KB 1 – Business Financial Reporting

Suggested Answers and Marking Grid

SECTION 1

Question 01

A.

Relevant learning outcome/s:
1.1.1 Demonstrate knowledge of the conceptual framework of Sri Lanka Accounting Standards, with emphasis on: - Objectives of general purpose financial statements - Underlying assumptions - Qualitative characteristics of financial statements - Elements of financial statements - Recognition and measurement of elements of financial statements - Concepts of capital and capital maintenance

Suggested detailed answer:

The going concern assumption is that an entity will continue in operational existence for the foreseeable future. This means that the financial statements of an entity are prepared on the assumption that the entity will continue trading for the foreseeable future. If the going concern assumption is not appropriate, various adjustments need to be done to the financial statements, such as provision for all losses and revaluation of assets to their possible market value. Further, non-current assets and non-current liabilities need to be classified as current assets and current liabilities.

Marking Grid
1 mark each for any three appropriate points with a maximum of 3 marks.

B.

1.

Relevant learning outcome/s:
2.2.1 Apply Sri Lanka Accounting Standards in solving moderately complicated matters.

Suggested detailed answer:

In the case of the convertible bond, the treatment proposed by the directors would increase profit and earnings per share for the year ended 31/03/2014 because of the lower interest rate of 10%. The Company's gearing would be lower as the bond would not be shown as debt.

However, this proposed treatment is not acceptable. A convertible bond is a hybrid financial instrument and LKAS 32: Financial instruments-Presentation requires that the proceeds of the issue be allocated between equity and debt and the finance cost be based on that of an equivalent non-convertible bond (15% in this case).

Marking Grid
1 mark each for any three appropriate points with a maximum of 3 marks.

2.

Relevant learning outcome/s:
2.2.1 Apply Sri Lanka Accounting Standards in solving moderately complicated matters.

Suggested detailed answer:

Extracts from the financial statements of Tharu PLC

Income Statement for the year ended 31st March 2014	
	Rs. '000
Finance costs	
Convertible bond (5,315 x 15%)	797

Statement of Financial Position as at 31st March 2014	
	Rs. '000
Equity	
Equity option of convertible bond	685
Non-current liabilities	
Convertible bond ((5,315 x 1.15)-600)	5,512

Workings

Convertible bond			*Rs. '000*
Year ended 31 st March	*Cash flow*	*Discount rate at 15%*	*Discounted cash flows*
2014	*600*	*0.87*	*522*
2015	*600*	*0.756*	*454*
2016	*6600*	*0.658*	*4,340*
Value of debt component			*5,315*
Value of equity component (balancing figure)			*685*
Total proceeds			*6,000*

Marking Grid
1 mark for finance cost of the convertible bond in the income statement. 2 marks for proper identification of the value of equity component in the statement of financial position. 1 mark for proper identification of the value of debt component in the statement of financial position as convertible debt under non-current liabilities. (Total Marks 4)

Question 02

1.

Relevant learning outcome/s:
2.2.1 Apply Sri Lanka Accounting Standards in solving moderately complicated matters.

Suggested detailed answer:

Even though invoices totaling Rs. 800,000/- (20 x Rs. 40,000) have been raised, this will not be the revenue to be recognized in the current year financial statements.

MCPL is selling both goods (course materials) and services (training). Revenue from sale of goods has to be recognized when the significant risks and rewards of the ownership have been transferred, which is usually when the delivery is made. Since the goods have been delivered as at the end of the reporting period, the revenue of Rs. 200,000 (20 x Rs. 10,000) can be recognized.

Revenue from rendering of services is recognized according to the stage of completion. Accordingly, the sales value of rendering services is Rs. 30,000 (Rs. 40,000 - Rs. 10,000). However, since only 10 classes have been completed, the revenue for rendering of services can only be recognized partially. Therefore, the revenue would be Rs. 200,000 (Rs. 30,000 x 10/30 x 20).

