THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

KC1 – Corporate Financial Reporting

December 2018

Suggested Answers and Marking Guide

SECTION 1

Answer 01

Relevant Learning Outcomes/s: 1.1 (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. Where: - 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.
Study text reference: Pages 24 – 34, 242 – 252, 528 – 531

(a) **If the company applies full SLFRSs, the treatment should be as follows**.

Per para 17 of LKAS 28 *Investments in Associates and Joint Ventures*, an exemption from applying the equity method is available to an entity if that entity is a parent that is exempt from preparing consolidated financial statements per para 4(a) of SLFRS 10 *Consolidated Financial Statements* or if all the conditions in (a) to (d) of para 17 of LKAS 28 are fulfilled.

In this case, Food (Pvt) Ltd is not a parent entity to be exempted from SLFRS 10 para 4(a).

Further, even though its equity or debt are not listed, the exemption per LKAS 28 para 17 does not apply as Food (Pvt) Ltd is not a subsidiary of a parent that produces financial statements for the public.

Therefore, Food (Pvt) Ltd should apply the equity method to account for the investment in Chips (Pvt) Ltd since its acquisition.

The financial impact would be as follows.

	Rs. '000
Cost	13,000
Share of profit in 2016 (14,000 * 25%)	(3,500)
Balance as at 31 March 2016	9,500
Share of profit in 2017 (18,700 * 25%)	(4,675)
Balance as at 31 March 2017	4,825
Share of profit in 2018	(4,825)
Balance as at 31 March 2018	-

Under the equity method, the initial cost of the investment should be increased or decreased to recognise the investor's share of profit or loss of the investee after the date of acquisition. However, per para 38, if an entity's share of losses of an associate or joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognising its share of further losses. Per para 39, after the entity's interest is reduced to zero, additional losses are provided for and a liability is recognised only to the extent that the entity has incurred a legal or constructive obligation or made payment on behalf of the associate or joint venture.

In this case, there is no reason to say that Food (Pvt) Ltd should recognise further losses. Therefore the share of losses to be recognised for the year ended 31 March 2018 is limited to Rs. 4.825 million.

Per LKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* this should be corrected in the financial statements for the year ended 31 March 2018 as a correction of errors. Retrospective restatement is required.

Alternative answer

As Food (Pvt) Ltd is an entity that does not have public accountability, it can apply SLFRS for SMEs.

Food (Pvt) Ltd is an investor that is not a parent but has an investment in an associate. Such an investor has the accounting policy election of either using the cost model, equity method or fair value method.

The company has used the cost model for subsequent measurement and this is appropriate. However, impairment losses should be recognised if the recoverable amount is less than the carrying amount of the investment. Since Chips (Pvt) Ltd has been making losses in previous years, there is an indication that the investment may be impaired. Therefore, Food (Pvt) Ltd should assess the fair value less cost to sell, and value in use of the investment. If the higher of these two is less than the carrying amount, an impairment loss should be recognised in the income statement by reducing the carrying amount of the investment. Per Section 10 of SLFRS for SMEs, to the extent it is practicable, this should be corrected in the financial statements for the year ended 31 March 2018 as a correction of errors. Retrospective restatement is required.

(b)

(i) **Kadawatha property (land)**

When measuring the fair value of an asset or a liability, characteristics that market participants would take into account in pricing the asset should be considered, including the condition and location of the asset and **restrictions** on the sale or use of the asset.

In this case the restriction (that the land should be used only for the purpose mentioned, even if the land is sold to another party) is passed to the market participant buyer with the land. Therefore the fair value of the land should take into account the effect of the restriction, regardless of the land prices in the neighbourhood.

(ii) **Kelaniya property (land)**

When measuring the fair value of an asset or a liability, characteristics that market participants would take into account in pricing the asset should be considered including the **condition and location** of the asset and restrictions on the sale or use of the asset.

Characteristics of this land are different from a land located facing the Colombo-Kandy main road. The price of another land can be used in the absence of prices for a similar land, but an adjustment will be required to that price to reflect the conditions and location of the Kelaniya land. This is because a market participant buyer will not pay the price of a land near the main road to buy a land close to the river, which is subject to flooding.

(iii) **Ratmalana property (land and building)**

Cost approach

The cost approach should reflect the amount that would be currently required to replace the service capacity of an asset. From the perspective of a market participant seller, the price that would be received for the asset is based on the cost (to a market participant buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.

