THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB1 – Business Financial Reporting

December 2017

SECTION 1

Answer 01

Relevant Learning Outcome/s: 1.1.1 and 1.3.1
1.1.1 Demonstrate knowledge of the conceptual framework of Sri Lanka Accounting Standards, with emphasis on: - Objectives of general purpose financial statements. - Underlying assumptions - Qualitative characteristics of financial statements - Elements of financial statements - Recognition and measurement of elements of financial statements - Concepts of capital and capital maintenance, and 1.3.1 Demonstrate the awareness of provisions in corporate governance, Companies Act (section 56, 69, 148 to 171 and 192) and SEC regulations and rulings.
Study text reference: Pages 15, 16, 46 and 47

(a)

(i) The company cannot control an employee as the employee can leave the company at any time, so there can be no certainty about the probability of future economic benefits. Therefore, the cost incurred for the employee does not meet the definition of an asset to be recognised.

(ii) Even though the outcome of the lawsuit cannot be controlled by DPL, as the realisation of income is virtually certain, there is a certainty about the probability of future economic benefits. Since it is virtually certain that the damages claimed of Rs. 10 million will be received by DPL, it can be measured reliably. Therefore, this can be recognised as an asset in the financial statements.

(b) **Audit committee**

The audit committee should comprise of a minimum of two independent non-executive directors (where the company has only two directors on its board), or exclusively of non-executive directors, the majority of whom should be independent, whichever is higher.

The chairman should be a non-executive director appointed by the board

Remuneration committee

Remuneration committee should comprise exclusively of non-executive directors, and should have a chairman, who should be appointed by the board.

(Total: 10 marks)

Answer 02

Relevant Learning Outcome/s: 2.2 (Level B)
Good knowledge and comprehension of the standard to identify moderately complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the analysis and application of standards in resolving a moderately complicated matter related to financial reporting. *Where:* A 'moderately complicated matter' includes transactions and/or events which require an analysis of a matter and evaluation of such matter with the related standard/s.
Study text reference: Pages 622-626

(a) (i) **Accounting treatment of the loan (Section 11 of SLFRS for SMEs)**

Since the loan is not granted at the market interest rate, it should be measured at the present value of future cash flows discounted at a market rate of interest for a similar debt instrument. The difference between the proceeds received and the initial fair value/present value should be charged to the profit or loss account.

Initial measurement of the loan (5mn/1.1)	= 4,545,454
Finance cost (5,000,000 – 4,545,454)	= 454,546

Subsequent measurement as at 31 March 2017 should be at the amortised cost using the effective interest method.

Amortised cost = 4,545,454 + (4,545,454 * 10% * 4/12) = 4,696,970

Finance income for the year ended 31 March 2017 = 151,516

(ii) Non-convertible preference shares should be measured initially at the transaction price of Rs. 2 million . Since these shares are not publicly traded, subsequent measurement should be at cost i.e. Rs. 2 million unless the fair value can be measured without undue cost or effort.

(b) Related party disclosures

- The parent-subsidiary relationship it has with Gold (Pvt) Ltd, irrespective of whether there had been any related party transactions.
- Related party transactions and outstanding balances with the parent and any transactions with other entities under common control.
- Transactions and outstanding balance with the associate.
- Provision for uncollectible receivables and the amount recognised in profit or loss during the year in respect of bad and doubtful debts.
- Key management personnel compensation of Zeena.

(Total: 10 marks)

Answer 03

Relevant Learning Outcome/s: 2.2 (Level B)
Good knowledge and comprehension of the standard to identify moderately complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the analysis and application of standards in resolving a moderately complicated matter related to financial reporting. Where: A 'moderately complicated matter' includes transactions and/or events which require an analysis of a matter and evaluation of such matter with the related standard/s
Study text reference: Pages 305-326

(a) Temporary differences are defined as differences between the carrying amount of an asset or liability and its tax base. The term temporary difference is used because ultimately all differences between the carrying amounts of assets and liabilities and their tax bases will reverse.

These temporary differences either may be taxable temporary differences or deductible temporary differences.

Taxable temporary difference result in increased amounts of tax in the future, and so a deferred tax liability. Taxable temporary differences arise when the carrying amount of an asset or liability exceeds its tax base.

Deductible temporary differences result in decreased amounts of tax in the future, and so a deferred tax asset. Deductible temporary differences arise when the carrying amount of an asset or liability is less than its tax base.

