SUGGESTED SOLUTIONS

KC1 – Corporate Financial Reporting

December 2015

Answer 01

Suggested detailed answer

(a) Related party transactions

(i) Per Para 9 (b)(i) of LKAS 24, one of the conditions required for an entity to be related to a reporting entity is that the entity and the reporting entity are members of the same group.

Accordingly, EAT and PBL are related as they are under the same parent HFP. The parts sales transactions (total value) and any outstanding balance should be disclosed. Terms and conditions of the transactions, i.e. the fact that the transaction is not at arm's length need to be disclosed.

(ii) HFP and Colourful-Printing (Pvt) Limited (CPL) are related parties as Shyamali Subasinghe is a close family member of a key management personnel (KMP) of HFP and CPL is jointly controlled by her.

Both transactions shall be disclosed with the discount given.

(iii) Per Para 11(a) of LKAS 24, two entities are not related parties simply because they have a common director. Accordingly, Highlight (Pvt) Limited (HPL) and HFP are not related parties. No disclosure is required.

(iv) Per Para 9(a)(iii) of LKAS 24, a person is related to a reporting entity if that person is a KMP of that entity or of the parent of that entity. In this scenario, all independent and executive directors as well as the CEO are KMP. Hence they are related parties.

All directors' fees, remunerations (emoluments) including vehicle benefits and performance bonuses shall be quantified and disclosed. Disclosure can be made as an aggregation.

(v) The government is a related party of Creative Solutions (Pvt) Limited (CSL), not a related party of HFP.

No disclosure shall be made in relation to the dividend paid to the government in HFP's books. Disclosure shall be made in relation to the dividend declared to the government in the consolidated financial statements.

(vi) CSL and Rebuild Nation (Pvt) Limited (RNL) are related parties as HFP has control over CSL and significant influence over RNL.

Disclosure shall be made in HFP's books only on transactions with RNL.

(vii) RNL and BSL are not related parties as HFP only has significant influence in both companies.

No disclosure required.

(14 marks)

(b) Adoption of SLFRS 15

1. The company shall identify performance obligations within the contract. Performance obligations shall be distinct and identified based on the following two (02) criteria:

   - Can customers benefit from the good or service on its own or together with other readily available resources?
   - Is the promise to transfer the good or service separately identifiable from other promises in the contract?

   Construction of apartment units and facilities such as a gymnasium, swimming pool, club house and golf course can be two possible performance obligations.

2. Consideration on sale of an apartment shall be allocated among the identified performance obligations based on the standalone selling price.

3. Recognition on the percentage completion basis under LKAS 11 needs to be re-assessed.

   Revenue can be recognised either at point-in-time or as the work is performed (based on the stage of completion). Revenue is recognised for each of the performance obligations at point-in-time if control of the asset is passed at point-in-time. It may be likely that the revenue is recognised at point-in-time as the construction is carried out on the developer's land and control of the property is transferred at the end of the construction.

4. Revenue shall not be recognised when advances are received. Such amounts shall be recognised as contract liabilities.

5. There may be a significant financing component on the consideration received as the construction could take place for a long period of time (more than a year). Hence it may required to recognise interest expense.

(5 marks)

(c) (i) Current income tax shall be computed using the existing rate of 28%.

Deferred tax shall be computed using the proposed rate of 15%.

It is assumed that the rate proposed is substantially enacted since the Parliament has formally approved the rates.

(3 marks)

(ii) Do not recognise the deferred tax liabilities arising from the initial recognition of goodwill.

No deferred tax shall be recognised at the initial recognition of the investment.

(3 marks)

(Total: 25 marks)

Answer 02

Suggested detailed answer

Part A

(a) **Accounting standards and ethical requirements**

The CFO is a Charted Accountant. Therefore he should be aware of the requirements of SLFRSs and should apply those requirements in order to achieve fairly presented financial statements. Further, he is bound by CA Sri Lanka's Code of Ethics.

Sri Lanka Accounting Standards

Section 50 of LKAS 39 states that an entity shall not reclassify any financial instrument into the fair value through profit or loss (FVTPL) category after initial recognition. Therefore the said reclassification is not in compliance with LKAS 39.

Had the previous year classification been incorrect, they can apply LKAS 8 *Accounting policies, Changes in Accounting Estimates and Errors*. Accordingly they can restate, considering it is a classification error done in the previous year. However, in the given scenario, it is clearly evident that there had been no classification errors. The possibility of reclassification is looked at in order to show a better profit and to qualify for a bonus. This is manipulation. Therefore adjustments cannot be done applying LKAS 8.