The total revenue to be recognized for the financial year with regard to the beginners course in cooking will be Rs. 400,000 (Rs. 200,000 + Rs. 200,000).

Marking Grid
1 mark for stating that the transaction involves sale of goods and rendering of services. 2 marks for the principle of revenue recognition in rendering of services. 2 marks for assessing the value of rendering of services. (Total Marks 5)

2.

Relevant learning outcome/s:
2.2.1 Apply Sri Lanka Accounting Standards in solving moderately complicated matters.

Suggested detailed answer:

Revenue is recognized when the significant risks and rewards of the ownership have been transferred, which is usually when delivery is made. If the effect of the time value of money is material, the sale price should be discounted to its present value. Since the payment for the goods is deferred, the transaction includes both a sale and a financing transaction.

As such, the revenue to be recognized in the current financial year would be the present value of the transaction amount. Therefore MCPL would recognize Rs. 2,391,582 (Rs. 3,000,000 / (1.12^2)).

Thereafter, over the period the credit is given, the interest will need to be unwound and recognized as a financing income. Accordingly, the financing income to be recognized in subsequent financial periods would be as follows:

FY ended 31st March 2015: Rs. 286,990 (Rs. 2,391,582 x 12%)

FY ended 31st March 2016: Rs. 321,428 ((Rs. 2,391,582+Rs. 286,990) x 12%)

Marking Grid
1 mark for the concept of time value of money. 2 marks for the amount of revenue to be recognized. 1 mark for the finance income for FY ended 31st March 2015. 1 mark for the finance income for FY ended 31st March 2016. (Total Marks 5)

Question 03

1.

Relevant learning outcome/s:
2.2.4 Demonstrate appropriate application and selection of accounting/reporting options given under standards.

Suggested detailed answer:

As per the general lease classification criteria of LKAS 17: Leases, if the lease transfers substantially all the risks and rewards incidental to ownership to the lessee, then the lease is a finance lease; otherwise it is an operating lease. The fact that land normally has an indefinite economic life is an important consideration. A lease of land is normally classified as an operating lease unless title passes to the lessee at the end of the lease term. However, a long term lease of land may be classified as a finance lease even if the title does not pass to the lessee.

The presence of an option to extend the lease at substantially less than a market rent implies that the lessor expects to achieve its return on investment mainly through the lease payments in the initial term. On the other hand, the presence of such an indicator makes it reasonably certain that the lessee will continue the lease for a secondary period at a small immaterial rental. This supports the fact that Hiru PLC can classify the lease as a finance lease. However, an option to extend it at a market rental may indicate that the lessor has not achieved its return on investment through the lease rentals and there is no reasonable assurance that the lessee will extend the lease. This is an indicator of an operating lease.

Given the fact that the initial lease premium is 75% of the current market value and the annual rental is 2% of the current market value for 40 years, it would also appear that the present value of minimum lease payments would equate to the fair value of the asset.

As a result of the above, it would appear that the lease is a finance lease. The up-front premium plus the present value of the annual lease payments at the commencement of the lease would be capitalized as property, plant and equipment and the present value of annual lease payments would be shown as a liability. The interest expense would be recognized over the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

Marking Grid
1 mark for classification criteria in the lease of land. 1 mark for describing the renewal option. 1 mark for noting the present value of minimum lease payments will equate to the fair value of the asset. 2 marks for explanation of the accounting treatment. (Total Marks 5)

2.

Relevant learning outcome/s:
2.2.2 Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.

Suggested detailed answer:

Under the principles of LKAS 17: Leases, the lease of the plant is an operating lease because the risks and rewards of ownership of the plant remain with Tharu PLC. The lease is for four years of the plant's eight year life and Tharu plc is responsible for breakdowns, etc.

Therefore, Hiru Plc will recognize lease rentals as an expense in the statement of comprehensive income. LKAS 17 states that this should normally be done on a straight line basis.

The total lease rentals payable over the four years would be Rs. 4 Mn. (Rs. 1 Mn. x 44 months) Therefore, the charge for the financial year 2013/2014 would be Rs. 11 Mn. (44/4).

