

## **KC1 – Corporate Financial Reporting**

**December 2017**

### **Examiner's Comments**

#### **GENERAL**

##### **Overall Performance-**

On average the performance was very weak, the knowledge and the ability demonstrated in identifying and solving issues in relation to the subject matter was far below accepted levels from final level candidates.

The approach to both question 1 and question 2 are both similar, although the nature of the questions are quite different. Most of the times, both these questions require the candidates to provide advice to the management on the accounting treatment and reporting requirements. Both these questions carries 25 marks each. The performance on question 1 was better than that of question 2.

At this level, all questions require the candidates to demonstrate their knowledge in problem solving and not just direct application of the relevant accounting standards. Questions are addressed in such a manner that candidates required most of the time to provide advice to management, criticize or evaluate or to compile a report which involve synthesis. Therefore, In order to perform well and obtain a pass for this paper a thorough knowledge and understanding of the SLFRS/ LKAS is required. In addition students should have a good understanding of the Code of Ethics, ethical issues and Corporate Governance.

Question on advice require a candidate to explain in detail with specific focus to the question asked. Points given in the scenario need to be extracted and analysed or related to the relevant accounting standards and the justifications of a particular treatment has to be explained. Just reproducing the standard does not attract any marks as this is an open book examination. Such action results only in waste of time.

Candidates should practice writing answers in preparation for the examination, which will assist them greatly in time management, focusing on the question asked and not producing general answers,

#### **Question 01**

The question required the candidates to advise the management on three issues relating to (a) accounting for investment property (trf to PPE of an investment property) and Borrowing cost (b) Advise on whether SLFRS for SME can be used for a given scenario and (c) to compute the effect of a bonus issue on earnings per share.

All candidates had attempted this question. However, it was noted that many missed out the opportunity to score the maximum marks due to bad planning and not building up the answer on a step by step basis. For e.g.: quite a lot of candidates started the answer from a mid-point, i.e. directly jumping to a conclusion. They took up the position that transfer of the property to PPE from Investment property was correct (which was in fact so) but did not justify why it was correct. Similarly, on the capitalisation of the borrowing cost, the candidates could have easily scored 80% of the allocated marks, actual performance was not so.

Some candidates had just written down the requirements of the standard without relating to the scenario. Candidates will not score any marks for only writing the standard without applying it to the scenario, as this is an open book examination.

Thus the candidates could not score total marks allocated to this part. Detailed observations on mistakes made by the candidates are given below.

**(a) Land transferred to PPE/borrowing cost /investment income and expenses**

Land transfer from IP to PPE

Very few candidates justified why this treatment was appropriate. There were sufficient information given in the question to justify this treatment. e.g.: facts given in the question were not applied, building the head office for administrative purposes is the commencement of owner occupation. Instead a majority answered explaining directly how such a transfer should be accounted as per the relevant standard.

Secondly quite a number of candidates missed out the point that the transfer had been done at its original cost which was incorrect. They failed to identify that the original cost is not the deemed cost in the given scenario, instead it should have been the FV on the date of the transfer.

Some candidates explained the standard in general. E.g. they explained the accounting for an investment property instead of the transfer from IP to PPE at fair value. Some others have explained the accounting treatment when PPE is transferred to IP. These candidates did not understand the requirements given in the question.

Borrowing Cost

Most of the candidates just explained the basic criteria for capitalization of the borrowing cost and did not justify why the borrowing cost can be capitalized in the given scenario. e.g.: Not mentioned the project is expected to continue for a substantial period of time (up to 2019) etc....

Commencement date of capitalisation of borrowing cost was not correctly identified. Candidates missed out that the full cost does not qualify to be capitalised in the given scenario.

Many candidates missed out the point given in the question that the borrowing was specific for the project. Hence they computed the weighted average cost which was an incorrect application of the standard and lost some of the marks. Further, it was mentioned in the question that a bank loan will be utilised only as and when required which was missed out by many candidates.

### Investment Income

Most candidates mentioned that the interest income from temporary investments should be netted off but failed to identify that the full income cannot be set off against the costs. e.g.: interest income from 1/4/2017 to 1/5/2017 to be recorded under investment income and the balance interest income to be netted off.

### Calculation of borrowing cost to be capitalised

Some candidates who explained the requirement of the standard in general made errors in the calculations. Some of the common errors observed are stated below.

- The borrowing was specific for the project as per the question. However, many candidates computed the weighted average cost as if general funds have been used to finance the project, computing a capitalisation rate instead of using the specific rate which was 9% e.g.:  $(45 \times 9\% / 55 \times 10\% = 9.55\%)$ .
- Interest was computed not on the total borrowing Rs. 45 Mn but only on the costs incurred, i.e. 15 Mn.
- Bank loan which was not utilised was also taken in the computations. (e.g. Rs 55\*10%)
- Interest for the total period (8 months) was capitalised instead of for 7 months. i.e., borrowing costs incurred prior to commencement of the project also capitalised.
- Similarly, total investment income was deducted from interest expense instead of 7 months interest income.
- Some other candidates did not perform calculations based on the figures given in the question. They only explained how to calculate borrowing costs. Therefore lost marks for not performing the calculations using the given information.

### WIP

- Some candidates missed out to mention that all expenses incurred cannot be capitalised under WIP.

#### (b) **SLFRS for SME**

It was observed that candidates were not aware of the situations when SLFRS for SME can be used.

A considerable number of candidates answered that since the Parent company is a PLC the group should adopt the same accounting standard and therefore all the companies have to comply with full SLFRS in their own financial statements.

For S & S (Pvt) Ltd - most candidates identified that this company does not have public accountability and therefore can use SLFRS for SME. However continued to mention that although it is so they need to follow full SLFRS because it will have to be consolidated with the Parent company. These candidates, (which was a majority) did not have a proper understanding of the requirement i.e. , the " for the consolidation purposes the parent company will still need to do only the **adjustments** required by full SLFRS" and there is no prohibition in using SME standards in preparing the individual companies financial statement.

