THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB 1– Business Financial Reporting

June 2015

SECTION 1

Answer 01

(a)

Relevant Learning Outcome/s:
1.1.1 Demonstrate knowledge of the conceptual framework of Sri Lanka Accounting Standards, with emphasis on: - Qualitative characteristics of financial statements

Faithful representation of financial statements

To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from errors.

Warranty provision:

Warranty provision was first made based on management judgment as the company did not have any history for these products. Therefore, making provision of 3.5% of revenue seems acceptable in the first year. However, in subsequent years the management should have assessed whether the initial assessment made was valid. In this case, it's not so as the actual claims are much lower than the estimate. Therefore, the management should have considered revising the estimate made. Faithful representation does not mean accurate in all respects. An estimate cannot be determined to be accurate or inaccurate. However, the estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate. Therefore, it is not appropriate to conclude the previous financials contain an error if the management judgment is clearly explained.

Impairment of assets

Under the given circumstances there are indications of impairment. Impairment is an estimate which is based on many assumptions. The estimate can be a faithful representation if the company has properly applied an appropriate process, properly described the estimate and explained any uncertainties that significantly affect the estimate. The assumptions made and uncertainties involved should be disclosed in the financial statements in order to enable the readers to understand the circumstances under which the estimate was made.

(b)

Relevant Learning Outcome: 1.3.1
Demonstrate the awareness of provisions in Corporate governance, Companies Act (sections 56, 69, 148 to 171 and 192) and SEC regulations and rulings.

Audit committee responsibility
As per D.3 in Code of Best Practice on Corporate Governance, the board of directors should establish formal and transparent arrangement for considering how they should select and apply accounting policies, financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Therefore, the Audit committee assists the board in the preparation of financial statements by:

- Selecting appropriate accounting policies for preparation of financial statements in accordance with Sri Lanka Accounting Standards.

- Monitoring company's compliance with financial reporting requirements and the Companies Act in the preparation of financial statements.

- Ensuring the adequacy of internal controls and risk management procedures to meet the requirements of Sri Lanka Auditing Standards.

- Assessing the company's ability to continue as a going concern in the foreseeable future.

(Total 10 marks)

Answer 02

Relevant Learning Outcome/s: 2.2.1, 2.2.3.
2.2.1. Apply Sri Lanka Accounting Standards in solving moderately complicated matters. 2.2.3. Demonstrate a thorough knowledge of Sri Lanka Accounting standards in the selection and application of accounting policies.

(a) **E- Pal** needs to consider whether recognition of provision is required in its financial statements. According to the information given there is no legal contract with the customer displaying the statement "100% refund is guaranteed"; but its website and also its conduct (the store in the past has refunded around 1% of its sales creates a constructive obligation.

According to *LKAS 37 – Provisions, Contingent Liabilities and Contingent Assets,* **Present obligation as a result of a past obligating event –** The obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that sales returns will be refunded by the store.

An outflow of resources embodying economic benefits in settlement – This is probable as a proportion of goods were returned for refund in the past.
Hence a provision should be recognized for the best estimate of the costs of refunds. In this case 1% of sales should be recognized as provision.

(b) As per *LKAS 18- Revenue,* when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognized as revenue over the period during which the service is performed. The amount deferred will cover the expected cost of the services together with a reasonable profit on the services.

According to the information given, price of an air conditioner consists of cost of service and mark-up on it. Accordingly, even though the revenue from the sale of air conditioners, is generated at the time of selling air conditioners, revenue from providing service is created on a future date. Accordingly 70% of selling price should be recognized as revenue during the financial year in which the sale of items takes place and the balance 30% should be deferred until the first year's service is provided.

Accordingly current revenue recognition policy of **AB- Elec Plc** is not in line with *LKAS 18 – Revenue* and needs to be revised as explained above.

(Total 10 marks)

Answer 03

(a)

Relevant Learning Outcome/s:
2.2.4 Demonstrate appropriate application and selection of Accounting/reporting options given under standards.

How to categorise the lease

LKAS 17 distinguishes between finance and operating leases based on whether the lease transfers substantially all the risks and rewards of owning the asset. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction. LKAS 17 contains examples of situations which would normally result in a lease being classified as a finance lease such as the lease term being the major part of the assets economic life and the present value of minimum lease payments amounts to substantially to the entire fair value of the asset. Any other lease is an operating lease.

