THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB1– Business Financial Reporting

December 2015

SECTION 1

Answer 01

Relevant Learning Outcome/s:
1.1.1 Demonstrate knowledge of the conceptual framework of Sri Lanka Accounting Standards 1.3.1 Demonstrate the awareness of provisions in Corporate governance, Companies Act (section 56, 69, 148 to 171 and 192) and SEC regulations and rulings

Suggested detailed answer

(a) (i) The conceptual framework for financial reporting defines an asset as a "resource controlled by the entity as a result of past events and from with future economic benefits are expected to flow to the entity".

Employee training – When the company incurs this expenditure, this may provide evidence that future economic benefits were sought. However, it is not conclusive proof that an item satisfying the definition of an asset has been obtained. In this case, the company does not have the control of the asset.

(ii) By raising a PO the company has not undertaken an obligation. As per the conceptual framework, an obligation arises when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. There is no indication of having an irrecoverable obligation therefore the company shall recognise the liability for the payment when the order is delivered by the vendor.

(5 marks)

(b) The board of iSecurity PLC requires information to make timely decisions with regard to the operations of the company, and also to assess its performance.

As per the Code of Best Practice on Corporate Governance, in order to discharge the duties of directors, the board should be provided with timely information in a form and of quality appropriate to enable it to discharge its duties. As a result the management of iSecurity PLC has a responsibility with regard to the provision of required information on the company's operations.

The directors also may make further inquiries on the information submitted (where necessary) or make requests for additional information, and the management needs to respond to these appropriately. It is important to provide information on a timely basis as it allows the board to prepare before meetings. For instance, the minutes, agenda, and board papers should be received by the directors at least 7 days before the meeting.

(5 marks)

(Total: 10 marks)

Answer 02

Relevant Learning Outcome/s:
2.2.1 Apply Sri Lanka Accounting Standards in solving moderately complicated matters. 2.2.2 Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.

Suggested detailed answer

(a) SMEs are generally owned and managed by one person or a family. The owners have invested their own money in the business and there are no outside shareholders to protect. Therefore, it could be argued that company accounts should be simple with fewer regulations and disclosure requirements.

Cost vs. benefit
Providing extensive disclosures and using certain measurement bases (e.g. fair value) prescribed in the full SLFRS involves a comparatively high cost. This cost may not be justified for the more limited needs of SME accounts. Generally for SMEs such information is not necessary because most of the time the owners/fund providers/management of the business are the same. Hence there is no outside shareholder to protect.

The purpose of the financial statements
The purpose of the financial statements and its uses will not be the same as for listed companies. The main characteristic that distinguishes SMEs from other entities is the degree of accountability. As SMEs hold comparatively lower level of public accountability, reduced version of GAAP can be justifiable.

(4 marks)

(b) (i) **Biological assets**

SMEs are to use the cost-depreciation-impairment model unless the fair value is readily determinable, in which case the fair value through profit or loss (FVTPL) model is required. If the fair value of sandalwood plants is readily determinable, the FVTPL model should be applied.

(ii) **Research & development (R&D) costs and borrowing costs**

These costs must be expensed. Therefore costs incurred on the R&D project to find a special formula to create a gents' fairness cream, should be expensed.

(iii) **Goodwill and other indefinite-life intangibles**

These assets are always amortised over their estimated useful life (or ten years if it cannot be estimated). An impairment test is only performed if there are indications of impairment (rather than annually).

(If the useful life cannot be estimated, the goodwill amount should reflect only the amount relating to the balance 5 year period).

(6 marks)
(Total: 10 marks)

Answer 03

Relevant Learning Outcome/s:
2.2.1 Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
2.2.4 Demonstrate appropriate application and selection of accounting/reporting options given under standards.
2.2.5 Outline the disclosures to be made in the financial statements.

