CA | THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC 1 - Corporate Financial Reporting

June 2018

Answer 01

Relevant Learning Outcomes/s; 1.1 Level A
Study text reference: 242-262, 156-177,298-326

(a) As per LKAS 37, *Provisions, contingent liabilities and contingent assets,* an entity must recognize a provision if, there is a present obligation as a result of the past event, the payment is probable and the amount can be estimated reliably. Further, contingent liabilities are liabilities for which there is an uncertainty with regard to the timing or the amount of the liability.

The fire occurred in BPP's building and subsequently a law suit was filed creating an obligating event to the company. But, till year end there was an uncertainty about the damage to be paid as the company had a possibility of losing the law suit.
But, on 10th April, ie subsequent to the year end, the lawyers of the company confirmed that the company will lose the case and may become liable for damages claimed.

This satisfies the conditions for a provision due to the following reason:

1. The fire and the law suit filed by the owner is the obligating event which arises before the financial statement date.
2. The payment is highly probable as the current law suit was unfavorable to BPP.
3. Amount can also be estimated reliably as the lawyers confirmed the amount of damages to be paid (80% of the damages claimed).

Hence, a provision must be made in the financial statement rather than a disclosure. Amount of the provision will be LKR 800 million.

The potential insurance claims receivable to cover some of the expenses required to settle a damages can be recognized, only if receipt is virtually certain if BPP settles the damages for the restoration of the historic building. LKAS 37 , *Provisions, contingent liabilities and contingent assets* requires to treat the above receivable separately as an asset. But, it was noted that the company will not receive the claim if it is proven negligent. Hence, the receipt of the claim is not certain even if BPP was ordered by court to pay the damages. Hence, the asset could not be recognized.

The company may also have to disclose the following regarding the provision made:
- A brief description of the provision.
- Indications of major uncertainties and major assumptions on the future events.
- Amounts expected to be reimbursed. This case it is expected to be zero
- A brief description of the nature of the contingent asset

(b) As per LKAS 36, *Impairment of Assets* cash flows shall be based on the most recent financial budget approved by the management which is the case here for the first five years.

According to para 44 of LKAS 36 *Impairment of Assets* future cash flows of the asset shall be estimated for the asset in its current condition.

Cash flows shall exclude any estimated future cash flows from future restructuring unless management is committed to it. Further, the growth rate beyond the first five years should be steady or declining growth rate unless a higher rate can be justified.

Therefore, considering future restructuring if the management is not yet committed to it using a higher growth rate for a subsequent period is not correct.

Estimates of future cash flows shall not include cash flows from financing activities. Therefore, loan proceeds cannot be considered in the VIU computation.

Discount rate should reflect the current market assessment of time value of money and risks specific to the asset. However, in this case such risks were not considered since the long term TB rate represents a risk free rate.

Therefore, POP PLC has to revisit the VIU calculation since the factors already considered were inappropriate. Further the company should revisit its impairment assessment as per LKAS 36 with the correctly calculated VIU.

(c) Deferred tax computation – John & Co. Ltd

Property, plant and equipment
When assets are carried at a revalued amount and the future recovery of carrying amounts will result in taxable economic benefits, the difference between the carrying amount of the revalued asset and its tax base is a temporary difference which results in a deferred tax asset or a liability. This is true even if the entity does not intend to dispose of the asset. Since no equivalent adjustment is required for tax purposes, the tax base is nil.

Goodwill
LKAS 12, *Income taxes* does not permit the recognition of deferred tax on initial recognition of goodwill because goodwill is measured as a residual and the recognition of a deferred tax liability would increase the carrying amount of goodwill.

Unused tax credits and losses
LKAS 12,*Income taxes* states that when an entity has a history of recent tax losses the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing evidence that sufficient taxable profits will be available against which such losses and credits can be utilized.
It is not clear in this case whether future taxable profits will be available. Therefore, recognition of a deferred tax asset on tax losses should be limited to the deferred tax liability recognized during the year (i.e. only to the extent of taxable temporary differences available).
The remaining amount for which a deferred tax asset is not recognized should be disclosed in the financial statements.
Accordingly the deferred tax computation should be corrected as follows.

	Carrying Amount	**Tax Base**	**Temporary Difference**	**Deferred Tax at 28%**
	Rs. '000	**Rs. '000**	**Rs. '000**	**Rs. '000**
Property, plant & equipment	650,120	453,001	197,119	55,193
Revaluation gains	175,000	-	175,000	49,000
Goodwill	25,700	-	25,700	-
Unused tax credits and losses	-	372,118	(372,118)	(104,193)

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s; 1.1, 4.1
Study text reference: 118-132, 24-35,287-291

(a) Bare Land in Colombo 2

As per para 57 (b), an investment property can be transferred to inventory only when there is a change in use evidenced by commencement of development with a view to sale. *(As per para 58 of LKAS 40, Investment property ,when an entity decides to dispose of on investment property without development, it continues to treat the property as an investment property until it is derecognized and does not treat it as inventory).* In this case, just because the management has decided, this property cannot be transferred to inventory without evidence of development. Therefore, as at 31 March 2018, the bare land will be treated as an investment property in the consolidated financial statement**.** The company can continue the valuing of the property at fair value.