Some irrelevant answers were also seen. These candidates explained points such as criteria for identifying SME, criteria for preparation of consolidated financial statement.

(c) **EPS calculation**

It was noted that some candidates do not have a clear understanding of Basic EPS and Diluted EPS.

Poor knowledge on the adjustments for previous year on bonus issue e.g.: most of the candidates made errors in restating the previous year EPS.

Some computed the weighted average number of shares in computing the Basic EPS for 2017 which indicated very poor technical knowledge.

Without restating the EPS in the year 2016, some students have calculated the basic EPS for two years and the difference between the years was considered as the diluted amount. (e.g.:  $800/1 = 800$  and  $920/2 = 460$ . Diluted amount =  $800 - 460 = 320$ )

**Question 02**

In part (a) Financial Instruments standard was tested for 15 marks under two separate scenarios (a compound instrument and the second scenario on hedge accounting) and part (b) for 10 marks was on internally generated Intangible assets.

The overall performance on this question was not good. Majority scored satisfactory marks for part (b) of the question which was very easy (LKAS 38) and obtained some marks. However performance on part (a) was unsatisfactory. It was noted that some candidates did not attempt part (a) at all.

Both parts required the candidates to **advise** the management. It was noted that candidates are very weak on explaining why a particular treatment is chosen. However, most candidates either just wrote the standard and did not justify the positions relating to the information given in the scenario or alternately just performed calculations. 50% of the marks were allocated for the advice (which was as it should be) and candidates failed to score these marks.

(a) **Convertible Debentures**

In this question there were many instances where the candidates directly proceeded to the conclusion without any explanation. This was a compound financial instrument and, candidates did not provide as to why split accounting is needed.

Lack of technical knowledge - Incorrect rate used in calculating PV (9.39% instead of 9%)  
Many candidates explained the subsequent measurement of the debt component, but did not mention that equity is not re-measured.

Some candidates performed the calculations but failed to point out that the accounting method followed was incorrect – e.g.: Issue cost 2 Mn charged to P & L was incorrect.

**Hedge accounting-**

This was a very open question where candidates could have justified the scenario taking up several positions.

Majority of the answers were based on hedge accounting which was the treatment suggested by the Treasury Manager as per the information given in the question. However a candidate could have taken up the position that this is a derivative and recommended the accounting

treatment based on accounting for derivatives. There were a few candidates who answered taking this position. Since hedge accounting is optional and the question was open, the candidates who justified properly and provided advice were also awarded the total marks. Majority of candidates were not able to justify the choice of cash flow hedge. In order to designate as a cash flow hedge **all** the criteria need to be fulfilled (as per para 85, LKAS 39). However, most candidates justified only based on the effectiveness. These candidates lost a considerable amount of marks.

Many candidates made errors in the accounting entries. Some justified for a cash flow hedge but produced entries for accounting for a derivative, showing a lack of technical knowledge.

(b) Internally Generated Intangible assets – (Patent Right)

This part was answered well by the majority. However some of the common mistakes seen are given below.

- The question required the candidates to provide advice. However, some candidates listed out the items of expenses and mentioned whether it could be capitalised or charged to the P & L ( i.e. Research or development)
- A majority of candidates failed to identify that the cost of improvement to the Plant needed to be capitalised under PPE and does not form part of intangible assets. Very few candidates identified this properly.
- It was noted that candidates repeated the same point in different places and wasted much time in building an answer, and in the process missed out to explain some of the expense items incurred.

### Question 03

Overall performance was disappointing. Less than a handful of candidates scored marks between 25-27. None scored beyond that. The main reasons for weak performance can be summarised as Not understanding the question properly, Lack of technical knowledge, answers produced not being focused on the question asked (corporate governance code written in general), pre- planned answers being reproduced which is irrelevant ( ratio analysis) .

Some common mistakes are stated below.

In the question part (a)

Candidates were required to evaluate the impact on the controlling power of QPL based on 2 separate financial strategies. Most candidates focused either only on one strategy or mixed up both and considered both as one single strategy.

The question specifically required the candidate to state any other factors or information that is needed to be evaluated to determine control. Most candidates did not identify these and lost on average 4 marks.

It was requested to explain the financial treatment in **THP's books** of both strategies. Many explained only on strategy 2 and a further considerable number of candidates answered from **QPL's perspective**.

The following common mistakes made by candidates in the computation of goodwill. (Deferred tax on fair value increase on building not considered by anyone, adjustment on intangible asset acquired

in business combination (Separability) not understood, how to treat an operating lease in which the acquiree is the lessor, not considering new share issue in the calculation) On average a majority lost 4 – 4 ½ marks (out of 10 ½ marks allocated for that part).

#### In part (b)

With 11 marks on ratio analysis, it was required to criticise the figures on revenue and GP margin. However candidates produced pre-prepared answers based on the pre seen information. And they commented at length on finance cost, admin expenses and ROE etc., in criticising the GP.

Candidates were unable to provide analysis on factors/ reasons that affected revenue or GP, but just commented on the % increase or decrease. Marks obtained was very poor for this part.

#### In part (c)

Most candidates failed to demonstrate how the suggested strategies would lead to improving the long term solvency by comparing given ratios with either the existing ratios (of the Company) or with industry ratios.

#### In part (d)

Candidates required to evaluate whether appointing outside directors and appointing an audit committee will strengthen the internal control system. However the candidates had written about the composition of the board, independence and audit committee responsibility of financial oversight without addressing the issue in the question. Hence, 6 marks which could have been easily scored was missed out by the candidates.

It was noted that a majority of the answers were not focused on the question.

#### In part (e)

Questions on ethics was also answered poorly. Some candidates wrote the ethical responsibilities of the organization whereas the question asked about the violation of ethical principles by Lasantha (Chartered Accountant). Many candidates failed to address the safeguards. A majority scored either one or two marks out of the 4 marks allocated.