(b) (i)

	Rs.
Accounting WDV = 35,000,000/50 * 46	32,200,000
Tax WDV = 35,000,000 – (35mn * 6.67% * 4)	25,662,000
Temporary difference	6,538,000
Tax liability (6,538,000 @ 28%)	1,830,640

OR

	Accounting WDV			**Tax WDV**		
Date	**Opening**	**Depreciation**	**NBV**	**Opening**	**Allowance**	**TWDV**
1-Apr-13	35,000,000	-	35,000,000	35,000,000	-	35,000,000
31-Mar-14	35,000,000	700,000	34,300,000	35,000,000	2,334,500	32,665,500
31-Mar-15	34,300,000	700,000	33,600,000	32,665,500	2,334,500	30,331,000
31-Mar-16	33,600,000	700,000	32,900,000	30,331,333	2,334,500	27,996,500
31-Mar-17	32,900,000	700,000	32,200,000	27,996,500	2,334,500	25,662,000

Deferred tax liability on building as at 31 March 2017 = Rs. 1,830,640

(ii) **Deferred tax after revaluation**

	Rs. million
Carrying value	50.0
Tax base	25.7
Taxable temporary difference	24.3
Deferred tax (Rs. 24.3mn @ 28%) **(½ mark)**	6.8

(iii) **Deferred tax asset on warranty cost**

	Rs.
Carrying value	2,000,000
Tax base	0
Temporary difference	2,000,000
Tax rate (28%)	
Deferred tax asset	560,000

(Total: 10 marks)

Answer 04

Relevant Learning Outcome/s: 2.2 (Level B)
Good knowledge and comprehension of the standard to identify moderately complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the analysis and application of standards in resolving a moderately complicated matter related to financial reporting. Where; A 'moderately complicated matter' includes transactions and/or events which require an analysis of a matter and evaluation of such matter with the related standard/s
Study text reference: Pages 336, 337, 344 and 345

(a) **Financial statement extracts**

Statement of comprehensive income

	Rs.
Other income – dividend income	150,000

Statement of other comprehensive income

	Rs.
Fair value gain on available-for-sale financial instrument	100,000

Statement of financial position

	Rs.
Non-current assets	
Available-for-sale financial asset	2,100,000
Current assets	
Dividend receivable	150,000

Change in the fair value of shares

FV at the time of purchase (per share)	=	Rs. 20
FV as at 31 March 2017	=	Rs. 21
FV increase	=	Rs. 1

FV of the shares = Rs. 1 * 100,000
= Rs. 100,000

(b) According to LKAS 32, the liability and equity components of a compound financial instrument need to be present separately .

The entity should first determine the liability component by measuring the fair value of a similar liability that does not have an associated equity component.

The equity component could then be determined by taking the difference between total fair value and the fair value of the liability component.

Fair value of the bond issued	=	Rs. 100 * 600,000
	=	Rs . 60 million
Annual interest payable	=	Rs. 60 million * 8%
	=	Rs. 4.8 million

PV of interest for 3 years

1^{st} year	=	Rs. 4.8 million /1.10	= Rs. 4,363,636	***(a)***
2^{nd} year	=	Rs. 4.8 million/(1.10)^2	= Rs. 3,966,942	***(b)***
3^{rd} year	=	Rs. 4.8 million / (1.10)^3	= Rs. 3,606,312	***(c)***

PV of principal repayment at the end of 3^{rd} year = Rs. 60 million * /(1.10)^3 ***(d)***
= Rs. 45,078,888

Total liability component	=	Rs. 57,015,778 ***(a + b + c + d)***
Equity component	=	Rs. 60,000,000 – Rs. 57,015,778
	=	Rs. 2,984,222

(Total: 10 marks)

Answer 05

Relevant Learning Outcome/s: 4.1
Financial statement analysis
Study text reference: Pages 632-667

(a)

- Inconsistent definitions of ratios
- Financial statements may have been deliberately manipulated (creative accounting).
- Different companies may adopt different accounting policies (e.g. use of historical costs compared to current values).
- Different managerial policies (e.g. different companies offer customers different payment terms).
- Statement of financial position figures may not be representative of average values throughout the year (this can be caused by seasonal trading or a large acquisition of non-current assets near the year-end).
- Impact of price changes over time, distortion caused by inflation.
- Ratio analysis is based on historical financial statements.
- Non-financial information is disregarded in ratio analysis.

(b)

MEMO

From: Finance division
To: Shareholders
Date: 24/12/2017
Subject: Financial performance of Decimal (Pvt) Ltd

Profitability

- GP ratio of the company when compared to the industry average is less by ten percentage points. This may be due to the company's lower selling price and/or higher cost of sales.

- Lower selling price may be due to the company focusing on sales volume in order to increase the net profit. Higher cost of sales may be due to the company purchasing high quality raw material in order to increase sales.

- Net profit margin of the company when compared to the industry average is less by 4.8 percentage points. After allowing for the ten percentage points difference in the GP ratio, it is evident that the company is more efficient in controlling expenses (overheads and finance expenses).