In this case Swift Company is leasing the property for 15 years which is less than the major part of the property's economic life and the minimum lease payments are not a substantial proportion of the property's fair value. In the absence of any other indicators the lease would be accounted for as an operating lease. LKAS 17 therefore requires that the lease payments are recognised over the lease term on a straight line basis (unless another systematic basis is more appropriate

(b)

(i) A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental at to ownership. All other leases are classified as operating leases. One of the situations where a lease is being classified as a finance lease is where the lease term is for the major part of the economic life of the asset, even if the title of the asset is not transferred. The company sells the property to the bank and leases it back. The lease arrangement is for 25 years which is substantially the asset's remaining economic life as explained in the question. Therefore, this lease arrangement should be treated as a finance lease. Therefore, the company will own the asset under a fiancé lease arrangement. The building has to be categorized as an asset held under finance lease at Rs 125 million.

(ii) The company cannot recognsie the entire profit for the year ended 31 March 2015. The profit of Rs 5 million should be deferred and thereafter recognized over the lease period of the property. Therefore, the profit of Rs. 116,667.67 [(125,000,000 – 120,000,000) = Rs. 5,000,000/25*(7/12)] should be recognized for the year ended 31 March 2015

(iii) Since the building is to be recognsied as an asset held under finance lease, its value should be recognsied as Rs 125 million on 1 September 2014 (the fair value). Therefore depreciation for the year ended 31 March 2015 should be: (125,000,000 / 25)* (7/12) = Rs 2.92 million. Hence, NBV is (Rs 125mn – Rs. 2.92mns) = Rs 122.08 million.

(Total 10 marks)

Answer 04

Relevant Learning Outcome/s:2.3.1, 2.3.2, 2.3.3.
2.3.1Explain the concepts/principals of Sri Lanka Accounting Standards.
2.3.2. Apply the concepts/principals of the standards to resolve a simple/straight forward matter.
2.3.3. List the disclosures to be made in the financial statements.

(a) **Directors' view on rights issue**

The employees of the company will get the rights issue in their capacity as shareholders. Therefore, it is accounted in a similar way as a normal rights issue to other shareholders of the company.

As per SLFRS 2, a transaction with an employee or other party in his / her capacity as a holder of equity instruments of the entity is not a share based transaction.
Accordingly in this case employees receive such a right because he / she is a holder of equity instruments of that particular class. The employees do not get this in exchange for services. Also, there are no other conditions attached for them to become entitled to the rights issue.

Therefore granting or exercise of that right is not within the scope of SLFRS 2, Share-based Payment.

(b) **Vesting condition** is defined as conditions that must be satisfied before a counterparty becomes unconditionally entitled to the equity instruments that it has been granted

OR

Condition that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. A vesting condition is either a service condition or a performance condition.

Vesting conditions in the scenario

(i) Employees to remain in the company for 3 years for them to become entitled to the share option. This is a service condition.

(ii) Share price should increase from Rs 15 to Rs 20. This is a market vesting condition

(c)

Year end	Calculation	Cumulative	Expense (Rs)
31 March 2015	20employees @ Rs 8* 10,000 *1/3	533,333	533,333
31 March 2016	20*10,000 *8 * 2/3	1,066,667	533,333
31 March 2017	20*10,000 * 8	1,600,000	533,334

(Total 10 marks)

Answer 5

Relevant Learning Outcome/s:4.1.2, 4.1.3
4.1.2 Interpret relevant financial ratios, including profitability ratios, liquidity ratios, efficiency ratios and gearing and solvency ratios. 4.1.3. Advise on the interpretation of an entity's financial statements for different stakeholders.

(i) Capital employed

Ratio	Formula	2013	2014
ROCE	PBIT x 100 Capital employed	-195%	87%
ROE	PAT – Pref.div x 100 Equity shareholder funds	-43%	- 0.48%

(ii) Profit margin

Ratio	Formula	2013	2014
GP margin	GP x 100 Revenue	16.52%	31.02%
NP margin	Profit for the year x 100 Revenue	-25.9%	-0.23%

(iii) Assets utilisation

Ratio	Formula	2013	2014
Accounts receivable turnover	= Net credit sales Average account receivable	4.77 times	6.59 times
Inventory turnover	= COS Average inventory	1.51	1.82

(iv) Interest cover

Ratio	Formula	2013	2014
Interest cover	PBIT Interest cost	-2.69 times	1.1 times

(v) Gearing

Ratio	Formula	2013	2014
Debt to equity ratio	Total debt Total equity	-2.53	-2.32
Debt ratio	Total debt Total assets	1.65%	1.74%

Assumptions

* Assumed all finance cost is equal to interest cost
* Assumed all sales are on credit

Analysis

(i) Capital Employed
ROCE

- ROCE is a measure to assess how well capital is used to generate profit.
- ROCE has improved in 2014.
- A higher ROCE indicates, more efficient use of capital. ROCE should be higher than the company's capital cost. Otherwise it indicates that, the company is not employing its capital efficiently and is not generating shareholder value.