Most candidates identified that there is a conflict of interest. However they were unable to highlight the possible safeguards that can be applied in that scenario.

Overall in the answers it was observed that candidates are very poor at structuring an answer. Further properly reading the question, analyzing the given points and building a relationship within the scenario is not practiced by the candidates. Therefore unstructured answers, directly jumping from a mid-point without constructing a proper answer, missing out some of the facts in the case were evident in many scripts.



## KC2 – Corporate Finance and Risk Management

### December 2017

#### Examiner's Comments

#### Question 01

##### 1. Understanding / comprehension of the question

##### a) Instances where Information given in the question was not understood by the candidates.

Following statements in the question seems to have not been understood by many candidates.

- i. "PLC has decided to go for a share split, splitting each share into 3 new shares". Some students have considered the number of shares after the split as 4 times of the existing shares.
- ii. "Immediately after the announcement, the share price adjusted to reflect the share split". Some students have considered the new share price as Rs. 630/- instead of Rs. 70/-
- iii. "Since this triggered the mandatory takeover code, Accenture had to make an offer to all shareholders.....". Most of the students had taken the holding percentage of 85% instead of 75%. (i.e. including Simdi, who declined to sell its shares originally).
- iv. "Accenture paid two times of SSL PLC's book value for its shares, resulting in a sizeable goodwill". Most of the students had not understood this statement. E.g. part (e).

##### b) Instances where the requirements of the question were not understood by the candidates.

In part (a) students were required to **assess** the shareholding structure before and after the share split, the price per share post-split and its market capitalization. Some students have not clearly mentioned the share structure and the number of shares before and after the split. Some candidates have stated only the percentage of holding.

In part (e) students were required to **discuss** by computing the goodwill, how the financial controller of Accenture could justify this acquisition and whether any

impairment of goodwill could arise from this transaction. Many students had not understood the question.

## 2. **Shortcoming / mistakes in candidates' answers**

### a. **Errors in principles/ shortcoming in technical knowledge**

- i. In part (c) EBITDA and EBIT has been messed up.
- ii. Most of the candidates have not done part (d) of the question correctly. Instead of calculating the transaction cost pertaining to each transaction separately, it was taken together. E.g. Brokerage cost & regulatory fees charged on total investment value.

### b. **Mistakes made in application of concept, formulae**

- i. In part (b) to arrive at the investment value, the transaction cost had been added instead of deducting it.
- ii. In the working capital calculation, the sales value had been used to calculate Creditors.
- iii. Almost of all the students were not aware how to compute the impairment of goodwill in part (e)

### c. **Common mistakes made by the students**

- i. Part (a), students have incorrectly computed the post-split no of shares as 100 Mn. (1 in to 3 taken as 1+3). For the purpose of valuation, the share price was taken as Rs. 630/- instead of 70/- (210 x 3). Candidates had not clearly assessed the shareholding structure before and after the split, the price per share post-split and its market capitalization as required by the examiner. E.g.: only the share structure was given.
- ii. In part (b) to arrive at the investment value, some candidates had calculated the transaction cost on the revenue value of Rs 50 billion. Some had added the transaction cost to the sales proceeds.
- iii. In part (c), students made mistakes in arriving at the EBITDA and EBIT. More than 50% of the students made mistakes in calculating the finance cost. In the working capital calculation, instead of taking  $2/12$  (i.e. 2 months divided by 12 months), candidates had taken it as  $2/365$ . This was a very common mistake made by a large number of candidates.
- iv. In part (d) most of the students have taken 85% as the holding percentage, instead of 75%.
- v. In part (e), the goodwill calculation was either not attempted or most of the calculations were incorrect. E.g. multiplied the total transaction cost by 2. Calculate goodwill using their accounting knowledge.
- vi. Made mistakes in extracting information. Students seems to be confused over the figures given e.g. Rs 50bn has been taken as 5000mn. Some have used all 11 digits for the calculations e.g. 50,000,000,000.

### d. **Building / planning of the answer**

Except for a few candidates, most students had just written without proper planning.

## 3. **Good side of the answer produced**

Students who read the question properly, have scored high marks without much difficulty. Average marks earned about 15 out of 25.



4. **Any other comments to be communicated to the students**

At this level it is essential to be updated with business world transactions. Students should be clearly aware about the number of zeros per million, billion and to select the correct denominators for the total proportions.

**Question 02**

1. **Understanding / comprehension of the question**

a. **Instances where Information given in the question is not understood by the candidates**

- i. Only a very few candidates were able to identify the overtrading position explained in the question, almost all the students have not identified the short term fund investment in long term assets. Most candidates were also unable to identify the cash drop of Rs. 400 million.
- ii. In part (b), students did not understand the saving of interest in alternative 2 & 3 by speeding up recoveries through discounting or factoring.

c) **Instances where the requirements of the question were not understood by the candidates.**

In part (a) the question required the candidate to analyse the financials to identify the root causes of the poor liquidity position. Students are required to support their findings with ratio analysis. However students had directly computed the ratios (mostly liquidity ratios) and explained the positive and negative effect on liquidity.

