394**	

Current Liabilities

Bank OD (490,086 + 85,600)	575,686
Trade & other payables (1,134,848 +92,100)	1,226,948
Tax payables (45,828 + 8,190)	54,018
Interest bearing loans	790,057
Total Current Liabilities	**2,646,709**
Total Equity and liabilities	**6,859,817**

Working 1 - Other Income/ Gain

Migaya ceramics	3,782	
Fair value decrease in contingent consideration (38,490 - 30,000)	8,490	**1 mark**
For value gain on 15% investment (52,500 - 30,000)	22,500	**1 mark**
Differed revenue-sale & lease back ((50,000 - 40,000) / 4)	2,500	**1 mark**
Reversal of depreciation for the period-Held for sale (Period 01/01/2015 - 31/03/2015)	3,080	**1 mark**
	40,352	

<u>Working 2 - Administrative expenses</u>

Migaya + Milanka (252,207 + 53,600 x 6/12)	279,007	
Impairment loss-Packing Machine	6,968	**1/2 mark**
	285,975	

<u>Working 3 - Finance Cost</u>

Migaya + Milanka (252,894 +25,390 x 6/12)	265,589	
Lease interest (45,000 x 8%)	3,600	**1/2 mark**
Interest-Long term loan	11,369	**1/2 mark**
	280,558	

<u>Working 4 - Fair Value increase - Land</u>

FV of net identifiable net assets acquired		265,000
Book value of net assets at acquisition		
Stated capital	160,000	
Retained earnings (100,000 + 9,500 x 6/12)	104,750	(264,750)
		250

Working 5- Property Plant & Equipment

Migaya + Milanka (2,971,624 + 295,000)	3,266,624	
Fair Value Increase- Land	250	**1/2 mark**
WDV of Plant leased back	(40,000)	**1/2 mark**
Fair value of Plant leased back under finance lease	45,000	**1/2 mark**
WDV of tile Packing Machine-Held for sale	(110,888)	**1/2 mark**
Reversal of lease installment	(15,000)	**1/2 mark**
	3,145,986	

Working 6 - AFS Investment

Migaya Ceramics	142,995	
Investment in Milanka -Cost	(130,000)	**1/2 mark**
Gain on AFS-Milanka Tile PLC	10,000	
Gain o AFS- Milanka Walltiles already adjusted	(12,500)	**1/2 mark**
	10,495	

Working 7- Consolidated Retained Earnings

Migaya Ceramics	588,469	
AFS reserve	(28,420)	**1/2 mark**
Revaluation surplus	(25,000)	**1/2 mark**
Profit already recognized included	(91,110)	
Profit for the year	58,355	**1/2 mark**
	502,294	

Working 8 - AFS Reserve

Milanka balance (28,420 - 12,500)	15,920	**1/2 mark**
FV gain(net of tax)- Milanka tiles PLC		
(60 x 500 - 20,000)	10,000	**1/2 mark**
	25,920	

Working 9- Differed Tax Liability

Milanka	40,023
	40,023

Working 10 - Lease Liability

Total Lease rentals- (15,000*4)	60,000	**1/2 mark**
Rental paid in arrears	(15,000)	**1/2 mark**
Interest for the period (45,000*8%)	3,600	**1/2 mark**
Total Interest in suspense	(15,000)	
	33,600	

Working 11 - Long Term Borrowing

Migaya + Milanka (806,388+90,000)	896,388	
Loan Obtained-Face Value	(100,000)	**1/2 mark**
Amortized cost (133,100/(1.12)3	94,738	**1/2 mark**
Interest cost	11,369	**1/2 mark**
	902,495	

Working 12 - Asset held for sale

Carrying value as at 31/03/2015	110,888	
147,850-(147,850/12*3)		
Reversal of depreciation (Period 01/01/2015-31/03/2015)	3080	**1/2 mark**
Carrying value as at 01/01/2015	113,968	**1/2 mark**
Recoverable Value (112,000-5,000)	107,000	
Impairment Loss	6,968	

Working 13 - Stated Capital

Migaya	2,289,750	
Equity component of loan	5,262	**(1 mark)**
	2,295,012	

Working 14 - Non controlling Interest

Balance as at acquisition date	157,500	**(1/2 mark)**
Profit for 06 Months (4,750*45%)	2,138	**(1/2 mark)**
	159,638	

iv)

Sustainability may also be known as corporate citizenship or social responsibility. It includes anything from environmental awareness to involvement in local community issues to modifying business processes to reduce the operational use of energy resources.

A sustainability report is an organizational report that provides information about a company's economic, social and environmental performance and impact. Such reports are becoming increasingly important to stakeholders who use them to evaluate the long term viability of a company.

There are a number of factors that encourage companies to provide a sustainability report with their financial statements. As stated, public interest in corporate social responsibility is steadily increasing. Although financial statements are primarily intended for investors and their advisors, there is a growing recognition that companies actually have a number of different stakeholders. These include customers, employees and the general public , all of whom are potentially interested in the way in which a company's operations affect the natural environment and the wider community. **2 marks**

These stakeholders can have a considerable effect on a company's performance. As a result many companies now deliberately attempt to build a reputation of social , economic and environmental responsibility. Therefore disclosure of sustainability information is essential. There is also growing recognition that corporate social responsibility is actually an important part of an entity's overall performance. Responsible practice in areas such as reduction of damage to the environment and the promotion of good employee relations increase share holders value. Companies that act responsibly and provide sustainability reports are perceived as better investments than those that do not. **2 marks**

Another factor is growing interest by government and professional bodies. Although there are no SLFRS s that specifically require sustainability reporting , it may be required by company legislation. There are now a number of awards for high quality sustainability disclosure in financial statements. These provide further encouragement to disclose information. **2 marks**

At present companies are normally able to disclose as much or as little information as they wish in whatever manner that they wish. This causes a number of problems. Companies tend to disclose information selectively ad it is difficult for users of the financial statements to compare the performance of the different companies. However, there are good arguments for continuing to allow companies a certain amount of freedom to determine the information that they disclose. **2 marks**

V)

IT AND IS COSTS.

The introduction of integrated reporting of Migaya will most likely require significant upgrade to be made to the company's IT and information system infrastructure . Such developments will be needed to assist Migaya in capturing both financial and non financial KPI data. Due to the broad range of business activities reported on using integrated reporting the associated costs in improving the infrastructure to deliver the relevant data about each area is likely to be significant. It may however , be the case that Migaya's existing information systems are already capable of producing the required non financial performance data needed in which case it is likely that the focus here will be on investigating which data sets should be included in the integrated report. **2 marks**

TIME IMPLICATIONS.

The process of gathering and collating the data to include in an integrated report is likely to require a significant amount of staff time. This may serve to decrease staff morale especially if staff are expected to undertake this work in addition to completing existing duties. In some cases this may require Migaya to pay employees overtime to ensure all required information published in the report on time. **2 marks**

STAFF COSTS.

To avoid overburdening existing staff the board may decide to appoint additional staff to undertake the work of analyzing data for inclusion in the integrated report. This will invariably lead to an increase in staff costs. **1 mark**

CONSULTANCY FEES.

As this will be Migaya's first integrated report the board may seek external guidance from an organization that provides specialist consultancy on reporting. Any advice is likely to focus on the contents of the report. The consultants fees are likely to be significant and will increase the associated implementation costs of introducing integrated reporting. **1 mark**

DISCLOSURE

A potential downside of adopting integrated reporting centers on Migayas potentially volunteering more information about its operations than was actually needed. In the event that Migayas fully disclosed the company's planned strategies is likely that this could be used by competitors. **1 mark**

(50 marks)