The difference between the charge for the period (Rs. 11 Mn.) and the actual amount paid (Rs. 8 Mn.) amounting to Rs. 3 Mn. will be shown as a liability in the statement of financial position.

Extracts from financial statements of Hiru PLC

Income Statement for the year ended 31st March 2014	**Rs.**
Operating lease rentals on plant	11,000,000
Statement of Financial Position as at 31st March 2014	**Rs.**
Non-current liabilities	2,000,000
Operating lease rental	
Current liabilities	
Operating lease rental	1,000,000

Marking Grid
1 mark for classification of lease. 1 mark for straight line charge of lease rentals. 2 marks for computation of amount to be charged to income statement. 1 mark for computation of amount to be shown in the statement of financial position. (Total Marks 5)

Question 04

A.

Relevant learning outcome/s:
2.3.1 Explain the concepts/principles of Sri Lanka Accounting Standards.

Suggested detailed answer:

- The identifiable assets acquired and liabilities assumed in a business combination are recognized at their fair values in accordance with SLFRS 3: Business Combinations, but no equivalent adjustment is made for tax purposes.
- Assets are revalued and no equivalent adjustment is made for tax purposes.
- Goodwill arises in a business combination.
- If goodwill is not deductible for tax purposes no deferred tax liability is recognized.
- The tax base of an asset or liability on initial recognition differs from its initial carrying amount.
- The carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures becomes different from the tax base of the investment or interest.

Marking Grid
1 mark for each correct point with a maximum of 4 marks.

B.

Relevant learning outcome/s:
2.3.2 Apply the concepts/principles of the standards to resolve a simple/straightforward matter.

Suggested detailed answer:

Situation A

Carrying amount	= Rs. 100 Mn.
Tax base	= Rs. 60 Mn. (150 -90)
Taxable temporary difference	= Rs. 40 Mn.
Deferred tax liability	= Rs. 40 Mn. x 25%
	= Rs. 10 Mn.

Situation B

Carrying amount	= Rs. 80 Mn.
Tax base	= Rs. 100 Mn.
Timing difference	= Rs. 20 Mn. x 25%
Deferred tax asset	= Rs. 5 Mn.

Situation C

Carrying amount	= Rs. 100 Mn.
Tax base	= Nil
Deductible temporary difference	= Rs. 100 Mn.
Deferred tax liability	= Rs. 100 Mn. x 25%
	= Rs. 25 Mn. (subject to availability of future taxable profits).

Marking Grid	
2 marks for Situation A.	
2 marks for Situation B.	
2 marks for Situation C.	(Total Marks 6)

Question 05

Relevant learning outcome/s:
4.1.2 Interpret relevant financial ratios, including profitability ratios, liquidity ratios, efficiency ratios, and gearing and solvency ratios.

Suggested detailed answer:

Note: Refer Appendix below for the relevant ratio calculations for the periods ending 31/03/2013 and 31/03/2014 respectively.

Return on capital employed

The overall performance of DAM as measured by the ROCE has improved from 30.47% to 32.59%, which is an increase in return of 6.96% ((32.59% - 30.47%)/30.47%). Looking at the composition of the ROCE, many areas have contributed to this improvement. Gross margins have improved, signifying either that selling prices have increased or cost of sales has reduced. Even though operating margins have improved, this can be mainly attributed to the increase in gross margins as operating overheads have increased proportionally with revenue.

Asset utilization

The other component of ROCE is asset utilization; here again DAM has had better performance since sales per Rs. 1 invested has increased by 2.96% ((1.39 – 1.35)/1.35). This can indicate positive performance in future periods with the new investment in property, plant and equipment and intangible assets. The negative effect the revaluation of the property has had on the asset utilization has been overcome since the increase in revenue has compensated for the increase in assets. The new intangible asset generating revenue during the financial year may be an important factor for the increase in revenue.