2. **Shortcoming / mistakes in candidates' answers**

a. **Errors in principles/ shortcoming in technical knowledge**

- i. Students are not familiar with the ratios and errors were observed in the calculations.
- ii. Not identified the overtrading position.
- iii. Not identified the long term investment on fixed assets from short term funds
- iv. Ratios calculated using average figures. But there is no opening figures for 2016 to compute the average
- v. Some students were under the impression that dividend is a compulsory payment.

b. **Mistakes made in application of concept, formulae**

- i. Wrong figures extracted for formulas.
- ii. Instead of calculating the Ratios for each year separately, some candidates calculated on the average values. As a result there was no basis for comparison.

c. **Common mistakes made by the students**

- i. Monthly savings were not annualized for computations. E.g. Annual interest charge on the loan compared with the monthly saving on bank charges etc.
- ii. Computing the ratios but not explained the implication on liquidity
- iii. Not evaluating the options of part (b) properly

- iv. Some students have not considered the saving on alternatives given under part (b) but had only taken the cost. E.g. 22% on 120 mn not considering as a saving, 15% on 120 mn was considered as a cost
- v. When calculating the cash discount of 2.5% some candidates had taken the debtor balance of 550 instead of sales of 3100 mn
- vi. When calculating the cost saving on debtors under cash discounts, some candidates had taken 20 days, which is the standard credit period of 30 days minus 10 days for cash discount.

d. **Building / planning of the answer**

Students attempted the question satisfactorily in terms of calculations but were not good in making their recommendations/ recognizing of other factors/ analyzing and interpretation of the computations.

3. **Positive aspects of the answer produced.** Average marks earned 14 out of 25

**Question 03**

1. **Understanding / comprehension of the question**

a. **Instances where Information given in the question is not understood by the candidates**

It was observed that a fair number of candidates have not understood the methodology to answer the following parts of the questions.

Part (a): FCF based valuation of the QPL and evaluation based on that approach (7 marks)

Part (c): Evaluation of the proposed expansion project (16 marks). Students were unable to understand the different calculations applicable to present the business and expansion project. There was also confusion in the application of 3 WACC to the project with additional new debt capital.

Part (b): Impact on the capital structure due to the addition of Rs. 20 million debt. (6 marks)

d) **Instances where the requirements of the question were not understood by the candidates.**

The candidates have not understood how to evaluate the proposed expansion project in part (c) of the question. None of the candidates had correctly calculated the WACC of different years. This was a new area and the candidates were unable to apply the year by year different WACC due to a lack of understanding.

2. **Shortcoming / mistakes in candidates' answers**

a. **Errors in principles/ shortcoming in technical knowledge**

- i. Many candidates did not have the required technical knowledge on the FCF approach calculations and WACC calculation for part (a) and (c) of the question.
- ii. The impact on the capital structure after the new addition of debt was not answered in part (b) and only the computations were done.
- iii. Candidates have considered the obtaining of the loan and settlement of the loan in the cash flow, which is a fundamental error in project analysis.
- iv. It was noticed that most candidates were not able to compare the correct beta factor of an unlisted company using levered beta, even though the information was given in the pre-seen (which could have been done prior to the exam)

- v. Candidates displayed very poor knowledge in advising QPL to make an appropriate decision in capital introduction due to the poor knowledge in venture capital and private equity firms. Some had confused private equity with private placement.

**b. Mistakes made in application of concept, formulae**

- i. Candidates have done a project evaluation rather than using the FCF formula to calculate FCF
- ii. No proper calculation of the terminal value in part (c).
- iii. Not using the growth model formula correctly in computing the firm value after calculating FCF.
- iv. After arriving at the firm value not deducted the debt value of the firm to calculate the equity value.

**c. Common mistakes made by the students**

- i. When candidates write essay type answers, they waste time in interpreting irrelevant data.
- ii. Extracting information from the pre-seen was very weak in general.
- iii. Due to poor time management candidates have missed easy questions like part (e)
- iv. In part (a) for the FCF basis valuation, used 5 year forecasted revenue instead of the year 2017 unaudited revenue + 4.5%.
- v. Again in part (a) Some candidates had just arrived at the asset based valuation, by merely indicating the stated equity of Rs. 55mn given in the pre-seen page 11, without the adjustments required by page 8 of the paper.
- vi. With regard to part (b) of the question, it was required to comment on the impact on capital structure using operational and technical information. Most of the answers were limited to the calculation of new WACC.
- vii. In part (c) the question, almost all the candidates failed to gain on average not more than 5 marks out of 16. The question was either not understood or misinterpreted.
- viii. Many candidates had written irrelevant answers for part (d) (i) & (ii) parts of the question. E.g. Except for a few candidates, most answered stating “agreeing to the MD’s idea and to select PEF or VCF to raise funds through an IPO
- ix. In part (d) (ii), it appears that most of the answers were based on part (i) of the question, which is irrelevant. E.g. It appears that candidates missed the most important part of the question, which is “through an IPO”.
- x. In part (e) of the question, almost all the candidates did not justify/validate the “findings. Only the calculations were done.

**d. Building / planning of the answer**

Other than those who got more than 15 marks for this question, other candidates did not have any idea on how to build the answer. They failed to realize the correlation between part (a), FCF approach and part (c) of the question. Most of the candidates answered part (e) successfully.

**3. Good side of the answer produced**

Overall, except for a few, others failed to produce good answers for part (a) FCF, (b), (c) & (d). However there were plenty of accurate answers on hedging option calculations in part (e) of the question.

4. **Any other comments to be communicated to the students**

- Poor time management was observed. Candidates need to improve their time management skills.
- Candidates should limit their answers only to the point, calculation, narration required in the question.
- It's a habit of the candidates to answer the question without reading it properly. E.g.: part (a),( c ) &( d)
- Candidates have to prepare for the examination well before exam. E.g. With regard to the calculation of WACC for part (a) of the question, candidates could have calculated the unlevered and levered beta even prior to the exam. (adequate information given in pre- seen of page 7).
- Candidates should study all the topics in the syllabus. Mere selection of a few possible topics and studying it is risky. It appears that a majority of candidates may have not studied the FCF approach before the examination.

## **KC3 – Corporate Taxation**

**December 2017**

### **Examiner’s Comments**

#### **General**

In overall, the candidates had made a good attempt at the questions and were satisfactory compared to previous examinations. Candidates clearly found question 2 particularly challenging.

Majority of candidates had answered using a methodical approach to questions and thereby were able to produce reasonably focused, relevant answers (other than question -02) addressing the principal and core components of each requirement.

