SUGGESTED SOLUTIONS

KB 1 – Business Financial Reporting

June 2016

SECTION 1

Answer 01

Relevant Learning Outcome/s:
1.3.3 Discuss the regulations applicable to the accounting profession and financial service industry
1.3.4 Discuss the disciplinary procedures relating to accountants

Suggested Detail Answer:

(a) The belief of the CEO that the IFRSs are international law is incorrect. IFRSs are not part of international law and therefore their use is not mandatory in a general sense. Their use in particular countries depends on their adoption by local authorities.

Since the company (RPL) is incorporated in Sri Lanka, in preparing the statutory financial statements it has to follow Sri Lanka Accounting Standards issued by CA Sri Lanka. CA Sri Lanka has adopted IFRS in Sri Lanka and they are called Sri Lanka Accounting Standards**.**

In Sri Lanka, CA Sri Lanka is the body responsible for issuing standards in Sri Lanka. Therefore the companies incorporated in Sri Lanka need to follow Sri Lanka Accounting Standards. Sri Lanka Accounting and Auditing Standards Act, No 15 of 1995 requires specified business entities to comply with accounting standards established by CA Sri Lanka.

Since this entity is not a listed entity and if the entity does not fall into the category of "Specified Business" category, RPL could also follow for SLFRS for SMEs.

(b) Chartered Accountant

RPL should recruit a chartered accountant to oversee the financial reporting function of RPL. CASL is the only organization in Sri Lanka with the right to award the chartered accountant designation.

A chartered accountant is a professional accountant . As a professional accountant in RPL he / she is required to gather accounting information of the operations of RPL, process this information and present its financial statements in accordance with Sri Lanka Accounting Standards and other regulatory requirements.

The shareholders of the business rely on the accountant to provide fair and honest financial information about their investment, which they can use as the basis for economic decisions. Therefore, the professional accountant should comply with applicable accounting standards in presenting the financial statements of RPL.

It is also the responsibility of a professional accountant to act in the public interest and not exclusively to satisfy the needs of the employer.

Answer 02

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

Suggested Detail Answer:

(a) (i) **Amount of revenue to be recognized in May 2016**

When the books are sold to the customers, the bookshop commits itself to providing future benefits to the customers. <u>Therefore, the entire consideration </u>received (Rs 10 million) should not be recognized as sales during May 2016.

IFRIC 13, Customer Loyalty Programmes applies in this instance. IFRIC 13 sets out the accounting rules to be applied by an entity that grants award points / credits to its customers. It must be applied to customer loyalty award credits or points issued as part of the transaction. <u>The consideration received need to be allocated between two components of the transactions</u> (i.e. sale of books or loyalty awards for discount in future purchases).

The amount of sales the bookshop should recognise in May 2016 is as follows:

Consideration received	=	Rs. 10 million
Loyalty credits earned by the customers	=	10,000,000/100*10
	=	Rs. 1,000,000

Rs. 9 million (10 – 1), should be recognised as sales for May 2016 and Rs. 1 million should be recognised as deferred revenue as the customers would purchase books using these points in future.

(ii) Journal entries required for June 2016 for redemption of loyalty points

Deferred revenue	Dr	Rs. 1,000,000
Revenue	Cr	Rs. 1,000,000

(b) (i) Management should determine the <u>fair value of revenue</u> by calculating the present value of the cash flows receivable because the customer is given extended credit on this sale.

Fair value of sale of Rs. 5 million as at 1 April 2015

Rs. 5,000,000 *[(1/1+0.1^2)] = Rs. **4,132,232**

(ii) Journal entries for debtors as at 31 March 2016

Amount receivable as at 31 March 2016	=	Rs. 4,132,231 *10%
	=	Rs. 413,223
	=	Rs. 4,132,231+Rs 413,223
	=	**Rs. 4,545,455**

Journal entries:

Amounts receivable (debtor)	Dr	Rs. 413,223
Interest income		Rs. 413,223

Answer 03

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 Detail Answer:

(a) Rs. 15, 000, 000*80%*0 = Rs. 0
Rs. 15, 000, 000*10%*20% = Rs. 300,000
15, 000, 000*10%* 50% = Rs. 750,000
Total = Rs. 1, 050,000

(b)

Year	Expected cash payment	Discount factor 6%	Present Value
2016	1,050,000 x 50% = 525,000	0.9434	495,285
2017	1,050,000 x 30% = 315,000	0.8899	280,318
2018	1,050,000 x 20% = 210, 000	0.8396	176,316
			951,919

(c) No change in the provision even if full SLFRS is applied.