ROE

- This gives a more restricted view of capital than ROCE, but it is based on the same principles.
- In Mean PLC, ROE also empowered in 2014, compared to 2013, as in 2014, the company could decrease its loss for the year. This is due to the decrease in selling, administration and finance expenses and increase in sales in 2014.
- However, ROE is not a widely used ratio.

(ii) Profit margin
GP margin

- When company profitability of 2014 is compared with last year, it has improved remarkably.
- From 2013 to 2014, sales has increased by 27%, and the gross profit has almost doubled.
- GP has increased by 138%. This indicate that the company has achieved a higher GP, through increase in selling prices rather than volume increases.

NP margin
- NP margin of Mean PLC is also improved in 2014 significantly to –0.23% from -25.9% in last year.
- High improvement in GP and reduction in selling, administration and finance costs affected this improvement in NP margin in 2014.

(iii) Asset utilisation

Accounts receivable turnover
- If the accounts receivable turnover ratio declines from one year to the next, it may signal a company's collection department is unable to collect from older customers or the company has an excessive amount of debt.
- If the accounts receivable turnover ratio increases from one year to the next, it may be a sign of an aggressive collection department or a conservative credit policy on the part of the company.
  Here there is a good sign of effective debt collection of Mean PLC.

Inventory turnover

* Due to increased sales, company's stock holding period has decreased (2013 = 168,722/254,403 = 0.66, 2014 = 0.54), it is a good sign with regard to company's working capital management.

* Low inventory holding period means high inventory turnover, which is good.

(iv) Interest cover

- Due to improvement in company's liquidity, company is able to cover interest expenses of the company during 2014.
- In the year 2013, the company is not able to cover its interest expenses as the company has earned losses in that year. But in the year 2014, this has changed in a positive way.

(v) Gearing

Debt to equity ratio/debt ratio

- When analyzing company's debt position, no significant change has taken place when compared to 2013.
- Company has financed the business mainly from the debt source.
- Debt ratio has increased slightly from 2013 to 2014.
- Mean PLC is a highly geared company, which is not a good sign.

(Total 10 marks)

SECTION 2

Answer 06

1.

Relevant Learning Outcome/s:
3.1.1 Prepare consolidated financial statements (Consolidated Statement of Financial Position and Consolidated Statement of Comprehensive Income) involving one or two subsidiaries and an associate firm, in accordance with SLFRS/LKAS, with emphasis on: – Elimination of inter-company transactions and balances – Fair valuation of purchase consideration and identifiable assets and liabilities of acquired subsidiary – Pre- and post-acquisition profits – Goodwill or gain on bargain purchase of simple acquisition of a subsidiary – Gain/loss on disposal of a subsidiary – Non-controlling interest – Equity accounting

(a)

Consideration	**Rs'000**	**Rs'000**	**Rs'000**
Cash		700,000	
Contingent	200,000	171,468	
	0.857339		
Total consideration		**871,468**	
FV of NCI		200,000	
			1,071,468
Net assets acquired			
- Stated capital		(450,000)	
- Retained earnings		(150,000)	
- Revaluation reserve		(200,000)	
-Brand valuation		(100,000)	(900,000)
Goodwill			**171,468**

(b) Components of equity

Retained earnings	**Rs'000**
Pink Co	350,000
Unwinding interest (working 5)	(13,717)
Brand amortization	(20,000)
Depreciation	(32,000)
Unrealized profit	(9,600)
Unrealised profit	(500)
Impairment of goodwill	(171,468)
Impairment of associate	(55,000)
Unrealised profit on machinery (working) **(A)**	(22,500)
Post acquisition profit	84,000
Impairment AFS	(25,000)
Associate share of profit	25,000
	109,215

Working (A)

Unrealised profit on machinery	**Rs'000**
Sold price	175,000
NBV	(145,000)
Profit on disposal	30,000
Depreciation	
- based on NBV	36,250
- based on transfer price	43,750
Difference	7,500
Net profit on transfer	**22,500**