It is advisable that students be able to prepare a comprehensive tax computation. They should also be able to compile a proper answer and advice on tax planning, decision making on minimizing tax expenses and mitigating risks and effective communication with tax authorities, clients and the management etc. Therefore, displaying mere technical knowledge is not adequate at this level.

Being an open book examination student’s level of presenting their answers in line with the required standard in terms of technical & legal aspects did not fully meet with the expectation.

Students are expected to be more focused on the structure of the paper since three questions were based on scenarios. Therefore the answers should be presented in a manner in line with the expectations and it is recommended to address the action verbs, expected learning outcomes, knowledge processes, knowledge dimensions etc.

The under mentioned reasons may have had an adverse influence on student performances;

- Lack of preparation connected with the Pre-Seen case study materials.
- Lack of understanding the requirements of the questions (not focused on action verbs)
- Producing irrelevant facts and thereby running out of time.
- Lack of knowledge on the recent amendments to the Inland Revenue Act.
- Lack of communication and presentation skills.

## **QUESTION-WISE COMMENTS**

### **Question 01**

**General Comment:** As a whole this question was answered well and the majority of candidates were able to complete it. Most candidates scored more marks on this question.

The Commonly observed weaknesses of candidates were;

- Lack of knowledge on amendments to VAT & NBT.
- Misunderstanding & errors in calculations.

#### **Part-(a) (i)**

A majority of candidates recognized that conducting Seminars on awareness programs in order to attract students are not treated as educational services. Many candidates demonstrated relevant knowledge on the application of concessionary tax rates and thereby concluded that the applicable 10% concessionary rate on educational services could not be applied to the seminar income.

A few candidates clearly understood the situation and applicability of other concessions prevailing at the time under Section 59B and proved their skills in analyzing, making decisions based on the information given.

A hand full of candidates were ignorant about the applicable year of assessment which was 2012/13 and the applicable tax rate under Section 59B which is 10%. Thereby the prevailing rate of 12% was incorrectly applied and candidates lost easy marks.

#### **Part-(a) (ii)**

On the whole, candidates scored well on this part of the question. The majority of candidates recognized that the service income from seminars does not fall in the category of education income, hence the VAT exemption is not available on seminar income.

#### **Part-(a) (iii)**

Candidates who attempted this part of the question generally made a reasonable attempt at identifying whether educational services are NBT exempted or not. A fair number of candidates have clearly identified that the NBT liability does not arise if the liable turnover of educational income does not exceed Rs. 25Million per quarter.

However a few candidates were ignorant of the Rs. 25Mn threshold. Important fact that, Educational Income exceeding 25 Million and thereby Seminar Income automatically is liable for NBT.

Only a small number of candidates were able to describe the consequences of nonpayment of NBT.

#### **Part-(a) (iv)**

A very high proportion of candidates were unable to give an exact answer on the time bar provisions that was expected.

Majority of candidates incorrectly stated, about the 18 months prevailing time bar period applicable for income tax matters and thereby arrived at an incorrect conclusion.

The time bar provisions applicable for VAT & NBT were identified and the correct conclusions were stated.

### **Part (b)**

This part of the question tested the penal provisions in the Inland Revenue Act applicable to Accountants, Auditors and Tax Practitioners. Almost all candidates were successful in stating the applicable penal provisions.

As a general comment, some candidates had a tendency to simply list out the penal provisions but did not quote the applicable section of such provisions whereas some had overlooked and not noted that the question required only to outline the provisions applicable to Accountants, Auditors and Tax Practitioners and thereby wasted time on stating facts on other similar provisions applicable to any person.

### **Part (c)**

This part of the question was answered very well, with the majority of candidates achieving the allocated marks.

Majority of candidates stated the basis and due dates of Income tax payments and penalties applicable for late payments. A very few candidates did not state, about the balance tax payment date of on or before 30<sup>th</sup> of September to avoid further penalty and lost easy marks allocated.

## **Question 02**

**General Comment:** This question was not well answered by the candidates when compared to other questions, particularly the elements of the question dealing with the assessing of the income tax liability of a non-resident person, double tax treaties & personal taxes.

Candidates who scored well had carefully read and interpreted what the question was asking for and were succinct in their responses, making their points clearly and concisely.

Some candidates spent a significant amount of time writing lots of detail about a subject based on their knowledge which, if not relevant to the question and scenario outlined, did not score marks.

The Commonly observed weaknesses of candidates were;

- Lack of knowledge in chargeability of Income tax on non-resident persons.
- Inability to support the answer by giving facts.
- Poor references to relevant sections of IRD Act and building the answer accordingly.
- Misunderstandings & careless mistakes in calculations.

### **Part (a) (i)**

Fair number of candidates knew that the profits arising on contracts entered into by the Non Resident Company with their customers in respective of other countries are liable to income tax in Sri-Lanka. Although this question required discussing the contents of the case law of “Anglo Persian Oil Company” which is similar to the circumstances given in the scenario and subsequently the same case law was superseded by section 84 of the Inland Revenue Act. Only a very few candidates identified and addressed the relevant case law facts (Anglo Persian Oil Company) as expected.

Instead many candidates had written about the “shivas” case and tried to relate the contents which are remotely connected with the scenario.

Only a very few candidates were able to secure at least 80% of the marks allocated for this part.

### **Part (a) (ii)**

The majority of the candidates struggled with this part but a limited number of students were able to clarify such liabilities to income tax based on Article 7(3) of DTA between Sri Lanka & China.

### **Part (b)**

In this part, the tax computation of a Non Resident Company was given and the candidates were required to assess the Income Tax liability for the Year of Assessment 2016/17 based on statutory accounts of Calendar year 2016 and to calculate the Remittance Tax as well.

Candidates seemed to have dealt reasonably well with this computation. A pleasing number of candidates correctly computed the required Income tax liability & Remittance Tax Liability despite the fact that a few candidates seemed to struggle with the computing of the Deemed Additional Profits.