Answer 04

Relevant Learning Outcome/s:
2.3.1 Explain the concepts / principles of Sri Lanka Accounting Standards 2.3.2 Apply the concept principles of the standards to resolve a simple/straight forward issue

Suggested Detail Answer:

(a) Financial instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity (LAKS 32 p.21).

(1) **Lease payments** –This is not considered as a financial instrument. Alankara is committed to provide space in the building for the use of the other party (lessee). However, the consideration will be received after providing the service. Therefore the lease arrangement is not a financial instrument until the lease amount becomes due from the lessee.

(2) **Preference shares –** Alankara has issued redeemable preference shares. By issuing these shares Alankara has a contractual obligation to deliver cash or another financial asset. These are redeemable and therefore should be considered as a financial liability in the balance sheet of Alankara

(3) **Interest free loan –** Alankara have a contractual right to receive cash or another financial asset from its subsidiary for the loan granted. As a result this will become a financial asset to Alankara and could be classified as Loans and receivable.

(4) **Tax liability -** There is no contractual obligation to the Inland Revenue Department. This is considered to be a statutory obligation. Therefore, this will not be a financial instrument of Alankara

(b) Fair value of available for sale investment

(i)

Price per share on 1 January 2016	=	Rs. 50
Number of shares purchased	=	100,000
Price paid to purchase shares	=	Rs. 50 * 100,000
	=	Rs. 5,000,000
Add: Commission paid	=	50,000
Fair value of the investment on 1 January 2016	=	Rs. 5,050,000 **(A)**
Fair value of the investment as at 31 March 2016	=	Rs. 60*100,000
	=	Rs. 6,000,000 **(B)**
Fair value gain (A – B)	=	**Rs. <u>950,000</u>**

(ii) Available for sale investments are measured at fair value and subsequently also measured at fair value. The resulting gains / losses are recognized in other comprehensive income. However, in respect of investments in non-quoted shares, <u>active market prices are not available</u>. LKAS 39 states, measure the fair value using other methods. LKAS 39 further states that if <u>the fair value cannot be reliably measured it shall be stated at cost</u>.

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.
4.1.3 Advise on the interpretation of an entity's financial statements for different stakeholders.
4.2.1 Outline the progress towards non-financial reporting standards, including sustainability reporting and integrated reporting

Suggested Detail Answer:

(a) Marks should be allocated for the calculation of any 3 of the following investor ratios

(i) Earnings per share
(ii) Dividend per share
(iii) Dividend cover
(iv) P/E ratio
(v) Dividend yield

Earnings per share	Net profit/Avg No of shares 36/1	= Rs.36 per share
Dividend per share	Dividend declared/Average No. of shares 1.5/1	= Rs. 1.5 per share
Dividend Cover	Earnings per share/Dividend per share = 36/1.5 = 24 times	
P/E ratio	Current share price/ EPS = 57/36 1.58	
Dividend Yield	Dividend per share/ market price = 1.5/57 = 0.026	

(b) Analysis of the solvency of the company

	2015/16	2014/15
Debt ratio	60%	50%
Gearing ratio	70%	60%
Interest cover	2.3 times	4 times

- Compared to last year the company's total debt to total assets has increased. Generally 50% is considered a safe limit for debt. However in the financial year 2015/16 the company's debt position has become comparatively unsafe.
- Gearing is concerned with the company's long term capital structure. Generally a company with a gearing of more than 50% is said to be highly geared. The company's has become comparatively highly geared in 2015/16. Consequently the degree of risk involved in holding equity shares in this company has escalated.
- Compared to last year's earnings, the ability to pay interest has decreased.
- Overall, the company's solvency position has become worse compared to last year.

(c) Importance of integrated reporting

- Integrated reporting (IR) links social, environmental and ethical performance to financial performance.
- Integrated reporting (IR) is the latest development in corporate social responsibility reporting.
- IR takes sustainability reporting a step further by linking it to financial performance.
- IR connects strategy, governance and performance.
- Fundamental concepts of integrated reporting – value creation for the organization and others, organisations' dependency on capital including financial intellectual, human, social, natural etc. and value creation process.
- IR is benefited to investors as it connects strategy governance & performance and allows the investor to understand how the strategy being pursued creates value over time.
- IR is a form of reporting that helps management to understand & implement strategy and drive internal performance. In turn this helps to attract investment capital.
- Other benefits include customer loyalty, improved stakeholder relations, reduced operational & strategic risk, expanded business & strategic alliance opportunities and an enhanced reputation.