Based on the above requirement, estimating the land value by using the current prices of similar land in the neighbourhood would be appropriate. However, the building value, which is the cost that would be required if a new building was constructed at the reporting date, does not reflect the fair value. This is because it has not considered obsolescence. Therefore the building value is not the amount required to replace the service capacity of the building.

Income approach

When the fair value is measured using the present value technique, it should capture all the following elements from the perspective of market participants at the measurement date.

- An estimate of future cash flows.
- Expectations about possible variations in the amount and timing of the cash flows.
- Time value of money represented by the risk-free interest rate.
- Risk premium.
- Other factors that market participants would consider in the circumstances.

In this case, rent income and expenses considered do not reflect future cash flows from the property, as there are annual rate revisions. Other possible variations in the amount and timing of the cash flows have not been considered. Further, cash flows have been discounted using the risk-free interest rate, and a risk premium that reflects the price for uncertainty inherent in the cash flows has not been considered.

Therefore, the value derived by the income approach also does not reflect the fair value.

When multiple valuation techniques are used, the fair value is not the highest value given by such techniques. The results should be evaluated considering the reasonableness of the range of values indicated, and the fair value is the point within that range that is most representative of the fair value in the circumstance.

(c) A contingent liability is when a possible obligation arises from past events whose existence will be confirmed by the occurrence or non-occurrence of uncertain future events.

OR

A contingent liability is a present obligation, but outflow of resources is not probable or the amount cannot be measured reliably.

For a provision to be recognised, there should be a present obligation. In this case, since the company has appealed against the assessment received, existence of the possible obligation will be confirmed based on the outcome of the court case. Therefore it is a contingent liability that needs disclosure.

However, if the company has received the opinion of legal experts for the existence of a present obligation, and if it is more likely than not that a present obligation exists at the reporting date, the company can recognise a provision at the best estimate of the outcome. If the amount already recognised is based on such information, that provision would be appropriate.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s: 1.1 (Level A)
Relevant Learning Outcomes/s: 1.1 (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. Where: - 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.
Study text reference: Pages 367 – 370, 668 – 674

(a)

(i) Equity instruments will not pass the cash flow characteristics test. Hence they will only be tested for the business model test.

Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price. Therefore, since the intention of the management was to benefit from short-term price fluctuations, the portfolio may need to be classified as trading. Therefore, the initial and subsequent measurement of the portfolio would be fair value through profit or loss.

(ii) The treasury bill portfolio will need to be tested for the cash flow characteristics test first. This requires you to see if the instrument compensates the holder solely payments of principal and interest (SPPI test). As treasury bills contractually give you the right to receive the principal plus interest, and government bills reflect the risk-free interest, the SPPI test will pass.

Thereafter, the business model test needs to be performed.

Option 1

Based on historical information, part of the portfolio is trading and the balance seems to be on a hold to collect motive. The company may consider the portfolio to have a mixed business model, as almost 20% is being traded and 80% is held to collect. Before concluding, the company may also consider factors such as the investment policy of the company, intention of the management, and reason for sale.

Measurement model – initial measurement will be at fair value, and subsequent measurement will be fair value through OCI. The fair value gains and losses will be recycled to the income statement on disposal.

Option 2 (alternative option)

Based on historical information, part of the portfolio is trading, and the balance seems to be on a hold to collect motive. The company may consider splitting the portfolio into two. It may identify part of the portfolio for example 20% – 25% to be trading, and the balance for example 80% – 75% to be hold to collect. Before concluding, the company may also consider factors such as the investment policy of the company, intention of the management, and reason for sale.

Measurement model – at initial measurement, the portfolio will be at fair value. Thereafter, it will be at amortised cost for the hold to collect portfolio, and fair value through profit or loss for the trading portfolio.

(b)

- In preparing the financial statements, the company must consider the functional currency of the entity.

  There are certain primary factors that LKAS 21 requires an entity to consider when determining its functional currency. For EL PLC, the following primary factors are present.
  - Sales prices are denominated and settled in USD.
  - Because the customers are in USA, the sales prices may be driven by competitive forces and regulations in USA
  - Main costs are denominated and settled in USD.

  Thus, based on the primary factors above, EL PLC's functional currency appears to be USD.

- The general rule per LKAS 21 is that exchange differences on the settlement of monetary items should be recognised in the income statement.

  Monetary items include liabilities to be paid in a fixed or determinable number of units of currency. Hence, the exchange gain or loss in relation to the liability should not be recorded in inventory, and instead should be recorded in the income statement.