Suggested detailed answer

(a) A compound financial instrument creates a primary financial liability of the issuer and grants an option to the holder of the instrument to convert it into an equity instrument of the issuer. In substance, the issue of convertible debt is equivalent to the issue of conventional debt plus a warranty to acquire shares in the future. The reasoning behind this approach is that an entity's equity is its residual interest in its assets after deducting all of its liabilities. Therefore to reflect the economic substance of the instrument, it is important to recognise, measure and disclose debt and equity components separately, which makes financial information provided to the users more relevant.

(2 marks)

(b) (i) As per LKAS 32, the instrument is a compound financial instrument and therefore it cannot be recognised as a non-current liability as per the MD's view. As the bond has the convertible option, the value of debt and equity should be split and identified separately in the financial statements. As per LKAS 32, the liability and equity components of a compound financial instrument should be classified separately based on the substance of the contractual arrangement and the definitions of a financial liability and equity instrument.

(3 marks)

(ii) Present value of the liability component should be measured first using the prevailing market interest rate for a similar debt without the conversion option.

	Rs.
Present value of the principal (Rs. 100 million is payable at the end of the 3rd year)	75,131,480
Present value of the interest (Rs. 6 million is payable annually in arrears for 3 years)	14,921,110
Total liability component	90,052,590
Total proceeds of the bond	100,000,000
Equity component	9,947,410

Rs. 90,0552,590 and Rs. 9,947,410 should be recognised in the statement of financial position as at the end of the first year, as a non-current liability and equity separately.

(3 marks)

(iii) Even if there are changes in the likelihood of the option being exercised, the split between the liability and equity components remains the same throughout the term of the instrument. This is because it is not always possible to predict how a holder will behave. The issuer continues to have an obligation to make future payment until conversion/maturity of the instrument or some other relevant transaction takes place.

(2 marks)

(Total: 10 marks)

Answer 04

Relevant Learning Outcome/s:
2.2.3 Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.
2.2.4 Demonstrate appropriate application and selection of accounting/reporting options given under standards.

Suggested detailed answer

(a) The general manager's view on the customer loyalty programme explained in the scenario is not correct. IFRIC 13 interpretation applies to customer loyalty award credits (points) that an entity grants to its customers as a part of a sale transaction, and subject to meeting any further qualifying conditions, the customer can redeem goods in the future for free or at a discounted price. IFRIC 13 requires the proceeds of a sale, in which the points are awarded, to be split into revenue and deferred revenue.

Accordingly, an entity's obligation to provide free goods in the future should be recognised and measured by allocating some of the consideration received/receivable from the sale transaction of revenue or providing for the estimated future cost of supplying the awards.

The fair value of the award credits (points) is recognised as revenue when the company has fulfilled its obligation by supplying awards.

Here, the fair value of a point equal to Rs. 1 out of Rs. 100 should be deferred and the balance Rs. 99 should be recognsied as revenue. The deferred Rs. 1 should be recognsied as revenue when these points are redeemed.

Contradictory to the general manager's point of view, the customer loyalty programme is not merely a method of accumulating points, but has an impact on the entity's future cash flows. Hence accounting is required.

(6 marks)

(b) The entity applies LKAS 18 *Revenue* and accounts for award credits as a separately identifiable component of the sale transactions in which they are granted as points. The fair value of the consideration received or receivable in respect of the initial sale shall be allocated between the award credits and the other component of the sale.

The consideration allocated to the award credits shall be measured by reference to their fair value i.e. amount for which the award credits could be sold separately.

- the discounts or incentives that would be offered to customers who have not earned reward points on initial sale.
- the proportion of reward points that are not expected to be redeemed by the customers.
- if customers can choose their award, the fair value of the range of available awards, weighed in proportion to the frequency with which each award is expected to be selected.

(4 marks)

(Total: 10 marks)

Answer 05

Relevant Learning Outcome/s:
4.1.2 Interpret relevant financial ratios, including profitability ratios, liquidity ratios, efficiency ratios, and gearing and solvency ratios. 4.2.1 Outline the progress towards non-financial reporting standards, including sustainability reporting and integrated reporting

Suggested detailed answer

(a) **Profitability of the company**

Increase in revenue is 12%, whereas the increase in cost of sales is 15%. Therefore, the increase in cost of sales is not proportionate to the revenue increase. As a result of this the gross margin has dropped from 35% to 34%. Sales would have increased with limited price increases and other factors would have affected the increase in cost of sales.