SECTION 2

Answer 06
(a)

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 Detail Answer:

Consolidated financial position as at 31 March 2016

	Amounts in Rs.'000				
ASSETS	**Arrow**	**Brown**	**Adjustments**	**Consolidated**	
Non-current assets					
Freehold property	290,000	250,000	74,167	614,167	**W2&6**
Plant and machinery	109,000	75,000	(18,750)	165,250	
Investments	480,000		(392,000)	89,200	**W7**
Intangibles - brand			40,000	40,000	**W2 &3**
Goodwill			30,529	30,529	**W2 & 12**
	879,000	325,000		939,946	
Current assets					
Inventories	115,000	60,000	(8,000)	167,000	**W8**
Trade receivable	66,000	58,000	(40,000)	84,000	
Cash	10,000	24,000	40,000	74,000	
	191,000	142,000		325,000	
Total assets	**1,070,000**	**467,000**		**1,264,146**	
EQUITY AND LIABILITIES					
Stated capital	400,000	200,000	(200,000)	400,000	**W2**
Retained earnings	292,000	177,000	(198,034)	270,966	**W2 & 4**
	692,000	377,000		670,966	
Non-controlling Interest				79,724	**W 5**
Non-current liabilities					
Borrowings	130,000	20,000		150,000	
Current liabilities					
Trade payable	136,000	70,000	-	206,000	

Borrowings	112,000			112,000	
Deferred consideration				45,455	**W 11**
	248,000	70,000		363,455	
Total equity and liabilities	**1,070,000**	**467,000**		**1,264,146**	

Working 1 (1/2 mark)	
% acquired on Brown	**million**
No. of shares acquired	16
Total shares	20
% acquired	**80%**

Working 2 - Goodwill		**Rs.'000**
Cash consideration		400,000
Deferred cash consideration		
50 Mn * 1/(1.1)^2		41,322
Fair value of NCI		
20million *20%*Rs. 20		80,000
Net assets acquired		
Stated capital	200,000	
Retained earnings	120,000	
Brand name revaluation	50,000	
Property revaluation	75,000	
		(445,000)
		76,322

Working 3 brand amortisation		
Useful life	5 years	
Amount	50,000	
Amortisation	**10,000**	

Working 4 - Retained earnings	**Rs'000**
Amortisation of brand	(8,000)
Depreciation	(667)
Unrealised profit W8	(6,400)
Unrealised profit W 9	(2,000)
Sale of machinery to subsidiary	(20,000)
Unwinding interest	(4,132)
Share of profit from associate	9,200
Goodwill amortisation	(36,635)
Post-acquisition profit – NCI	(11,400)
Excess of net FV of Associates net assets - Over depreciation on machinery	2,000
	(78,034)

Working 5 - Non-controlling interest	
Fair value of NCI	80,000
Brand amortisation	(2,000)
Depreciation - building	(167)
Over depreciation of machinery (6,250 x 20%)	1,250
Unrealised profit - inventories - W8	(1,600)
Goodwill amortisation	(9,159)
Post-acquisition profit	11,400
	79,724

Working 6 - Depreciation on revaluation		
Remaining useful life on the date of acquisition	45	Years
Depreciation for 31 March 2016	**833**	
75000*.5*1/45		

Working 7 – Investment in associate

1-Apr-15	40%	80,000
Negative goodwill on Associates		2,000
		82,000
Post-acquisition profit		
(78,000-55000)*40%		9,200
Unrealised profit [W 9]		(2,000)
		89,200

Working 8 - Unrealised profit on inventories - Arrow		
Arrow held	40,000	
Unrealised profit	**8000**	

Working 9 - Unrealised profit on inventories - Crown		
Inventories	25,000	
Unrealised profit	5,000	

Working 10 - Adjustments on machinery sale	
Profit on sale	25,000
(100000-75000)	
Depreciation based on book value	18,750
Depreciation based on sale value	25,000
Difference (25,000 – 18,750) – 6,250 x 80%	**5,000**
	20,000

Working 11 - Deferred consideration	
Deferred consideration	45,455
Fair value	41,322
Unwinding interest	**4,132**

Working 12 Goodwill amortisation
76,322 * 60% = 45,793

(b) **Difference between joint operations and joint ventures**

- The arrangement is a joint operation when the contractual agreement provides rights to assets and obligations for liabilities for those parties sharing joint control. Parties who share joint control over a joint operation are joint operators.

- The joint arrangement is a joint venture when the agreement grants rights to the arrangement's net assets. The parties who share the joint control over a joint venture are joint venturers.

How to differentiate joint operations and joint ventures?