The common mistakes that were observed are as follows;

- Overlooked the readily given information of Net Profit of Rs. 118 Million and instead worked out Revenue-cost of Sales – Expenses and thereby wasting unnecessary time on the calculation.
- Export income of car seat belts to all the plants of BCMC China for the newly manufactured cars are not considered when deemed additional Profit is calculated.
- Had not identified the Head Office Expense limitation of 10% of the total Income or actual expense whichever is lower.
- Many applied incorrect income tax rates.
- Completely omitted the calculation of Remittance Tax or did not consider the export sales proceeds of the Sri Lanka Branch retained abroad.

### **Part (c)**

This part of the question is connected with Personal taxation. Almost all candidates were successful in identification of the residency status. Overall performance for this part of the question was good and candidates got more marks.

A hand full of candidates identified that the non-resident person would be liable to Income Tax in Vietnam only in respect of Profits & Income arising in or derived from Vietnam.

Some candidates incorrectly stated that taxes paid in Sri Lanka could be claimed as a tax credit in Vietnam.



## **Part (d)**

The majority of candidates struggled with this part of the question and mixed-up the changes that took place during the year 2016. Many did not know the VAT liable limit of income during the period tested in the question.

Many of the candidates had the applicable VAT rates for the given period and related turnover limits. However, some of them had mentioned that “Renuka” is required to register for VAT as his quarterly supply had exceeded the limit.

In computing the VAT payable by Renuka, after mentioning about the registration, some students had done detailed numerical calculations, taking the figures in the question which was not necessary and wasting their time. Students are strongly advised to read what is required in the question and in this part the action verbs used were “recognize the chargeability” and “Advise”.

## **Question 03**

### **General**

The overall performance was satisfactory compared with previous examinations.

### **Part (a)**

In this part, tax computation of a Limited Liability Company was tested and the candidates were required to assess the Income Tax liability for the Year of Assessment 2016/17.

This question was a computational question and the candidates scored well, particularly in relation to the disallowable items and capital allowances etc.

### **Good performances that were observed are as follows:**

- Majority of candidates were successful in forming a methodical answer
- On the whole the calculation of allowable/disallowable expenses such as advertisement, business promotions, entertainment, donations, and legal fees, repair etc. was dealt with well
- Despite the fact that a few candidates made mistakes in recognizing allowed and disallowed expenses majority of them made the adjustments accurately.
- The capital allowances computation was dealt with very well and most candidates attained close to full marks.
- Accurate adjustments were made to the provision for gratuity.
- Most candidates were successful in correctly adjusting other sources of income.
- Some candidates were silent on adjusting the rent income and some clearly indicated that since it is part of Business Income and hence no need to show as a separate source of income. However many of the candidates displayed their knowledge on disallowing repair allowances restricted to 25 % on gross rent income of a Company.

### **The common mistakes that were observed are as follows:**

- Some candidates have not identified that the advertisements published in newspapers to sell the land is of capital nature and hence fully disallowed for tax purposes.
- Few candidates had not identified that the advertisement on staff recruitment of Rs. 50,000/- is 100% allowed for tax purposes.

- In some cases the rent income is not recognized as a part of business income and treated as a separate source of income.
- A handful of candidates knew that repair allowance against Rent Income of a Company is limited to 25% of Gross Rent Income or actual expense whichever is lower.
- Although many candidates properly identified the disallowed portion on foreign travelling expenses, very few candidates allowed the air ticket allowance of 100% saying it is meant for incentives.
- Many students misunderstood the business promotion and disallowed the whole expenditure instead of disallowing 25% of it.
- A handful of candidates knew that Legal Fees on lease Agreement signed to lease out standalone shops should be allowed as the Act does not disallow it.
- Very few candidates incorrectly identified the foreign exchange gain as a separate source of income and thereby it has been disallowed and added back.
- Some candidates accurately calculated the adjusted tax profit/ (loss) on disposal of two vehicles and have not done any adjustments in the tax computation for the second vehicle that is sold to wife. (Considered it as allowed which is incorrect treatment)
- Some candidates have not identified the applicable 28% tax rate in the calculation of income tax liability.
- Most candidates disallowed the finance loan interest of Rs. 12,235,000 paid on a bank loan taken to procure the fixed assets for standalone shops opened in the year of assessment 2015/16 ignoring the fact that now it is allowed under section 25.

### **Part (b)**

The question tested knowledge for calculating distributable profit.

A good proportion of candidates were able to answer this part successfully.

#### **Good performances that were observed are as follows:**

- Most candidates have correctly computed the distributable profit.
- Most candidates have correctly calculated the Depreciation on capital asset acquired during the Y/A 2016/2017.

#### **The common mistakes that were observed are as follows:**

- Some candidates have not taken the correct book profit before taxation to calculate distributable profit  
Very few candidates have incorrectly calculated Depreciation on capital assets acquired during the Y/A 2016/2017.

### **Part (c)**

Question required advising the accountant, giving an opinion about the gain from the disposal of a land by referring to appropriate provisions in the local tax statute and relevant case laws.

Most of the candidates have answered this part successfully and only a small number of candidates were not able to score marks.

**Good performances that were observed are as follows:**

- Most of them have identified the relevant case laws and knew that the gain from disposal of land is a capital gain and is not taxable.

**The common mistakes that were observed are as follows:**

- Very few candidates have not identified, the relevant case laws and they incorrectly argued indicating the gain from disposal of particular land is not a capital gain therefore it should be taxable.
- Although some of them argued accurately were unsuccessful in presenting the final conclusion and thereby lost some marks.
- Some candidates did not describe the relevant points such as nature of trade, isolated transaction, period of transaction, profit motive etc..... to gain more marks.

**Part (d)**

The first part of the question required the students to compile a brief memorandum to the board of directors of QPL explaining whether the position taken by the Assistant Commissioner is correct or not with regard to the issue of the notice of intimation in respect of VAT, and to recommend the course of action that should be taken.