Property in Galle

When the property is occupied by the subsidiary company for administrative purpose, the property does not qualify as investment property <u>in the consolidated financial statements</u> since the property is owner occupied by the group. This should be reflected as property, plant and equipment of the group and measured according to the group's accounting policy for property, plant and equipment. No fair value gain can be recognized in profit or loss.

Property in Kalutara

There is a change in use of this property on 1 September 2017 i.e. owner occupied property has become an investment property. When an owner-occupied property becomes investment property that will be carried at fair value, LKAS 16 *Property, plant and equipment* should be applied up to the date of change in use. The difference between the carrying amount of Rs. 147.62 million as per LKAS 16 and its fair value of Rs. 170 million should be treated as a revaluation. At the year-end the fair value should be estimated according to the group's accounting policy.

Property in Peliyagoda

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property, if and only if, the property meets the <u>investment property definition</u> and lessee uses the <u>fair value model</u>. Since the lessee has sublet the property, the property meets the definition of investment property**.** However, as this property is measured at the total lease rentals paid to the lessor up front less the accumulated amortization, it appears that the fair value model has not been applied. Therefore, this property cannot be classified as investment property.

(b) The code requires the Board, at least annually to assess the performance of the CEO. In doing this, at <u>the commencement of every fiscal year</u>, the <u>Board in consultation with the CEO</u> should set objectives of the company and reasonable financial and non-financial targets that should be met by the CEO during the year. As in this case, the Board should not do targets setting in the middle of the year.

The performance of the CEO should be evaluated by the Board at the end of each fiscal year to ascertain whether the targets have been met and whether any failure to achieve such targets was reasonable.

(c) As per SLFRS 15, *Revenue from contracts with customers* (para 22) an entity should identify goods or services promised in a contract with a customer and should identify each promise as a performance obligation. In doing this, it is required to assess whether each good and service is distinct.

As per para 27, a good or service that is promised to a customer is distinct if both of the following criteria are met:

(i) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e. the good or service is capable of being distinct); and

(ii) The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. the good or service is distinct within the context of the contract).

In this case the first criteria is met as BEL and its competitors regularly sell many of these services separately to other customers.

However, the second criteria is not met as promise to transfer the good or service to the customer is not separately identifiable from other promises in the contract (i.e. the promise in the contract is to build an apartment complex, not to sell each of the goods and services mentioned).

Therefore, BELL should account for all the goods and services in the contract as a single performance obligation.

(d) Unquoted equity
Even though the share price of a similar quoted company was used as inputs to the valuation technique in measuring the fair value, risks associated with each company can be different. Therefore an adjustment to the value derived is required, as in this case a 25% adjustment was made for non-marketability. A 25% adjustment is considered to be significant. Therefore inputs for the asset is not observable and this should be classified as a level 3 fair value measurement.

Investment in Treasury bills
Inputs used (yield curve and interest rates) are observable. Therefore this is a level 2 fair value measurement.

Investment properties
Prices of recent market transactions of properties in the same area cannot be considered as quoted prices for the asset. This should be classified as a level 3 fair value measurement as significant adjustments were made to the prices.

(Total: 25 marks)

Answer 03

Relevant Learning Outcomes/s; 2.1, 2.2, 1.1,1.3,5.1	
Study text references: 557-569,468 -476, 13-20,728- 750	

(a)

(i) Currently the Joint Venture (JV) is accounted as a Joint Venture and it is equity accounted. With additional equity being contributed and majority board representation by ETD PLC, joint control may no longer be present. The Joint Venture may be controlled by ETD PLC, and as a result it will be a subsidiary.

In order for you to control an investee, you must be exposed, or must have rights to variable returns from its involvement with the investee and has the ability to affect those returns through your power over the investee. Since ETD PLC has majority board representation and management of the Joint Venture will be with ETD PLC, control is with ETD PLC.

When an existing JV is made a subsidiary, it amounts to a step acquisition.
Since ETD PLC had a non-controlling equity investment in the Joint Venture immediately before obtaining control, ETD PLC re-measures that previously held investment at its acquisition-date fair value and recognises any resulting gain or loss in profit or loss.

