THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

No of pages: 11

Corporate Level

Corporate Financial Reporting
(Pilot Paper)

<u>Instructions to candidates</u>

(1) Time allowed: 3 hours.

(2) Section 1: 2 questions – **both questions are compulsory**
Section 2: 1 question – **compulsory**
Common pre-seen information provided prior to the examination is in relation to this question.

(2) 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.**

KC1

June 2015

Section 1

1. Hiru PLC is in the business of manufacturing and sale of dairy products. It has fifty outlets through which dairy products manufactured by the Company are sold. The chairman of the audit committee of Hiru PLC requires you to review the financial statements of the Company prepared for the year ended 31st March 2015 as the Company is the subject of a bid from a rival company, Tharu Plc. The offer price from Tharu PLC was agreed at twenty times the earnings per share (EPS) of Hiru PLC, reported for the year ended 31st March 2015. The number of shares in issue of the company as at 31 March 2015 was 50 Mn.

   Mr. Saman, the chief financial officer (CFO) of Hiru PLC, is an unqualified accountant and has computed profit after tax as Rs. 300 Mn for the year ended 31st March 2015. The members of the audit committee of the Company have reviewed the financial statements and identified a number of issues over which they have some concerns.

   The CFO of the Company is the brother-in-law of Hiru PLC's Chief Executive Officer (CEO) Mr. Nuwan. The CEO and CFO owned 25% of Hiru PLC's equity shares as at 31st March 2015.

   The audit committee has provided you with the following details.

   i. Hiru PLC introduced a loyalty card scheme for customers on 1st March 2015. The card was sold at a nominal price of Rs. 200 each and allows existing customers to claim a 5% discount on all future purchases from Hiru PLC for three years from the date of purchasing the card. As of 31st March 2015 Hiru PLC had issued 150,000 loyalty cards, which have an unexpired period of 35 months. Saman has recognized card sales revenue of Rs. 30 Mn in the financial statements prepared for the year ended 31st March 2015. None of the customers have used this discount card in the month of March 2015.

   ii. On 1st April 2014 Hiru PLC leased out an existing plant which was not being used regularly, to another company. As at 1st April 2014 the plant had a useful life of 5 years and its carrying amount was Rs. 250 Mn, which was also its fair value.

   The terms of the lease were that the lease is for a period of five years and the lessee would pay Hiru PLC Rs. 60 Mn a year in advance for 5 years starting from 1st April 2014. At the end of the lease term the plant was expected to have a scrap value of Rs. 20 Mn, of which Rs. 15 Mn was guaranteed by the lessee.

   Saman has shown the transaction as an asset disposal and recognized a gain on disposal of Rs. 70 Mn (({5 x Rs. 60 Mn} + Rs. 20 Mn) – Rs. 250 Mn) in profit for the year. The implicit interest rate in similar lease arrangements is 10%.

   iii. On 1st March 2015 Hiru PLC purchased 2.5 million equity shares in Sandu Plc, a listed company, for Rs. 50 each. The purchase was authorized by the board of directors after the CEO had read a newspaper article suggesting that Sandu Plc had performed exceptionally well during the first nine months of the 2014/2015 financial year and was about to announce nine months results. According to the article the shares of the company were undervalued.

The nine months results of Sandu Plc were announced on 10th March 2015. However, the results released were not as good as expected. Sandu Plc's share price reduced to Rs. 20 per share as at 31st March 2015. Hiru PLC sold the purchased shares on 20th April 2015 for Rs. 25 per share.

The CFO has measured these shares at cost in the statement of financial position. The accounting policy of the Company is to classify all non-group related equity investments of this nature as available for sale financial assets.

iv. On 1st April 2014, Hiru Plc invested Rs. 360 Mn in corporate bonds issued by Good Finance Plc. The Company purchased 4,000,000 bonds of which the face value was Rs. 400 Mn. Under the terms of issue, these bonds are redeemable at Rs. 120 each on 31st March 2020 and interest on these bonds is payable on 31st March in arrears at the rate of 10% on par value. This represents an effective annual interest rate of 15% for Hiru PLC. Hiru PLC's intention was to hold these bonds until redemption.