Profit margins

The net profit margin of DAM has deteriorated from 16.38% to 14.34%. Increase in sales revenue has not led to a proportionate increase in profit due to several factors. The most likely cause could be that the Company has increased its sales by reducing prices. However, the increase in the gross profit margin (from 40.58% to 41.51%) rules out this possible explanation. Another potential cause of the disappointing profit margin could be the escalation in overhead costs (distribution costs and administrative expenses). However, when these expenses are expressed as a percentage of sales the ratio has remained at approximately 18%, and therefore does not explain the disparity in profit. There has been a significant increase in finance costs which is illustrated by the interest cover deteriorating from 35 times to only 9 times. The other factor is the taxation expense, as the effective rate of tax has gone from 25.41% in 2013 to 31.22% in 2014. Looking at DAM's financials, it is most likely that there has been a material adjustment from an under-provision of tax in 2014 or there has been a considerable increase in the rate levied by the taxation authority. Therefore, it can be concluded that the increase in the tax rate and increase in finance costs due to much higher borrowings have accounted for the decrease in the net profit margin.

Gearing

When comparing DAM's financials of 2014 with that of 2013, the other key factor is that the Company has invested a significant amount in long-term assets. These acquisitions have been mainly financed by cash resources and issuing debentures (no equity was issued). This in turn explains the reason for the increase in the gearing ratio (debt / equity) from 37.63% to 70.25%, representing an increase of 86.65% ((70.25% - 37.63%)/37.63%). The rapid increase in gearing has led to the sharp drop in interest cover mentioned above.

Appendix			
		2014	2013
Return on Capital Employed (ROCE)	$\frac{22{,}100 + 2{,}700}{44{,}700 + 26{,}400 + 5{,}000}$	32.59%	30.47%
Gross profit margin	44,000/106,000	41.51%	40.58%
Operating expenses % of revenue	$\frac{7{,}400 + 11{,}800}{106{,}000}$	18.11%	17.97%
Net profit margin	15200/106,000	14.34%	16.38%
Interest cover	$\frac{22{,}100 + 2{,}700}{2{,}700}$	9 times	35 times
Effective rate of tax	6,900/22,100	31.22%	25.41%
Net asset turnover	$\frac{106{,}000}{44{,}700 + 26{,}400 + 5{,}000}$	1.39	1.35
Gearing (debt/equity)	$\frac{26{,}400 + 5{,}000}{44{,}700}$	70.25%	37.63%

Marking Grid

1 mark each for computation of following ratios(Maximum 4 marks)

- Gearing ratio
- Any two relevant profitability ratios
- ROCE
- Net assets turnover ratio

1.5 marks each for the valid comment/explanation on the following (maximum 6 marks)

- ROCE
- Profitability
- Asset utilization
- Gearing

(Total Marks 10)

SECTION 2

Question 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

Suggested detailed answer:

Calculation of goodwill in Been		
Purchase consideration:		Rs.
Rs.		
Cash		96,000
Deferred consideration (9,680/(1.1 x 2)		8,000
Fair value of non-controlling interest		20,000
		124,000
Fair value of identifiable net assets acquired :		
Stated capital	40,000	
OCE	12,000	
Retained earnings	30,000	
FV adjustment - intangible asset	3,000	
FV adjustment - land	2,000	(87,000)
Goodwill in Been		37,000
Less: Impairment of goodwill		(5,000)
Goodwill to be shown in the SOFP		32,000

Marking Grid
Goodwill in Been 0.5 marks for correct cash consideration. 2 marks for correct deferred consideration. 0.5 marks for correct fair value of non-controlling interest. 0.5 marks for FV adjustment in intangible asset. 0.5 marks for FV adjustment in land. 0.5 marks for goodwill in Been. 0.5 marks for stated capital, 0.5 marks for OCE, 0.5 marks for retained earnings. (Total 6 marks)

2.