(c)

Consolidated Statement of Financial Position as at 31 March 2015

	Rs '000				
ASSETS					
Non-current assets	**Pink**	**Quick**	**Rose Co**	**Adjust.**	**Consol**
Property (w1)	250,000	350,000	100,000	168,000	768,000
P&M	450,000	150,000	150,000	(22,500)	577,500
Goodwill				-	-
Intangible - Brand (w2)				80,000	80,000
Investment (w5)	1,000,000	-	-		269,500
Available for sale	150,000	-	-	(75,000)	75,000
	1,850,000	500,000	250,000		1,770,000
Current assets					
Inventories	200,000	100,000	25,000	(12,000)	288,000
Trade receivables	200,000	375,000	200,000	(60,000)	515,000
Cash	75,000	30,000	30,000	10,000	115,000
	475,000	505,000	255,000		918,000
TOTAL	**2,325,000**	**1,005,000**	**505,000**		**2,688,000**
Equity					
Stated capital	700,000	450,000	250,000		700,000
Other component of equity	250,000	-	-	(50,000)	200,000
Retained earnings	350,000	255,000	150,000		109,215
	1,300,000	705,000	400,000		1,009,215
NCI (w3)					218,600
Total equity					1,227,815
Non- current liabilities					
Loan	550,000	150,000	-		700,000
Current liabilities					
Trade payable	425,000	150,000	105,000	(50,000)	525,000
Overdraft	50,000	-	-		50,000
Deferred consideration (w4)					185,185
	475,000	150,000	105,000		760,185
TOTAL	**2,325,000**	**1,005,000**	**505,000**		**2,688,000**

Working 01

PPE	
Property	200,000
% building	40%
	80,000
	32,000
PPE	168,000 (200,000 – 32,000)

Working 02

Brand	
Value	100,000
Amortisation	20,000
	80,000

Working 03

NCI	
FV	200,000
Unrealised profit	(2,400)
Post acquisition profit	21,000
	218,600

Working 04

	Rs'000
Deferred consideration	185,185
Unwinding interest	**13,717**

Working 05

Investment in Associate	300,000
Profit share for the year	25,000
Impairment loss	(55,000)
Unrealised profit on inventory	(500)
	269,500

(Total 25 marks)

Answer 07

Relevant Learning Outcome/s:2.1.1, 2.1.2, 2.1.3, 2.1.6
2.1.1.Advise on the application of Sri Lanka Accounting Standards in solving complicated matter. 2.1.2.Recommend the appropriate accounting treatment to be used in complicated circumstances in conformity with Sri Lanka Accounting Standards. 2.1.3. Evaluate the impact of application of different accounting treatments. 2.1.6. Advise on the appropriate application and selection of accounting/reporting options given under standards.

Suggested Detail Answer:

(a) Financial statements should be prepared on the going concern basis unless management either intends to liquidate the entity or cease trading. In this situation the continuous losses, decline in revenues and deficit in the working capital indicate going concern issue for Sweet Choco PLC. There is a material uncertainty. Therefore, the management should state clearly that there is a material uncertainty related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern and therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

Since the management intends to continue the business and actions are already under way it indicates that the management will be able to prepare the financial statements under going concern basis. However, management should disclose the actions taken to address the going concern issue faced by the company.

This disclosure should be made in the financial statements (preferably under 'the basis of preparation of financial statements').

(b) If the asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognized in profit or loss (income statements). However, the decrease shall be recognized in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. Therefore, as management commented the entire decrease in value should not be charged to the income statement as there is a previous revaluation surplus relating to this asset. (LKAS 16 para 40).

(c) **Recommended accounting treatments**

(iii) ***Borrowing classification***

Although the loan is due for repayment within six months after the end of the reporting period, the entity has the ability and intent to roll this borrowing amount over into the new loan negotiated with the same bank. In substance the borrowing does not need settlement until the new four year committed facility expires. Therefore, the borrowing of Rs 75 million need not be classified as current. Based on the new loan agreement the management can determine the amounts to be classified as current and non-current.

(iv) ***Accounting for store building leased***

Previously used store has now been leased out under an operating lease. Therefore, it meets the definition of an investment property**.** Therefore, from 1 October 2014, the asset should be reclassified as investment property at net book value. Since the management's intention for subsequent measurement is not mentioned it is assumed that the investment property will be carried at cost and LKAs 16 provisions will be applicable and depreciation should be charged for the property**.** Monthly rental income of Rs. 450,000 should be charged to P & L.