Good Finance Plc was carrying on its business successfully up to 1st May 2015. However, the company started to experience many liquidity problems due to the sudden withdrawal of deposits by a few large deposit holders of the company. On 1st June 2015 the debts of Good Finance Plc were restructured due to severe liquidity problems experienced by the company. As part of the restructuring process Good Finance Plc entered into negotiations with the bond holders of the company on interest payments. After several discussions, on 1st August 2015 Hiru PLC agreed to forgo the interest payments due on 31st March 2015 and 2016, with the payments from 31st March 2017 onwards resuming as normal. The CFO has recognized an interest income of Rs. 40 Mn in the 2014/2015 financial statements of the Company.

You are required to:

a) **Advise** on how the above issues should be dealt with in the financial statements for the year ended 31st March 2015 and any subsequent years.

(15 marks)

b) **Compute** the revised profit and earnings per share for the year ended 31st March 2015 after making the above adjustments.

(5 marks)

c) **Discuss** any ethical issues arising from the above scenario, and advise the chairman of the audit committee, from a corporate governance perspective, of any actions that they should consider.

(5 marks)

Total 25 marks

2. HiFi Bakers (Pvt) Ltd is a fully owned subsidiary of Rich Food Plc. It is in the business of manufacturing and sale of bread and bakery products. The board of directors of Rich Food Plc has taken a decision to sell its shares in HiFi Bakers (Pvt) Ltd.

   You are the accountant of Tasty Bakers (Pvt) Ltd. The managing director of your company has sent you the following note with some financial and non-financial information of Hifi Bakers (Pvt) Ltd and the industry.

   'I am interested in acquiring Hifi Bakers (Pvt) Ltd. I would like you to spend some time analyzing the attached financial statements and other information. I am particularly interested in Hifi Bakers' financial performance and financial position (including liquidity and solvency). Please send me a report that documents your review and conclusions."

   Hifi Bakers (Pvt) Ltd. – Key matters identified in review of operations of the year ended 31st March 2013.

   - Selling prices to third parties for bread and bakery products have been increased by over 10% in the last year. A significant proportion of revenue is generated by selling to Rich Food Plc.

   - Purchase prices of raw materials such as flour have increased by 15% during the year and are still increasing.

   - Electricity cost has increased substantially during the year under review.

   - Rich Food Plc charges Hifi Bakers (Pvt) Ltd annually for management services it provides to Hifi Bakers (Pvt) Ltd.

   - New manufacturing equipment costing over Rs. 20 Mn was installed in October 2013.

   - An additional range of products launched in March 2015 has not proved popular with customers.

   - All of Hifi's loans are provided by Rich Food Plc.

Hifi Bakers (Pvt) Ltd – Income statement for the year ended 31st March 2015.

	Year ended 31st March 2015 Rs. 000	Year ended 31st March 2014 Rs. 000
Revenue (see Note 1)	207,300	152,500
Cost of sales	(152,500)	(122,700)
Gross profit	54,800	29,800
Administration expenses	(15,300)	(11,400)
Selling and distribution expenses	(5,000)	(10,000)
Finance costs (see Note 1)	(5,000)	(2,500)
Profit before taxation	29,500	5,900
Income tax	(5,000)	(1,600)
Profit after taxation	24,500	4,300

No dividends have been paid or proposed during the financial years 2013/2014 and 2014/2015.

Hifi Bakers (Pvt) Ltd – Statement of financial position as at 31st March, 2015.

	As at 31st March 2015		**As at 31st March 2014**	
	Rs. 000	**Rs. 000**	**Rs. 000**	**Rs. 000**
ASSETS				
Non-current assets				
Property, plant & equipment		48,700		26,000
Current assets				
Inventories	5,300		4,600	
Trade and other receivables	18,100		6,500	
Cash and cash equivalents	7,000		5,000	
		30,400		16,100
Total assets		79,100		42,100
EQUITY & LIABILITIES				
Issued capital – (1 Mn ordinary shares)		10,000		10,000
Retained earnings		(14,300)		(38,800)
		(4,300)		(28,800)
Non-current liabilities				
Long-term loan		50,000		50,000
Current liabilities				
Trade and other payables	28,400		18,900	
Taxation	5,000		2,000	
		33,400		20,900
Total equity and liabilities		79,100		42,100

Note 1 – Related party transactions

During 2014/2015 Hifi Bakers recognized revenue of Rs. 120 Mn (2013/2014 – Rs. 55 Mn) on sales to Rich Food Plc. Hifi Bakers charged a management fee of Rs. 5 Mn (2014 - Rs. 10 Mn) in respect of administrative and other operating services provided. This is included under administration expenditure. The loan due to Rich Food Plc is repayable in 2022 and carries a fixed rate of interest of 10% per annum.