Most of the candidates have answered this part successfully.

**Good performances that were observed are as follows:**

- Most candidates identified the relevant section of the Inland Revenue Act and gazette notification.
- Most candidates successfully recognized the applicable incomes that are liable for VAT and applicable exemptions available.
- Most candidates correctly identified that the input VAT could be claimed only on liable sources.
- Most candidates correctly argued that the Assistant Commissioner is correct and the intimation letter has a valid base.

**The common mistakes that were observed are as follows:**

- Some candidates did not identify the relevant section of the Inland Revenue Act and gazette notification.
- Some candidates incorrectly argued saying the company has received foreign currency and therefore the entire sale is exempt.
- Very few candidates incorrectly described the appeal procedure for VAT assessment
- Most candidates did not give recommendations although it was required to give the course of action.
- Very few candidates gave an incorrect opinion about the Assistant Commissioner's letter.

## **Part (d)**

Question asked to advise on the tax and regulatory implications due to the unethical practice of purchasing grocery items at inflated prices under the deferred settlement scheme from the proprietorship owned by the managing director's wife, and the action they could take in the future. The majority of candidates struggled with this question but a very few scored highly.

### **Good performances that were observed are as follows:**

- Some of the candidates had mentioned the relevant sections of the Inland Revenue Act.
- Few of the candidates recognized that the transaction is between two related parties and hence should be at arm's length price.

### **The common mistakes that were observed are as follows:**

- Some candidates have described unnecessarily the type of pricing methods applicable on transfer pricing.
- Most candidates were unable to advise the possible action that could be taken in the future.

# **KC4 – Corporate Governance, Assurance and Ethics**

## **December 2017**

### **Examiner’s Comments**

#### General comments

This paper consisted of two sections. Sec 1 carried two questions for 25 marks each and Sec 2 carried one question with 50 marks which is based on a pre-seen. Overall performance is not up to the expected standard. The candidates preparing for this exam should relate the number of points to the marks available, as most of them demonstrated poor time management. A number of common issues were observed in the answers that contributed to the disappointing pass rate such as;

- Lack of application skills
- Not delivering the question’s requirement
- Not planning the answers
- Not following the action verbs

#### Specific comments

##### **Question 01**

Majority of the candidates have not performed well in this question.

##### **Part (a)**

The examiner expected the candidates to propose significant audit areas that should be reviewed by the engagement of quality control review partner referring to the scenario. The candidates demonstrated poor technical knowledge on quality review in accordance with SLAuS 220. Many candidates were unable to differentiate the function of the quality review partner from the engagement partner. There were some candidates who wrote what is to be done by the quality review partner just copying from the SLSQC 1 sec 38. Some candidates have identified the significant audit areas in the given scenario but failed to write how the quality review partner reviews those, as a result got less marks. Some candidates have wasted time in explaining business risks in the given scenario. Some candidates who did not have any knowledge on quality review and produced irrelevant answers such as;

- Quality review partner should review the internal controls
- Communicate the issues to the management
- Comply with rules relating to listed company
- Nature, timing and extent of audit procedures
- Procedure for setting targets for Lak Power Plc

## Part (b)

In this question it was required to evaluate the modification required to the initial audit plan of the company. Candidates were expected to address the issues that were identified by the engagement team. Initially the audit team had identified only revenue recognition and management override as risk areas. The examiner expected the candidates to evaluate the subsequent findings such as going concern, impairment, component depreciation which have an impact on the audit. Many candidates had failed to understand why modification is required to the audit plan and wrote audit procedures for each risk area without specifying that modification is required to the initial audit plan and wrote;

- Increase the control tests carried out, without mentioning the requirement to carryout substantive tests
- Modify the audit opinion

Some candidates have produced general answers such as;

- Consider nature, timing and extent of planned risk assessment process
- Consider the other procedures to be followed

There were common irrelevant answers such as;

- Assign engagement teams with quality
- Relevant ethical requirement

## Part (c)

(1) It was required to evaluate the matters to be considered to decide in producing an assurance report on the non-current assets of the company. The examiner expected the candidates to write elements of assurance engagement which are in existence. Candidates could have easily scored marks if the SLAuS framework on assurance engagements was followed. The majority of the candidates ignored the action verb to evaluate although they identified that such an assurance engagement has to be carried out in terms of SLAuS 805. Some candidates have written the considerations when accepting the engagement referring to SLAuS 805 such as;

- Comply with relevant ethical standards
- Compliance with the requirement SLAuSs relevant to the audit
- Acceptability of the Financial Reporting Framework
- Form of opinion

Some candidates wrote irrelevant answers such as;

- Auditor should not provide an assurance report on the non-current assets of the company as a self-review threat will arise
- The assurance engagement should be an agreed upon procedure according to SLSAE 4400
- The auditor should not provide such a report as it involves valuation of non-current assets and as per code of ethics auditor should not carry out valuation of assets

(11) It was required to advise how the auditor could mitigate the possible misunderstanding by a reader of such a report. Many candidates were unable to understand that when an assurance engagement is performed on non-current assets, the readers may confuse it for a full audit. Although they have identified that SLAuS 805 applies in this regard they failed to understand that this is regarding single financial statements and specific elements. They have produced irrelevant answers such as;

- Discuss with management
- Mention auditors responsibility and management responsibility clearly
- As it violates ethics must appoint a separate audit team.