The previous year distribution costs were 11% of revenue, and this year it represented 13% of revenue. The company would have incurred high promotional and advertising costs to improve the revenue line. This indicates that there is intense competition in the market.

Although the country's interest rates are low, the finance costs of the company have increased by more than 100%, and it represents 5% of revenue in contrast to 2.5% in the previous year. This might indicate that the company has obtained significant additional borrowings. During the year, ROCE has declined and the debt ratio has increased. This is due to a decrease in profit before tax compared to the previous year. This may also indicate an increase in the asset base of the company. Therefore, the company would have used the borrowings to purchase new assets.

The tax expense has dropped when compared to the previous year due to the low profit generated by the company. However, the effective tax rate is 45% (tax divided by PBT), whereas in the previous year it was only 29%. This might indicate that the disallowed expenses have increased (due to the high level of distribution costs) and/or the fact that there is an under-provision of tax in respect of the previous year. Information on the tax composition is not available to conclude on this.

Administrative expenses remain relatively constant; it represents 10% of total revenue compared to 11% in 2014. The increase is 7%, which is not a significant increase and it may indicate a fixed level of expenses of the company.

ROCE has declined from 13% to 7% during the year. If the company intends to borrow in the future, and assuming that the current interest rate (8% - 11%) prevails in the future, the company may not be able to obtain additional funds.

Net profit margin has fallen from 8% to 3%. Although revenue has increased, the costs (including distribution and finance) have increased significantly.

Solvency of the company

The debt ratio has increased during the year due to increased borrowings (from 20% to 32%). Further, the gearing ratio above 50% reflects that the company is high geared. Financial institutions will have a concern in the future when granting additional funds. Also, the interest cover has decreased compared to the previous year**.**

(6 marks)

(b) **Limitations of financial statement analysis**

Damith is a potential investor of CT. Before investing he wants to know whether the business is profitable and will generate a good return on his investment. This means his focus in on the future. It is not necessarily the case that past performance will continue. Therefore, historical financial information will have limited use in achieving an understanding of future performance. It does not indicate the management's plans for the business.

Financial analysis often cannot provide answers to questions that arise from such analysis. For instance, although it could be noted that there is a drop in gross profit margin as a result of an increase in cost of sales and a decrease in sales, the investor will not be able to understand the exact reason for that change solely by analysing the financial statements. Further investigation is needed.

Window dressing is the practice of manipulating the year-end statement of financial position in order to report favourable amounts. For example, delaying payment of an amount due will result in a higher cash balance (or a lower overdraft). Even where window dressing does not take place, it must be remembered that statement of financial position balances are relevant only at the year-end date; they may have varied significantly throughout the year. As a result of both these factors, direct comparison of asset and liability balances and ratios that include either of them do not necessarily provide a true view of the position of the company throughout the year.

(4 marks)

(Total: 10 marks)

SECTION 2

Answer 06

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

(a) Goodwill (GW) on acquisition of Silver (Pvt) Limited (SPL)

	Rs. million	**Rs. million**
Cash consideration		3,000
Deferred consideration – fair value (W1)		413
Fair value of non-controlling interest		1,200
Net assets acquired		
Stated capital	2,000	
Retained earnings	1,200	
Revaluation on property	800	(4,000)
		613

<u>Workings</u>

W1: Fair value of deferred consideration = 500*(1/1.10)^2
= Rs. 413 million

(4 marks)

(b) Platinum (Pvt) Limited (PPL)