Additional information

	2014/2015	2013/2014
Gross profit margin	26 %	19.5 %
Industry average gross profit margin	40%	45%
Return on capital employed (ROCE)	75.49%	39.62%

You are required to:

a) **Explain** the usefulness of related party disclosures when analyzing the financial position and financial performance of a business organization.

(5 marks)

b) **Analyze** the given financial information of HiFi Bakers (Pvt) Ltd and write a detailed report to the managing director of your company on your observations. Your report should cover your analysis of profitability and liquidity of HiFi Bakers as reported in the financial statements.

(20 marks)

Total 25 marks

Section 2

3. The draft consolidated financial statements of Migaya Ceramics Group for the year ended 31st March 2015 were prepared by the accounts executive of the Company. The following additional information relating to the draft consolidated financial statements is available for your consideration.

a) The statement of consolidated other comprehensive income of Migaya Ceramics PLC for the year ended 31st March 2015 was as follows.

<u>Statement of comprehensive income</u>

	Rs. 000
Profit for the year (after tax)	91,110
Fair value gain (net of tax) on AFS financial assets	28,420
Revaluation surplus	25,000
Total Comprehensive Income	**144,530**

The fair value gain on AFS & revaluation surplus relates to the AFS financial assets and property, plant & equipment owned by Migaya Ceramics PLC. The above total comprehensive income has been added to retained earnings shown in the consolidated statement of financial position.

b) Migaya acquired 15% of the equity capital (1,500,000 shares) of Milanka Walltiles (Pvt) Ltd on 1st April 2014 for Rs. 30 Mn. As of that date Milanka Walltiles (Pvt) Ltd had retained earnings of Rs. 100 Mn.

A further 40% of equity shares (4,000,000 shares) in Milanka was acquired on 1st October 2014 giving Migaya control over Milanka Walltiles. The purchase consideration for this was agreed as follows:

- Immediate cash payment of Rs. 100 Mn.
- Further cash payment of Rs. 40 Mn on 1st October 2017, if average profit of Milanka Walltiles (Pvt) Ltd for the three years ending 30th September 2017 exceeds Rs. 12 Mn per annum. Management has informed you that the Company's incremental borrowing rate is 8% which can be used as the discount rate.

As of 1st October 2014, the fair value of net assets of Milanka Walltiles (Pvt) Ltd was Rs. 265 Mn. The increase in fair value of net assets of Milanka Walltiles (Pvt) Ltd is attributed to the land owned by the Company. Further increase in the fair value of Milanka Walltiles (Pvt) Limited is not reflected in the separate financial statements of the Company.

The fair value of a share of Milanka Walltiles (Pvt) Ltd as of 1st October 2014 was determined at Rs.35. It is the Company policy to value non-controlling interest at fair value.

The above investment in Milanka Walltiles (Pvt) Ltd amounting to Rs. 130 Mn (100 Mn +30 Mn) is shown in the draft consolidated financial statements under available-for-sale financial assets at fair value through other comprehensive income. However, the further cash payment to be made has not been recorded in the books of accounts of the Company. The total gain recognized in the statement of other comprehensive income prepared for the year ended 31st March 2015 in respect of the investment in Milanka Walltiles (Pvt) Ltd was Rs. 14,500,000.

The directors of Migaya Ceramics PLC are of the view that the fair value of the contingent consideration as at 31st March 2015 is Rs. 30 Mn based on the expected future cash flows from the business.

You may assume that income and expenses of Milanka Walltiles (Pvt) Ltd have occurred evenly throughout the year and accounting policies of the Company are the same as those of the group.

The statement of financial position & statement of comprehensive income of Milanka Walltiles (Pvt) Ltd for the financial year 2014/2015 were as follows.