However, as management commented the management does not intend making any prior year adjustment for this. LKAS 8 para 16 states that the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring are not considered to be a change in accounting policy (previously used for own use and now leased out to earn rental). Therefore, it is not required to restate the financial statements.

(v) ***Restructuring***

LKAS 37 states, a constructive obligation to restructure arises only when an entity:

(a) Has a detailed formal plan for the restructuring (including the identification of business, principal location affected, when the plan will be implemented etc.); and

(b) Has raised valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

As per the information provided, Sweet Choco PLC has a formal plan with sufficient details as to identifying the business unit affected, when the implementation will be etc. Hence the condition (a) is met.

The plan was approved and announced on 20 April 2015 before financial statements were authorized for issue. The announcement does not represent an adjusting post balance sheet event as there is no commitment to restructure at the year end from which the entity could not withdraw.

Therefore, this should be disclosed as a non-adjusting event after the balance sheet date, if the restructuring is material and non-disclosure would influence the economic decision of the users of financial statements.

(vi) ***Litigation against the company***

As per LKAS 37 para 14, a provision shall be recognized when:

(a) An entity has a present obligation (legal or constructive) as a result of past events;

(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) A reliable estimate can be made of the amount of the obligation.

In this case there is a present obligation to pay a claim to an affected customer as a result of selling unhealthy food products of the company. As per the legal opinion there is 80% likelihood of incurring the liability. Therefore there is a high probability for outflow of resources embodying economic benefits required to settle the obligation.

With the available information the claim to be paid is estimated as Rs 2 million. Therefore, a provision should be recognized as of 31 March 2015.

The settlement is due after 2 years. Therefore, if the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditure expected to be required to settle the obligation. The present value could be arrived at using the discount rate of 8%.

(d) **Journal entries for 31 March 2015**

(i) ***Revaluation loss on machinery –***

	DrRs'000	**CrRs'000**
Elimination of accumulated depreciation		
Accumulated depreciation	27,142	
(Revaluation surplus) OCI		27,142
Adjusting for devalued amount		
(Revaluation surplus) (95,000 – 57000) OCI	38,000	
Machinery (cost)		38,000
Revaluation loss (income statement) (7500—10,858)	3,358	
(Revaluation surplus) OCI		3,358

Working
Revaluation loss adjustment on machinery

	Machinery
31 March 2012	
	Rs '000
1 April 2011 Cost	100,000
Useful life	8 years
Depreciation for the year ended 31 March 2012	12,500
NBV as at 31 March 2012	**87,500**
	Rs '000
31 March 2013	
Revaluation in April 2012	95,000
Revaluation surplus	7,500
Depreciation for the year (95000/7)	13,571
NBV as at 31 March 2013	**81,429**
31 March 2014	
Depreciation for the machinery	13,571
NBV as at 31 March 2014	**67,857**
(2 marks for arriving at NBV as at 31 March 2015)	
31 March 2015	
1 April 2014 - revalued amount	57,000
Revaluation loss	(10,857)
Depreciation for the year	(11,400)
NBV as at 31 March 2015	**34,743**

(ii) **Lease of store building**

	Dr. Rs'000	**Cr. Rs'000**
Transfer of store building from PPE to investment properties		
Investment property	45,000	
Building account		45,000
Adjusting for depreciation		
Depreciation – Investment property	4,500	
Accumulated depreciation		4,500
Rental income for 6 months		
Cash/rent income receivable	2,700	
Rent income		2,700

(iii) **Litigation Provision –**

Provision to be recognized – Rs 2 million
PV of the obligation Rs 2 million *(1/(1.08)^2) = Rs 1,714,678

Litigation claims (income statement) expenses Dr Rs 1,714,678
Provision for claim Cr Rs 1,714,678

(e) **Fair value of leased store building**
Since 1 October 2014, this building is to be classified as investment property. Initially investment properties are recognized at their cost. As per LKAS 40, the management can choose its accounting policy either as cost model or fair value model for subsequent measurement of investment properties.

If the management intends to fair value investment properties, it should be continued until the asset is disposed of or until the change in the intended use of the asset. The resulting gains or losses should be recognized in the income statement during the period in which those arise. The fair value should be assessed at each reporting date.

(Total 25 marks)

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1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

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