Consolidated Statement of Financial Position as at 31 March 2015

				Rs. million
	PPL	**SPL**	**Adjustments**	**Consolidated**
Non-current assets				
Freehold property	3,900	2,500	+ 800 **(GW)** – 21 **(W3)**	7,179
Plant & machinery	1,090	750		1,840
Goodwill				613
Investments				
- SPL	3,000		– 3,000	-
- APL	1,000		+ 99 **(W6)** – 15 **(W7)**	1,084
				10,716
Current assets				
Inventory	1,150	600	– 80 **(W4)**	1,670
Trade receivables	660	580	– 300	940
Cash	100	240	+100	440
	1,910	1,420		3,050
Total assets	**10,900**	**4,670**		**13,766**
Equity and liabilities				
Equity				
Stated capital	4,000	2,000	– 2,000	4,000
Retained earnings	2,920	1,700	-1700 **(W2)-**16-87**(W2)** **-**60 **-**15 **(W7)** +375 **(W8) +** 99 (W6)	3,216
	6,920	3,700		7,216
Non-controlling interest			+1,200 **(GW) –** 5 **(W3) –** 20 **(W4)** +125 **(W5)**	1,300
Non-current liabilities				
Loan stock	1,500	200		1,700
Current liabilities				
Trade payables	1,360	770	**–** 200	1,930
Deferred consideration			413 + 87	500
Bank overdraft	1,120	-		1,120
	2,480	770		3,550
Total equity and liabilities	**10,900**	**4,670**		**13,766**

Workings

W2 **Discount unwound**

[500 * (1/1.12)] – Rs. 413 million (W1) = Rs. 87 million

Dr: Retained earnings
Cr: Deferred consideration

W3 **Depreciation – fair value adjustment**

Fair value	=	Rs. 800 million
Building (60%)	=	Rs. 480 million
Depreciation	=	480/45 years * 2 years
	=	Rs. 21 million

Dr: Retained earnings	*16*
Dr: NCI	*5*
Cr: Freehold property	*21*

W4 **Unrealised profit on inventories**

Inventories	=	Rs. 400 million
Unrealised profit	=	400/125*25
	=	Rs. 80 million

Dr: Retained earnings	*60*
Dr: NCI	*20*
Cr: Inventories	*80*

W5 **Post acquisition profit – NCI**

Retained earnings as at 31 December 2015	=	Rs. 1,700 million
Less: Retained earnings at the acquisition date	=	(Rs 1,200) million
Post acquisition retained earnings	=	Rs. 500 million
Profit for NCI	=	500 * 25%
	=	Rs. 125 million

Dr: Retained earnings
Cr: NCI

W6 **Acquisition of associate**

% of interest	=	30%
Share of profit	=	(780 – 450) * 30%
	=	99

W7 **Unrealised profit on inventories**

Inventory at the year end	=	Rs. 250 million
Unrealised profit	=	250/125*25
	=	Rs. 50 million x 30% = Rs. 15 million

Dr: Retained earnings
Cr: Investment

W8 **Post acquisition profit on subsidiary**

Retained earnings at the date of acquisition	= Rs. 1,200 million
Retained earnings at 31 December 2015	= Rs. 1,700 million
Post acquisition profit	= (1,700 - 1,200) = 500
Share of profit (75%)	= Rs. 375 million

(16 marks)

(c) The litigation has been disclosed as a contingent liability in the financial statements of the Swedish company. If PPL acquires the Swedish company it will be considered as a business combination under SLFRS 3. SLFRS 3 provides limited exceptions to the recognition and measurement principles.

As per LKAS 37, a contingent liability is defined as a 'possible obligation that arises from past events and whose existence will be confirmed only by occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the entity'.

SLFRS 3 requires that a contingent liability of an acquiree is recognised in consolidation, provided that it is a present obligation arising from past events and the fair value can be measured reliably. Unlike in LKAS 37, there is no requirement for an outflow of resources to be probable. Therefore, PPL needs to assess whether the facts and circumstances of the litigation still remain the same (as a contingent) and if so, it has to see whether the fair value could be measured reliably. If it is possible, the contingent liability should be recognised under SLFRS 3.