Income statement of Milanka Walltiles (Pvt) Ltd
For the year ended 31st March 2015

	Rs. 000
Turnover	422,560
Cost of sales	(245,200)
Gross profit	**177,360**
Distribution expenses	(82,040)
Administrative expenses	(53,600)
Financial cost	(25,390)
Profit before tax	16,330
Income tax expenses	(6,830)
Net profit for the year	**9,500**

Statement of financial position of Milanka Walltiles (Pvt) Ltd
As at 31st March 2015

	Rs. 000
Non-current assets	
Property, plant & equipment	295,000
Current assets	
Inventories	115,000
Trade & other receivables	92,100
Financial assets	22,690
Cash & cash equivalents	30,100
Total current assets	259,890
Total Assets	554,890
Equity and liabilities **Stated capital and reserves**	
Stated capital (10 Mn shares)	160,000
Retained earnings	109,500
Total equity	269,500
Non – current liabilities	
Interest bearing loans	90,000
Retirement benefit liabilities	9,500
Total non-current liabilities	99,500
Current liabilities	
Bank overdraft	85,600
Trade and other payables	92,100
Income tax liabilities	8,190
Total current liabilities	185,890
Total Equity & Liabilities	554,890

c) On 1st October 2014, Migaya Ceramics acquired 500,000 equity shares of Milanka Tiles PLC, a listed company, for Rs. 20 Mn. These shares were acquired for strategic reasons and do not allow Migaya to exercise control or significant influence over the financial & operating policies of Milanka Tiles PLC. The investment was designated as available-for-sale and shown at Rs. 20 Mn in the financial statement of the Company as at 31st March 2015. The market price of a share of Milanka Tiles PLC as at 31st March 2015 was Rs. 60.

d) The plant belonging to Migara Ceramics PLC located in Godakawela was sold on 1st April 2014 for Rs. 50 Mn. It had a net book value of Rs. 40 Mn at the time of sale. The proceeds received had been credited to the revenue account erroneously. There was a revaluation surplus of Rs. 50 Mn included under reserves in the financial statements of the Company in respect of the plant disposed. The fair value of the plant as at 1st April 2014 was Rs. 45 Mn. The plant was immediately leased back over a lease term of four years which is the asset's remaining useful life. The residual value of the plant at the end of the lease period is estimated to be a negligible amount. The first lease installment paid on 31st March 2015 amounting to Rs.15 Mn had been debited to the non-current assets account. No other adjustment has been made in the financial statements in respect of the above. The implicit interest rate in the lease is 8%.

e) The long-term borrowings of Migaya Ceramics include a loan at a carrying amount of Rs. 100 Mn which was taken from a venture capital company on 1st April 2014. No interest is payable in respect of this loan during the loan period of three years. However, Rs. 133.1 Mn is payable to the venture capital company on 31st March 2015. This represents an effective annual rate of return of 10% for the venture capital company. As an alternative to repayment, the venture capital company can exchange its loan for equity shares of Migaya on 31st March 2017. The annual rate of return required by such venture capital company on a non-convertible loan would have been 12%. Migaya has not charged any finance cost in respect of this loan in the financial statements prepared for the year ended 31st March 2015.

f) On 1st January 2015 Migaya Ceramics PLC decided to outsource its tile packing process. As a result, a specialist machine which was used for the tile packing process was no longer needed and the directors of the Company decided to sell it. The machine was taken out of use and has been advertised in national newspapers for sale at a price of Rs. 112 Mn. This machine was originally acquired on 1st April 2004 at a price of Rs. 200 Mn and was estimated to have a useful life of 20 years. The machine was revalued on 31st March 2012 at Rs. 147.85 Mn when its carrying value was Rs. 120 Mn, although there was no change to its estimated remaining useful life. The resulting revaluation surplus is included in the reserves of the financial statements of Migaya Ceramics PLC.

The machine's fair value and cost to sell as of 1st January 2015 have been estimated at Rs.112 Mn and Rs. 5 Mn respectively. No accounting entries have been made in respect of the above in the draft financial statements of the Company prepared for the year ended 31st March 2015.

You may disregard tax implications if any, arising from the above adjustments.

You are required to:

i) **Advise** the board of directors of the Company on the impact of the matters highlighted above from (a) to (f) on the 2014/2015 draft consolidated financial statements of the Company.

(15 marks)

ii) **Compile** the consolidated statement of comprehensive income of the Migaya group for the year ended 31st March 2015, after making the adjustments required for the items highlighted in (a) to (f) above.

(8 marks)

iii) **Compile** the consolidated statement of financial position of the Migaya group as at 31st March 2015, after making the adjustments required for the items highlighted in (a) to (f) above.

(12 marks)

iv) **Outline** factors which provide encouragement to companies such as Migaya Ceramics to disclose sustainability information in their financial statements, briefly discussing whether the content of such disclosure should be at the company's discretion.

(8 marks)

v) **Outline** the likely implications of introducing "integrated reporting" which Migaya should consider before deciding to proceed with its adoption.

(7 marks)

Total 50 marks