(ii)

	Rs.'000	
Non-Current Assets - ETD PLC	7,321,863	
(-) Investment in Joint Ventures	(2,241,551)	JV recognized in ETD
	5,080,312	
100% of the JV NCA	4,500,000	FV of NCA
Goodwill (W1)	559,842	
Total NCA	**10,140,154**	

	Rs.'000
Equity & Reserves - ETD PLC	7,278,118
Profit on disposal of Joint Venture (W2)	399,397
Minority Interest (4,401,580*30%)	1,320,474
	8,997,989

W1 Goodwill Calculation		**Rs. '000**
Purchase consideration to acquire control of JV 10%		1,000,000
NCI FV as at that date	(30%* 4,401,580)	1,320,474
FV of initial investment	(60%* 4,401,580)	2,640,948
		4,961,422
FV of assets acquired		(4,401,580)
Goodwill		559,842

W2 Profit on disposal of Joint Venture	**Rs. '000**
Existing equity amounted Joint venture	2,241,551
Fair value of the initial investment	(2,640,948)
	399,397

As per the proposed acquisition, non-current asset of the group will increase by 38% and Equity and reserves by 23%. However, the profit in the income statement will further decline as the consolidate income statement will reflect the entire loss of the newly acquired subsidiary. The board must note that the increase in reserves is due to a Minority Interest being held at fair value, and this amount is not attributable to the equity holders of ETD PLC.

(b) The proposed merger will be a transaction scoped under Statement of Recommended Practice (SORP) for merger accounting for common control combinations. Under the merger the controlling party does not change. Hence, it is a common control transaction. Common control transactions are scoped out of SLFRS 3, *Business Combinations*.

Generally no goodwill is recognized under common control acquisitions.
The financial numbers of the two companies will be consolidated and carried forward in the merged balance sheet.

(c) Under SLFRS 16, *Leases* the lessee will be impacted. The impact would be that all leases more than 12 months will need to be recorded on the balance sheet. The lease liability discounted will be recorded, and a right of use (ROU) asset will be recorded. The ROU will be amortised over the lease period. The lease liability will be unwound to record an interest expense in the income statement.

(d) Identification of segments – the note provides segments based on the separate entities which is not appropriate. The standard requires determination of segments by determining the smallest components of the business for which information about profit is presented for use by the entity's chief operating decision maker (sometimes referred to as 'CODM'). CODM function requires allocating resources and assessing performance of the operating segments.

A feature of an operating segment is the potential for revenue generation rather than actually earning revenues in the reporting period.

(e) According to section 320 of code of ethics, a professional accountant in business shall take reasonable steps to maintain information for which the professional accountant in business is responsible in a manner that:

(i) Describes clearly the true nature of business transactions, assets, or liabilities;
(ii) Classifies and records information in a timely and proper manner; and
(iii) Represents the facts accurately and completely in all material respects.

As per the code of ethics of CA Sri Lanka the principle of integrity imposes an obligation on all professional accountants to be straight forward an honest in all professional and business relationships.

According to the given scenario it is a significant threat as the amounts are material and it is a non-compliance with LKAS 24 *Related party disclosures*. As such, a professional accountant should not be associated with reports where they believe that the information contains materially false or misleading statements.

(f) (i)

	ET Finance PLC (ETF PLC)	USB PLC
EPS	5.81	11
PE ratio	17	21

- The EPS of ETF PLC is much lower compared to USB PLC. Performance of ETF PLC could have been much lower if they have recognized the correct valuation of the loan portfolio in the financial statements. EPS is typically used by analysts and traders to establish the financial strength of a company. Hence, based on EPS, USB PLC is a better investment.

- PE ratio is much lower compared to USB PLC. A high PE ratio generally indicates increased demand because investors anticipate earnings growth in the future. Hence, USB PLC is more attractive to its investors. However, before taking the decision, it should be ensured that stock prices are based on reliable earnings estimates.

- The Net interest margin of USB PLC is higher compared to ETF PLC. However you need to evaluate the components of interest income as USB PLC includes other income as well in the finance income. On the other hand, even if ETF PLC included other operating income to compute net interest margin, the ratio does not change as the other operating income is not very significant. Hence, USB shows better performance.

(ii) Other factors to be considered:

1. Growth strategy (past & future) should be looked at. For example, the reason behind including fees and commission under “finance income”. The variations in product strategy may drive this.
2. Future expansion plans and capacity needs to be looked at. (Conservative vs aggressive)
3. An evaluation of non-performing loans ratio is useful, in order to analyze the loan portfolio of the company.
4. Corporate Governance of the company
5. The caliber of the senior management
6. There could be different accounting policies and estimates may be adopted by the two companies
7. Companies may follow different financing strategies and non-financing strategies for HR, Marketing etc.

(Total: 50 marks)

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