(5 marks)

(Total: 25 marks)

Answer 07

Relevant Learning Outcome/s:
2.1.1. Advise on the application of Sri Lanka Accounting Standards in solving complicated matter 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. 2.2.4 Demonstrate appropriate application and selection of accounting/reporting options given under standards.

Suggested detailed answer

(a) **Investment property**

(i) **Dambulla - Land & Building**

LKAS 40 para 6 states that a property interest that is held by a lessee under an operating lease may be classified and accounted for as an investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model.

- In this situation, the land should be accounted for as an operating lease under LKAS 17, and it can be recognised as an investment property only if it meets the definition of investment property and the entity has chosen the fair value model for investment property.
- The building however meets the definition of investment property (as the company earns rentals) and should be accounted for under LKAS 40 *Investment Property.*

(ii) **Negombo Land**

The management is yet to decide the future intended use of the land Therefore, as per LKAS 40 when the future use of the land is not decided, it is assumed that the land is for capital appreciation**.** Therefore, it meets the definition of investment property and DFPL can capitalise this land as investment property. Therefore, the directors' opinion on this is correct.

(6 marks)

(b) **Non-current assets held for sale**

An entity shall classify a non-current asset as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

The restaurants will not be transferred until the supply commitments are fulfilled**.** This demonstrates that the restaurants are not available for immediate sale in their present condition. Therefore, the two restaurants cannot be classified as held for sale as at 31 December 2015. It must be treated in the same way as other items of property, plant and equipment.

(5 marks)

(c)

(i) **Defined benefit plan**

	Asset Rs. '000	**Liability Rs. '000**
Fair value of plan asset	5,500	-
Present value of obligation	-	5,750
Interest		
- On plan asset (5,500 * 10%)	550	-
- On obligation (5,750 * 10%)	-	575
Current service cost	-	850
Contribution for the plan - 2015	600	-
Benefits paid	(500)	(500)
Return on plan asset	250	-
Loss on measurement of obligation	-	125
FV of plan asset / PV of obligation – 31 December 2015	**6,400**	**6,800**

Profit or loss

Interest cost (net) = Rs. 25,000
Current service cost = Rs. 850,000

Other Comprehensive Income (OCI)
Difference between the return on plan asset and the loss on measurement of defined benefit obligation = (250,000 – 125,000) = Rs. 125,000

Statement of financial position

Net defined benefit liability = Rs. 400,000

(ii) **Capitalisation of borrowing costs and depreciation**

Although the loan was available from 1 July 2015, since the construction took place from 1 October, the interest cost should be capitalised from that day.

The loan amount = Rs. 200 million
Interest rate = 12%
Construction period = 4 months (October to January 2015)
Interest expenses for the period = Rs. 200 million * 12% * 4/12
= **Rs. 8 million**

Interest income earned during the period

October 2015 = 200 – 20
= Rs. 180 million

→ 180 *6%*1/12 = Rs. 0.9 million

November 2015 = 180 – 50
= Rs. 130 million

→ 130 * 6% * 1/12 = Rs. 0.65 million

December 2015	=	130 – 75		
	=	Rs. 55 million		
	→	55 * 6% *1/12	=	Rs. 0.275 million

Total interest income = **Rs. 1.825 million**

Net interest to be capitalised	=	Rs. 8 million – Rs. 1.825 million
	=	Rs. 6.175 million
Cost of construction	=	Rs. 200 million + Rs. 6.175 million
	=	**Rs. 206.175 million**

Therefore, on the balance sheet date, the cost of this new building should be stated as Rs. 206.175 million.

(10 marks)

(d) As per LKAS 16 para 55, depreciation of an asset begins when it is available for use (i.e. when it is in the location and in the condition necessary for it to be capable of operating in the manner intended by management).

According to the scenario given, construction was completed by 1 February 2015. The hotel was in a condition to operate as of 1 March 2015. Therefore, the company should begin charging depreciation from 1 March 2015. The garden preparation is <u>not necessary</u> to bring the asset to the location and for the asset to be in a condition capable of operating in the manner intended by management.

(4 marks)

(Total: 25 marks)

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