Code of Ethics

If the CFO were to accept the CEO's suggestion to manipulate the accounts, this would be a clear breach of integrity.

Acceptance of the suggestion by the CFO also displays a lack of objectivity.

The requirement to behave professionally and display professional competence and due care means that the CFO must comply with the applicable professional standards and regulations and avoid any act that discredits the profession.

The CFO should explain to the CEO the requirement of accounting standards and principles in respect of the suggested amendments to the financial statements. He should attempt to persuade the CEO to refrain from amending the financial statements.

If the CEO insists on the suggested adjustment being made, the CFO should consider his position and identify the misstated amounts to those charged with governance (Audit Committee etc.)

(7 marks)

(b) At the period end, the entity does not have an unconditional right to defer the settlement of the liability for at least 12 months. The company's inability to maintain the minimum annual sales volume could be a breach of the loan covenant. This could make the loan having to be paid on demand. Therefore classification of the liability should be changed to 'current' even though it is a long-term loan.

(2 marks)

Part B

(a)

Year	Cash Flow	Discount Factor	NPV of Cash Flow
1	210,000	1/1.10	190,909
2	210,000	1/1.10^2	173,554
3	3,210,000	1/1.10^3	2,411,721
			2,776,183
Total Value			3,000,000
Total Equity Component			223,817

(3 marks)

(b) Per Para 38 of LKAS 32, transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of the proceeds.

	Liability Component	Equity Component	
Gross proceeds	2,776,183	223,817	3,000,000
Issue cost allocated	185,079	14,921	200,000
	2,591,104	208,896	2,800,000

(5 marks)

(c) Subsequent measurement basis:
- Equity component is not re-measured subsequently
- Liability component is measured at amortised cost.

Effective interest rate				
Year 0	2,591,104			
Year 1	(210,000)			
Year 2	(210,000)			
Year 3	(3,210,000)			
	12.748%			
Year	**Liability B/F**	**Interest**	**Cash paid**	**Liability C/F**
1	2,591,104.43	330,309.90	210,000.00	2,711,414.33
2	2,711,414.33	345,646.81	210,000.00	2,847,061.14
3	2,847,061.14	362,938.86	3,210,000.00	-

(8 marks)

(Total: 25 marks)

Answer 03

(a)						
TharuSevana Eco lodge (Pvt) Limited						
Consolidated Statement of Financial Position						
As at 31 March 2015						
Assets						
Non Current Assets			Total	Consolidation Adjustments	Other	Consolidated
Property, Plant and Equipments (net)	792,201	550,000	1,342,201	130,000	(160,000)	1,312,201
Lease hold Land					28,000	28,000
Intangible assets- Goodwill				172,000		172,000
Intangible assets- Brand		50,000	50,000	30,000		80,000
Investments (quoted public companie	12,520		12,520			12,520
Other Investments	250	150,000	150,250	40,000		190,250
	804,971	750,000	1,554,971	372,000		1,794,971
Current Assets						
Inventories	35,845	30,000	65,845			65,845
Trade and Other Receivables	47,500	25,000	72,500			72,500
Amounts Receivable from Related Parti	30,250	-	30,250		(28,000)	2,250
Deposits , Prepaymnets and Advances	6,150	-	6,150	(3,000)		3,150
Fixed Deposits at the Commercial Bank	19,150	-	19,150			19,150
Cash & Cash Equivalents	1,250	5,000	6,250			6,250
Assets held for Sale					117,000	117,000
Others	2,160	-	2,160		40	2,200
	142,305	60,000	202,305	(3,000)		288,345
Total Assets	**947,276**	**810,000**	**1,757,276**	**369,000**		**2,083,316**
Equity & Liabilities						
Shareholders Equity						
Stated Capital (Rs.1 per share)	550,000	450,000	1,000,000	270,000		1,270,000
Revaluation Resreve	43,000	-	43,000			43,000
Available for sale Reserve	(482)	-	(482)			(482)
Accumulated Losses	(74,681)	150,000	75,319	(153,000)	(52,960)	(130,641)
	517,837	600,000	1,117,837	117,000		1,181,877
Non-Controling Interest				180,000		180,000
Total Equity				297,000		1,361,877
Non Current Liabilities						
Interest Bearing Borrowing (in cluding	164,374	60,000	224,374			224,374
Deferred tax		50,000	50,000	12,000		62,000
	164,374	110,000	274,374	12,000		286,374
Current Liabilities						
Amounts Payable to Related Parties	105,401		105,401			105,401
Trade & Other Payable, Foreing Agants	95,961	40,000	135,961	60,000	10,000	205,961
Interest Bearing Borrowing (Overdraft	57,178	60,000	117,178			117,178
Others	6,525	-	6,525			6,525
	265,065	100,000	365,065	60,000		435,065
Total Liabilities	429,439	210,000	639,439	72,000		721,439
Total Equity and Liabilities	**947,276**	**810,000**	**1,757,276**	**369,000**		**2,083,316**