	Joint operations	**Joint ventures**
(i) Terms of the contractual arrangements	The parties to the joint arrangement have rights to the assets and obligations for liabilities relating to the arrangement	Have the rights to the net assets of the arrangement
(ii) Rights to assets	The parties share all interests in the assets relating to the arrangement in a specified proportion	The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interest in the assets of the arrangement
Obligations for liabilities	The parties share all liabilities obligations, costs and expenses in a specified proportion	The joint arrangement is liable for debts and obligations of the arrangement. The parties are liable to the arrangement only to the extent of their respective: - Investments in the arrangement - Obligations to contribute any unpaid or additional capital to the arrangement; or both

Answer 07

Relevant Learning Outcome/s:
2.1.1. Advise on the application of Sri Lanka Accounting Standards in solving complicated matters. 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.

(a)

(i) The accounting issue in this incident is whether to recognise the cost of the transformer as an asset of BAND or charge to profit or loss.

(ii) Accountant needs to analyse the facts and see whether this expenditure is of revenue nature or of capital nature.

(iii) Generally the transformer is a property of the Ceylon electricity Board. However once it is located in the company premises, Band PLC has the right to use it hence economic benefits would flow to the company. Therefore it can be recognised as an asset.

(iv) Considering whether this company has done a similar kind of investment in the past and how it has been reflected in the accounts i.e. whether the company has an accounting policy for a similar asset.

(v) In addition accountant must consider the materiality of the transaction. If Rs. 1 million is not so material to this company because the company size/ the asset base is comparatively very large then charging this amount to the profit or loss can be justifiable.

(vi) Finally, the decision must be made based on the fact of usefulness to the users of financial statements, whether the information is relevant to the users for making economic decisions. The accountant must take into account qualitative factors discussed in the financial reporting framework as well.

(b) Assets held for sale in 2014/2015 – Rs. 350,000 – measurement base/ amount recognised should not change – An asset can still be classified as held for sale, even if the sale has not actually taken place within one year. In this case the company has taken reasonable steps to sell this item. The delay must have caused by events or circumstance beyond the entity' control. Therefore not charging the depreciation for the last year for this particular asset is justifiable.

Assets held for sale in 2015/2016

Carrying value	Rs. 400,000
Fair value	Rs. 300,000
Cost to sale	Rs. 50,000
Fv- COS	Rs. 250,000

The measurement of the asset held for sale is at the lower of carrying value or fair value less cost to sell. Rs. 250,000

(c)
- the cost of unused leave should be charged to profit or loss. The Accountant needs to find out the per day cost per employee then multiply it by the number of unused leave.
- Profit shares payable within 12 months after the end of the accounting period should be recognised as an expense and a liability when the entity has a present obligation to pay it. i.e. when the employer has no real option but to pay. Band must recognise a liability and an expense amounting to 8% of net profit.

(d)

To: Board of Directors

From: Accountant
Subject: Impact of introducing an ESOP

A share option is a contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

ESOPs have wide financial implications for the company. It has an impact on the share capital, share holding pattern, accounting impact, financial commitment.

ESOP is a share based payment which is requires to be accounted as per SLFRS 2. Similar to other expenses paid by cash for services obtained from employees share based payments should also be treated as an expense. Therefore after introducing ESOPs there will be a <u>charge to the P/L</u> though there is no real cash outflow. ESOP is an <u>equity settled transaction</u> therefore a <u>corresponding increase in equity should also be recognised</u>.

Share options are measured at the fair <u>value at the grant date</u>.

The <u>expense recognised in each year of the vesting period should be based on the best available estimate of the number of equity instruments expected to be vested</u>. This estimate should be revised if subsequent information indicates that the number of equity instruments expected to vest changes from previous estimates.

On the vesting date, the entity should <u>revise the estimate to equal the number of equity instruments that actually vest</u>.

(e)

SLFRS 15 replaces the LKAS 11 – Construction Contracts

- Under LKAS 11- recognition of revenue and profit on a percentage of completion basis was required. Under SLFRS 15, progressive revenue recognition will only be permitted where the enforceable contractual rights and obligation satisfy certain criteria. There is no automatic right to recognize revenue on a progressive basis for construction contracts.
- LKAS 11 explains how to recognize foreseeable contract losses. This guideline is not available in SLFRS 15 therefore provisions in LKAS 37 are applied for such contracts.
- LKAS 11 permits a broader range of pre- contract cost to be capitalized however SLFRS 15 allows incremental costs of obtaining a contract and fulfillment cost to be capitalized when they are expected to be recovered.

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