Relevant learning outcome/s:
Compute the other components of equity to be shown in the statement of financial position

Suggested detailed answer:

OTHER COMPONENTS OF EQUITY	Rs.
Balance as at 31st March 2014	15,000
Add: Post acquisition reserves – Been (4000*80%)	3200
OCI of CATE (3000* 40%)	1200
Less: Reversal of Fair value gain in Cate	(10,000)
Impairment of AFS financial assets	(180)
	9,220

Marking Grid
<u>Other components of equity</u> 0.5 marks for balance as at 31 March 2014 0.5 marks for post-Been acquisition reserves 1 mark for reversal of investment in Cate 0.5 marks for impairment of AFS financial asset 0.5 marks for other components of equity in Cate (Total 03 marks)

3.

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

Suggested detailed answer:

Adem Group **Consolidated Statement of Financial Position at 31st March 2014**		
	Rs. 000	Rs. 000
Assets		
Non-current assets		
Property, plant and equipment (W4)		109,300
Intangible assets (W5)		5,800
Goodwill		32,000
Investment in associate (W1)		23,200
Available-for-sale financial assets (W6)		3,325
		173,625
Current assets		
Inventory (W7)	123,500	
Trade receivables (W8)	34,300	
Bank (W9)	16,200	174,000
Total assets		347,625
Equity and liabilities		
Equity		
Equity shares of Rs. 10 each		150,000
Other components of equity (W12)		9,220
Retained earnings (W2)		38,525
		199,745
Non-controlling interest(W3)		22,200
Total equity		221,945
Non-current liabilities		
Deferred tax		58,500
Current liabilities		
Trade payables (W10)	59,500	
Deferred consideration (W 11)	9,680	
		69,180
Total equity and liabilities		347,625

Working 1: Investment in Associates.	**Rs. 000**
Amount shown in the SOFP	30,000
Less :Fair value adjustment	(10,000)
Add : Post-acquisition earning (8,000 x 40%)	3,200

	23,200
	========

Working 2: Consolidated retained earnings	**Rs. 000**
Balance as at 31st March 2014	45,000
Add: Post acquisition reserves Been (12,000 x 80%)	9,600
Share of profit of Cate (5,000 x 40%)	2,000
Less: URP of inventory (20,000 x 20% x 1/2)	(2,000)
Impairment of AFS financial asset	(395)
Unwinding interest of deferred consideration	(1,680)
Impairment of goodwill	(4,000)
Development expenditure disallowed in capitalizing	(8,000)
Amortization of intangible assets	(2,000)
	38,525
	======

Working 3: Non-controlling interest	**Rs. 000**
Fair value at acquisition	20,000
Add: Post acquisition reserve OCE – Been(4,000 x 20%)	800
Post acquisition reserve RE- Been (12,000 x 20%)	2,400
Less: Impairment of goodwill – Cate	(1,000)
	22,200
	======

Working 4: Property, plant and equipment	**Rs. 000**
Adem	59,200
Been	48,100
Fair value adjustment – land	2,000

	109,300
	=======

Working 5: Intangible assets	**Rs. 000**
Adem	12,800
Add : Fair value adjustment – patent	3,000
Less: Amortization of patent	(2,000)
Expenses not permitted to capitalize	(8,000)

	5,800
	=====

Working 6: Available - for- sale financial assets

Adem	3,900
Impairment (3,325 - 3,900)	(575)
	3,325

Date	Exchange rate	$ '000	Rs.'000	Change in fair value(Rs.'000)
1/4/2012	120	31	3,720	
31/3/2013	130	30	3,900	180
31/3/2014	133	25	3,325	-575

The fair value of AFS investment in the overseas currency ($) has declined for successive periods. However, no impairment loss is recognized in the year ended 31/03/2013 as there is no loss in the reporting currency (Rs.). The gain of Rs.180,000 would be recorded in equity. However, in the year to 31/03/2014 an impairment loss of Rs.575,000 will be recorded as follows.