- ROCE of the company (28%) is much higher than that of the industry (14%), indicating that the company is more profitable than the other companies in the industry, giving a better return on shareholder investment.

Liquidity

- Current ratio of the company (1.2), though less than the industry average (1.8), is still above the critical level of 1.0.

- Quick asset ratio of the company (0.52) is less than the industry average (0.84). If the company can get better credit terms from its creditors than the debtors collection period (46 days) or inventory holding period (58 days), the company could still manage without liquidity/cash flow problems.

Shareholder investment

- The company is trading at a lower multiple (1.4 times) of its earnings per share. This may be due to the company being a private company and the restriction in share transfers leading to low liquidity of the company shares.

- The shareholders can recoup their investment in terms of earnings per share in just 1.4 years.

(Total: 10 marks)

Answer 06

Relevant Learning Outcome/s: 3.1
Consolidated financial statements
Study text reference: Pages 509-553

Statement of financial position as at 31 March 2017

(Rs. '000)						
	Pan	**Sage**	**Adjustments**	**Total adjustment**	**Consolidated**	
Non-current assets						
Property, plant and equipment	101,500	31,500	+ 1,500 (FV) – 300 (dep^n)	1,200	134,200	**W1**
Goodwill					7,450	**W3**
					141,650	
Current assets						
Inventories	15,000	6,250	– 1,286 (URP)	(1,286)	19,964	**W2**
Trade and other receivables	17,500	7,250	– 1,500 (inter-co)	(1,500)	23,250	
Cash	7,500	3,000	+ 500 (inter-co)	500	11,000	
	40,000	16,500			54,214	
Total assets	**141,500**	**48,000**			**195,864**	
Equity and liabilities						
Equity (issued at Rs. 10 each)	25,000		+ 19,200 (shares)	19,200	44,200	**W6**
Retained earnings	88,500		+ 4,731 **(W4)**	4,731	93,231	**W4**
	113,500	26,250			137,431	

Non-controlling interest (NCI)			+ 1,183 (W5) + 8,500 (FV of NCI)	9,683	9,683	**W5**
Non-current liabilities						
12% loan	7,500	10,000			17,500	
Current liabilities						
Trade and other payables	13,250	8,000	– 1,000 (inter-co)		20,250	
Borrowings	7,250	3,750			11,000	
	20,500	11,750			31,250	
Total liabilities	28,000	21,750			48,750	
Total equity and liabilities	**141,500**	**48,000**		**-**	**195,864**	

Statement of profit or loss for the year ended 31 March 2017

(Rs. '000)						
	Pan	**Sage**	**Adjustments**	**Total adjustments**	**Consolidated**	
Revenue	212,500	105,000	– 12,000 (int. sales)	(12,000)	305,500	
Cost of sales	(157,500)	(80,000)	– 12,000 (int.purch) + 300(dep^{n}) + 1,286 (URP)	(10,414)	(227,086)	**W1** and **W2**
Gross profit	55,000	25,000			78,414	
Administrative expenses	(15,000)	(8,750)			(23,750)	
Distribution costs	(5,000)	(4,250)			(9,250)	
Finance costs	(750)	(1,000)			(1,750)	
Profit before tax	34,250	11,000			43,664	
Income tax expenses	(11,750)	(3,500)			(15,250)	
Profit for the year	**22,500**	**7,500**			**28,414**	
Profit attributable to:						
Parent					27,231	
NCI **(W5)**					1,183	
					28,414	

Workings

W1: FV of the plant		Rs. '000
Fair value		1,500
Depreciation	(1,500 * 20%)	300
WDV as at 31 March 2017		1,200

W2: URP		Rs. '000
Purchase from Sage		12,000
Sales to customers		(7,500)
		4,500
URP	4,500 * 40/140	1,285.71

W3: Goodwill		Rs. '000
Consideration transferred (W6)		19,200
FV of non-controlling interest		8,500
Less: FV of net assets at acquisition		
Share capital		(12,000)
Pre-acquisition profit	14,250 – 7,500	(6,750)
FV adjustment of plant (W1)		(1,500)
Goodwill		7,450

W4: Retained earnings	Rs. '000
Retained earnings of Sage as at 31 March 2017	14,250
Movement on FV adjustment of plant (W1)	(300)
Unrealised profit (W2)	(1,286)
Pre-acquisition profit (W3)	(6,750)
	5,914
Group share (5,914 * 80%)	4,731

W5: Non-controlling interest (NCI)		Rs. '000
Post acquisition profit of Sage		7,500
Unrealised profit (W2)		(1,286)
Movement on FV of plant (W1)		(300)
		5,914
NCI	5,914 @ 20%	1,183