(25 marks)

(b) (i) Fair value (FV) measurement

FV is the price that would be ***received when selling an asset or paid to transfer a liability*** in an orderly transaction between ***market participants*** at the ***measurement date.***

FV is an exit price. It is the price to sell an asset rather than the price to buy an asset. Therefore the price to sell an asset embodies expectations of market participants. Hence FV is a market based measure and not an entity specific measure.

The FV hierarchy depends on the inputs used in the valuation techniques. The inputs can be classified as:

Observable inputs – inputs that are developed based on observable market data and reflect market participants' assumptions.

Unobservable inputs – inputs for which market data is not available and which are developed based on the best available information on market participants' assumptions.

Level 1 – quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the reporting date.

Level 2 – inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly.

- quoted prices for similar assets or liabilities in active markets
- quoted prices for identical or similar assets or liabilities in markets that are not active
- inputs other than quoted prices that are observable for the asset or liability (e.g. interest rates and yield curves, volatilities, prepayment speeds, loss severities, credit risks and default rates)
- inputs derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – unobservable inputs.

Significant unobservable inputs are used. An adjustment to a Level 2 input that is not based on observable data and is significant to the entire measurement would result in a Level 3 measurement.

E.g. inputs derived based on management assumptions – company specific internal information such as cash flow forecasts and budgets.

(5 marks)

(ii) Integrated reporting

Integrated reporting (IR) is a process undertaken by an organisation that communicates how its strategy, governance, performance and prospects lead to the creation of value over the short, medium and long term.

- Improved corporate reporting – IR addresses the information limitations in current financial reporting and provides additional information required by stakeholders.
- IR provides more performance-oriented measures on an organisation's strategy, governance, performance, prospects and value creation.
- IR provides information on how changes in environmental, social and governance issues impact the business. It integrates both internal and external non-financial information when assessing performance and long-term prospects.
- IR also works as an internal source of performance measurement, which allows an organisation to better allocate its resources.

(5 marks)

(c) The answer shall at least contain the following:

- Comparison between actual results and budgeted amounts
- Comparison of 2014 and 2015 results

Performance

1. The company has budgeted revenue growth of 27%, expecting growth in occupancy of 20% and an increase in price of 6% for 2015. However, the actual revenue was significantly short of the budget and grew only by 10%.
2. The actual growth is also below the expected industry growth of approximately 14% – 11%. It appears that the company is performing below market average.
3. The company has been able to make marginal Net Profit Before Tax (NPBT) for financial years 2013 and 2014 at 55% occupancy levels. However, 2015 has resulted in a loss at the same occupancy rate.
4. This could be due to the company not being able to maintain its gross profit at expected or breakeven levels.
5. It is noted that the actual gross profit for 2014 and 2015 was approximately 50%, whereas the budgeted gross profit to keep the company profitable is approximately 70%.
6. The main reason for not being able to meet the budgeted gross profit could be the fact that the company is not charging the right prices/rates due to competition or high cost of production.
7. Heavy finance cost due to USD borrowing – the interest cover ratio has significantly deteriorated from 1.17 to 0.86, thereby increasing the threat to solvency.

Comparison and evaluation of other ratios also required.

Summary

1. Gearing and all other solvency ratios are deteriorating and increasing the threat to solvency;

- Return on equity (ROE) has weakened
- Losses are increasing and leading to serious loss of capital (no sufficient reserves)

2. Debtors' collection periods are extended, which could lead to bad debts.

3. Inventory turnover ratio has improved mainly due to maintenance of low inventory levels. This could be due to low performance (occupancy) levels in 2015.

4. Accounts payable periods have improved perhaps due to pressure from vendors.

(15 marks)

(Total: 50 marks)

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