Dr - OCE	180,000	
Dr - Profit & Loss	395,000	
Cr - AFS financial assets		575,000

Working 7: Inventory	**Rs. 000**
Adem	69,300
Been	56,200
URP inventory (20,000 x 20% x ½)	(2,000)

	123,500
	========

Working 8 : Trade receivables	**Rs. 000**
Adem	11,100
Been	28,200
Cash in transit	(1,000)
Inter-company	(4,000)

	34,300
	======
Working 9: Bank	**Rs. 000**
Adem	5,700
Been	9,500
Cash in transit	1,000

	16,200
	======

Working 10: Trade payables	**Rs. 000**
Adem	33,600
Been	29,900
Inter-company	(4,000)
	59,500

Working 11: Deferred consideration	**Rs. 000**
Present value as at 1st April 2012 (9,680/1.1 x 2)	8,000
Unwinding interest	1,680
	9,680

Working 12: Other Components of Equity	Rs.
Balance as at 31st March 2014	15,000
Add: Post acquisition reserves – Been (4000*80%)	3,200
OCI of CATE (3000* 40%)	1,200
Less: Reversal of Fair value gain in Cate	(10,000)
Impairment of AFS financial assets	(180)
	9,220

Marking Grid

Working 1

1 mark for fair value adjustment,

0.5 mark for post acquisition earnings.

Working 2

0.5 marks for balance as at 31st March 2014

0.5 marks for Post-acquisition reserves: Been (80%)

1 marks for post-acquisition profit of Cate

0.5 marks for URP of inventory

0.5 marks for impairment of AFS financial assets

0.5 marks for unwinding interest of deferred consideration

0.5 marks for impairment of goodwill - Cate

0.5 marks for development expenditure written off

0.5 marks for amortization of intangible assets

Working 3

0.5 marks for fair value at acquisition

0.5 marks for post-acquisition reserve OCE

0.5 marks for post-acquisition reserve R/E

1 mark for impairment of goodwill

Working 4

0.5 marks for fair value adjustment –land

Working 5Working 5

0.5 marks for fair value adjustment – patent

1 mark for expenses that cannot be capitalized

Working 6

0.5 marks for available-for-sale financial assets

0.5 marks for impairment

Working 7

0.5 marks for URP of inventory

Working 8

0.5 marks for cash in transit

0.5 marks for inter-company receivables

Working 9

0.5 marks for c ash in transit

Working 10

0.5 marks for inter-company payables

Working 11

0.5 marks for present value as at 1st April

0.5 marks for unwinding

0.5 marks for interest

(Total 16 marks)

Question: 07

Part 1 – To test whether students can explain the provisions of the investment property standard and borrowing cost standard.

(i)

An investment property is land or buildings (or a part thereof) held by the owner (or lessee of a finance lease) to generate rental income or for capital appreciation (or both) rather than for production or administrative use. The difference between investment property and non-investment properties is that investment property generates cash flows that are largely independent of the other assets held by an entity and non-investment properties generate cash flows in combination with other assets. Therefore investment properties do not form part of the entity’s normal operations.

Both the revaluation model (owner-occupied property) and fair value model (investment property) require properties to be valued at their fair value which is usually a market-based assessment. This is normally done by an independent valuer. In the case of the fair value model any gain (or loss) over a previous valuation is taken to profit or loss. However, for an owner-occupied property, any gain is taken to a revaluation reserve (via other comprehensive income). On the other hand, a loss on the revaluation is charged to profit or loss unless there is a previous surplus in the revaluation reserve which can be used to offset the loss. A further difference is that owner-occupied property continues to be depreciated after revaluation, whereas investment properties are not depreciated.

(ii)

As per LKAS 23, borrowing costs which are directly incurred on a 'qualifying asset' must be capitalized as part of the cost of that asset. A qualifying asset may be a tangible or an intangible asset that takes a substantial period of time to get ready for its intended use or eventual sale. Construction of a property or power plant would be typical examples. Further, it can also be applied to intangible assets during their development period. Any borrowing costs that are not eligible for capitalization must be expensed. Borrowing costs cannot be capitalized for assets measured at fair value.