W6: Share exchange		
No. of shares of Sage		1,200,000
Holding (%)		80%
		960,000
No. of shares transferred	960,000/2*3	640,000
Market value		30.00
		19,200,000
	Dr	**Cr**
Consideration transferred	19,200	
Share capital		19,200

W7: Cash in transit	Dr	Cr
Receivable	1,500	
Payable		1,500
Group		

(Total: 25 marks)

Answer 07

Relevant Learning Outcome/s: 2.1 (Level A) and 2.2 (Level B)
2.1 (Level A) Thorough knowledge and comprehension of the standard to identify significant complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the evaluation and application of standards in resolving a complicated matter related to financial reporting - A "complicated matter" includes transactions and/or events which require thorough analysis of the matter and evaluation of standards. - It may require the analysis application and evaluation of relevant standard/s. 2.2 (Level B) Good knowledge and comprehension of the standard to identify moderately complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the analysis and application of standards in resolving a moderately complicated matter related to financial reporting. Where; A 'moderately complicated matter' includes transactions and/or events which require an analysis of a matter and evaluation of such matter with the related standard/s.
Study text reference: Pages 122-123, 164-166, 285-289, 474-476

(a) For the purpose of calculating basic EPS, weighted average no. of shares outstanding should be adjusted for the events other than the conversion of potential ordinary shares.

Therefore the basic EPS of the company will not change and remain at Rs. 8.27.

However, for calculating diluted EPS, the dilutive and antidilutive effects on ordinary shares need to be assessed.

First consider whether the convertible bonds are dilutive or antidilutive:

8% bonds

Incremental earnings = Rs. 4,000,000 * 8% * (1 – 28%)
= Rs. 230,400

Incremental share = 4,000,000/100 * 1
= 40,000

Therefore EPS = Rs. 230,400/40,000
= Rs. 5.76 → dilutive

10% bonds

Incremental earnings	= Rs. 2,000,000 * 10% * (1 – 28%)
	= Rs. 144,000
Incremental share	= 2,000,000/200 * 1
	= 10,000
Therefore EPS	= Rs. 144,000/10,000
	= Rs. 14.4 → antidilutive

Therefore,

Diluted EPS	= (16,540,000 + 230,400)/(2,000,000 + 40,000)
	= Rs. 8.22

(b) Per SIC 32, websites can be recognised as an intangible asset if:

1. It is probable that future economic benefits will flow to the entity. Based on management estimates, this website will increase the company's revenue by allowing customers to place online orders. Therefore this requirement is met.

2. Cost of the asset can be measured reliably, which is the case here.

3. Recognition criteria associated with development costs are met This requirement is met as the company has already completed the development of the website, of which the costs can be measured reliably and the website is expected to provide economic benefits through generating revenue from online sales.

   Therefore the website can be recognised as an intangible asset.

Accordingly, the costs incurred will be accounted for as follows:

- Costs incurred in planning the website of Rs. 10,000 should be recognised as expense for the year.
- Costs of developing the website
  - To the extent that the content is developed to advertise products, it should be expensed. Therefore Rs. 150,000 should be expensed.
  - Other development costs should be recognised as intangible assets

	Rs.
▪ Obtaining domain name	50,000
▪ Developing hardware and operating software	4,050,000
▪ Designing the web pages and content	1,600,000
Total	**5,700,000**

(c) Here the buyer has requested to delay the delivery and has accepted the legal title and billing for goods purchased. Therefore this is a bill and hold sales arrangement.

The following criteria have been met for this sale.

- Since Win PLC has accepted Narah's request to delay the goods and stored them separately, it is probable that these goods will be delivered per the request.
- Goods are available with Win PLC for delivery in 10 days.
- Narah's acknowledgement of delaying the delivery is clear.
- Payment should be made per normal payment terms of Win PLC as no additional payment will be made for delaying the delivery.

  Therefore Win PLC should recognise revenue of Rs. 660,000 for the year ended 31 March 2017 as risks and reward have been transferred to the buyer

(d) Per LKAS 8, the initial application of a policy to revalue assets in accordance with LKAS 16 *Property, Plant and Equipment* is a change in accounting policy, and should be dealt with as a revaluation in accordance with LKAS 16 rather than in accordance with this standard.

Therefore, changing the measurement basis for land and building should be accounted as follows.

Fair value gain in land amounting to Rs. 2 million should be recognised in other comprehensive income and in equity under the heading of revaluation surplus. Fair value reduction in building amounting to Rs. 2.55 million should be recognised in profit or loss.

Change in the remaining useful life of the building is a change in estimate and should be recognised prospectively. Accordingly, the fair value of the building of Rs. 15 million should be depreciated over 10 years. This will result in depreciation for the year of Rs. 1.5 million

(Total: 25 marks)

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