## Question 02

### Part (a)

In this part of the question examiner tried to test the knowledge of the candidates on how the internal auditor can contribute to the risk management process of an entity. Almost all the candidates have attempted this question and some have given satisfactory answers. Some have ignored the fact that the internal auditor should be independent of the management, and written that the internal auditor can get involved with the management functions such as;

- Help to control complex areas
- Develop strategic plan
- Develop risk management strategy

Majority of the candidates did not have a clear idea about the scope of the internal audit as a result they wrote management functions as the work of internal auditor and the special functions of the internal auditor without relating to risk management such as;

- Investigation of special matters
- Conducting forensic audit

Some have answered using the given scenario as;

- Carryout forecasting of Foreign Exchange rates
- Checking accounting records
- Prepare action plan for handling cash of Lora

Some candidates have wasted time in writing the tasks that the internal auditor should not do such as management functions. The candidates should be trained to plan to focus their answers to the relevant specific points.

### Part (b)

In this part of the question the candidates were required to identify the possible business risks in the given scenario. Candidates were required to identify the risks and explain the nature of the risks. Only a few candidates have explained the risks. Some candidates have identified the audit risks as risks and explained in detail and given the impact and the mitigation plan accordingly. But the examiner did not expect the candidates to identify the audit risks. Candidates have stated the following audit risks and not obtained marks.

- Revenue recognition
- Accounting of lease agreement finance & operation risks
- Cutoff procedure
- Non availability of segregation of duty- payroll preparation

Some candidates had identified business risks which are not directly relevant to the issues in the given scenario such as;

- Ownership of the organization
- Reputation risk
- Credit risk
- Loss of staff

Some have identified the correct business risks but they have failed to explain such risks, as a result obtained fewer marks.

### Part (c)

In this part of the question it was required to recommend tests of controls for inventory and cash management. Those who have studied the textbook had given relevant answers. Many candidates were able to secure full marks. There were some answers giving only one control instead of two controls. Some candidates have misunderstood the question and had written controls instead of tests such as;

- Introduce bar coding
- Change the time to deposit cash
- Appoint an independent person to check the receipt of cash and its recording

### Question 03

#### Part (a)

(1) It was required to comment on available SLAuS to structure an assurance engagement to meet with the objective of providing the required certified 5 year forecast. In this part of the question the examiner expected the candidates to recognize that there is no direct SLAuS for the performance of assurance engagements other than audits of historical financial information, the SLSAEs may be referred in this regard. Almost all candidates have identified SLSAE 3400 as the suitable type of engagement for reporting of prospective financial information. Most of them were unable to comment that SLAuSs are applied for the audits or reviews of historical financial information not suitable for forecast.

(11) It was required to recommend suitable areas to consider when planning the proposed engagement for QPL. The examiner expected the candidates to consider the suitable areas which are considered when planning all assurance engagements such as,

- Suitable applicable criteria
- Applicable criteria is suitable for the intended use , here to obtain a loan
- Appropriate materiality
- Reports and statements which will be considered by the bank such as;
  - Cash flow
  - Interest cover
  - How the information are compiled,
  - The applicability and basis for assumptions
- Possible sources of evidence and notes

Only a few candidates have addressed such areas instead, most of them have referred to SLSAE3400 and written the areas to be considered. Those who have considered the areas as per SLSAE3400 also obtained marks when they have linked to the scenario. Most of them failed to link to the pre-seen. Most of them ignored the fact that the prospective financial information is prepared for the user which is a bank to grant a loan and the information is based on the assumptions which should be supported with evidence such as basis for assumptions, cash flow statements, interest calculation and details of other expenses.



### **Part (b)**

It was required to advise Kasun on the steps that can be taken to comply with responding to NOCLAR. Although many candidates had written relevant points, they failed to write that the NOCLAR enables Kasun to set aside the principle of confidentiality when there is a strong public interest; as a result they lost 4 marks. There were irrelevant answers such as;

- Inquire whether the staff is competent
- Maintain a register with significant laws and regulations
- Develop a code of conduct
- Initiate appropriate systems
- Seek legal advice

### **Part (c)**

It was required to propose areas of key audit risks which are to be addressed in the audit plan. Most of the candidates produced satisfactory answers, but there were some candidates who just wrote audit risks which are not found in the given scenario.

### **Part (d)**

It was required to evaluate the effect of the issue in connection with setting off of assets under lien with interest bearing loans. Many candidates just wrote that it is incorrect and the audit report should be modified but failed to evaluate the issue.

### **Part (e)**

It was required to evaluate the ethical dilemma that Kasun is faced with as a result of Lasantha's takeover plan. The examiner expected the candidates to address the conflict of interest faced by Kasun and the unprofessional request of Lasantha to deceive the other main shareholder. Some candidates have identified the threat as a conflict of interest but failed to refer to the scenario and explain the required ethical behavior and identify the safeguards that Kasun can apply. Some have produced irrelevant answers such as;

- There is a self-review threat
- Kasun is facing a familiarity threat and intimidation threat

Some have wasted time in explaining theories such as Kohlburg's theory on convention theory, and post-convention theory.

### **Part (f)**

It was required to propose factors that can facilitate good decision making and lead to board effectiveness in the discussion process and the documentation of meetings. There were some candidates who understood the question's requirement and scored full marks. The candidates, who read only the last part of the question, wrote irrelevant answers such as;

- There should be an independent director
- There should be a non-executive director
- There should be committees such as audit committee, nomination committee
- Adopt internal controls
- Separate chairman from CEO
- Maintain Board diversity

## **Conclusion**

Majority of the candidates demonstrated poor technical knowledge, inability to plan the answer and comprehend the question requirement. As this is an open book exam most of the candidates attempted to refer to the standards without planning the answer. Most of the candidates were unable to adequately explain, discuss or describe their points in detail as a result they obtained less marks. Candidates must ensure that they answer the specific requirement which has been set and focus answer points on the scenario. Candidates are also reminded that it is important to have good knowledge of financial reporting, in order to link that to the appropriate audit issues that arise in the question scenario. Candidates are advised to ascertain the marks allocated for each part of the question and allocate time accordingly, as it was observed that some candidates who have answered two questions satisfactorily found little time to answer the 3<sup>rd</sup> question. It was disappointing to note that some candidates who scored good marks for two questions were unable to be successful at the exam due to poor time management.