Marking Grid

(i)

1 mark for features of an investment property
1 mark for similarities in accounting treatment
1 mark for differences in accounting treatment

(ii)

1 mark for explaining qualifying asset
1 mark for explanation on borrowing costs that can be capitalized.

(Total 5 marks)

Part 2

Learning outcome: To test whether students can apply Sri Lanka Accounting Standards Investment Property and Borrowing Costs for a non-complicated scenario.

The finance cost of the debentures must be calculated using the effective rate of 15%, so the total finance cost for the year ended 31st March 2014 is Rs. 1,200,000 (Rs. 8 Mn. x 15%). As this was to construct a qualifying asset, part of the finance cost must be capitalized.

Capitalization should commence from the date on which expenditure is being incurred (1st June 2013) and must cease when the asset is ready for its intended use (28th February 2014). Interest cannot be capitalized during a period where development activity is suspended. However, an entity can continue to capitalize the borrowing cost if the delay is due to an external event which is beyond the entity's control or during an interruption caused by technical or legal obstacles that are a typical part of the construction process. In this case capitalization would be ceased in August 2013 (internal issue) and in December 2013 (typical part of the construction process). Therefore, only eight months finance cost can be capitalized = Rs. 800,000 (Rs. 1,200,000 x 8/12). Finance cost of Rs. 400,000 for the remaining four months must be expensed. In addition, interest earned from the temporary investment of specific loans should be deducted from the amount of finance costs that can be capitalized. However, in this case, part of the interest was earned during the months (April, May and August 2013) in which the finance costs were not being capitalized, thus Rs. 100,000 interest earned in April, May and August 2013 would be credited to the income statement and Rs. 200,000 interest earned during the capitalization period would be deducted from capitalized finance costs.

Borrowing cost to be capitalized:

Rs. 800,000 – Rs. 200,000 = Rs. 600,000

Borrowing cost to be expensed:

Rs. 400,000

Marking Grid

1 mark for use of effective interest rate of 15%
2 marks for capitalized finance cost for eight months
1 mark for finance cost to income statement
0.5 marks for interest received to income statement 0.5 marks for interest deducted from capitalized finance cost
0.5 marks for interest deducted from capitalized finance cost.

(Total 5 marks)

Part 3 – To test whether students could apply the provisions of investment property standard for a non complicated scenario

Extracts from financial statements of Rich (pvt)Ltd		
Income statement for the year ended 31 March 2014		
	Rs.'000	Rs.'000
	Dr	Cr
Depreciation of property, plant and equipment		
Property A (8,600 / 50) x 1/12	14	
Property B (8775 / 29.25) x 1/4	75	
	89	
Gain on investment properties		
Property B (8,775 - 8,600)		175
Property C (16,100 - 15, 200)		900
		1,075
Other income		
Investment income		100
Finance costs		
Debenture interest	400	

Other comprehensive income for the year ended 31 March 2014		
Revaluation gain of property, plant and equipment		
Property B (9,100 - 8,700)		400
		400

Statement of financial position as at 31 March 2014		
Non-current assets		
Property, plant and equipment		
Property A (8,000 + 600 (finance cost element) - 14 (depreciation))	8,586	
Property B	9,100	
	17,686	
Investment Property		
Property C	16,100	
	16,100	
Equity		
Revaluation Reserve		
Property B		400

In Rich (Pvt) Ltd's consolidated financial statements Property B would be accounted for under LKAS 16 Property, Plant and Equipment from the beginning and be classified as owner-occupied from the group perspective.

Marking Grid

Depreciation of property, plant and equipment
Property A 2
Property B 1

Gain on investment properties
Property B 2
Property C 1

Revaluation gain of property, plant and equipment
Property B 1

Property, plant and equipment
Property A 2
Property B 1

Investment Property
Property C 1

Revaluation Reserve
Property B 2

Investment Income. 1

Debenture Interest 1

(Total Marks 15)