- Per the ruling given by CA Sri Lanka, an entity enjoying a tax exemption period shall recognise deferred tax in their financial statements for temporary differences, where reversals of such differences extend beyond the tax exemption period.

  Hence the company needs to evaluate whether temporary differences that extend beyond the tax exemption period exist. Where such temporary differences exist, deferred tax will need to be provided.

(Total: 25 marks)

SECTION 2

Answer 03

Relevant Learning Outcomes/s: 2.1, 3.1, 4.1 and 5.1 2.1 Consolidated financial statements 3.1 Internal financial statement analysis 4.1 Corporate governance and sustainability reports including integrated reporting 5.1 Recent ethical issues
Study text reference: Pages 42 – 47, 593 – 626, 728 – 750

(a) **Briefing note to the management of PHPL**

TWPL

PHPL initially had a 40% ownership of TWPL, and the share transfer by Nihal Fernando increased the total shareholding in TWPL to 75%. Further, it can be concluded that TWPL was controlled by PHPL even before the above share transfer, as PHPL had 40% voting power, and Charith Perera who had a 25% shareholding in TWPL, had a 60% stake in PHPL. This indicates that PHPL had power over investees and was exposed to variable returns from TWPL, which it could affect using the above power. Hence, it could be established that the new share transfers will increase the ownership percentage of PHPL in TWPL and effectively reduce the NCI.

TTL

Acquisition of 60% voting rights in TTL by TWPL indicates that it has power over TTL, and effectively controls it. Hence, the above transaction will create a complex group structure for PHPL. The structure would be as follows.

PHPL
↓ **75%**
TWPL
↓ **60%**
TTL

Due to the above transaction, the shareholding of the group and non-controlling interest (NCI) will appear as follows.

	TWPL	**TTL**
Group	75%	45%
NCI	25%	55%
	100%	**100%**

Further, the proposed share transfers will change the shareholding structure of PHPL as given below.

Shareholder	**Number of shares**	**% holding**
Charith	18,000,000	18.94%
Nihal	25,000,000	26.31%
Saman	6,000,000	6.32%
Krishan	6,000,000	6.32%
BET	40,000,000	42.11%
	95,000,000	**100.00%**

Goodwill
As a result of the acquisition of TTL, goodwill will increase by LKR 17 million as calculated below. Further the existing goodwill from TWPL will remain the same as shown below.

Goodwill	**Rs. '000**	**Rs. '000**	**Alternatively**
	TWPL	**TTL**	**TTL**
Investment	200,000	(60,000 * 0.75) 45,000	45,000
NCI at acquisition	195,000	40,000	55,000
	395,000	85,000	100,000
Net assets (150 + 175)	(325,000)	(82,956)	(82,956)
Goodwill	70,000	2,044	17,044
Total goodwill	72,044		

Group reserves

Further, group reserves will be impacted by the above transactions as follows.

Revaluation reserve
The group revaluation reserve attributable to equity holders of the parent will remain the same from TWPL as shown below.

	Rs. '000
Revaluation reserve (200,304 * 0.4)	80,121

The balance 60% is attributable to NCI.

Group retained earnings

Group retained earnings will be reduced by the loss resulting from the purchase of NCI. This will be calculated as shown below.

	Rs. '000
Purchase consideration (shares transferred)	250,000
Value of NCI before sale	382,743
Value attributable = 382,743/60%*35%	223,267
Loss on purchase	26,732

Hence, the group retaining will be as follows.

Group retained earnings	**Rs. '000**
TWPL	
At acquisition (287,603 – 175,000) * 40%	45,041
Loss on purchase of NCI (250,000 – 223,267)	(26,732)
PHPL profit	112,852
	131,161

There will be no contribution from TTL for the year ended 31 March 2018.

Non-controlling interest (NCI)

Interest attributable to NCI will be reduced by the purchase, for the equity holders of the parent, while the acquisition of TTL will result in an additional NCI interest.

Hence, NCI as at 31 March 2018 will be as follows.

NCI	**Rs. '000**	**Alternatively Rs. '000**
	TWPL	
At acquisition (150 + 175) x 10%	195,000	
Post-acquisition reserve		
Revaluation (200,304 x 60%)	120,182	
Retained earnings (287,603 – 175,000) x 60%	67,562	
	382,744	
Less: Purchase	(223,267)	
	159,477	**159,477**
From TTL	40,000	55,000
Investment TTL (60,000 * 25%)	(15,000)	(15,000)
	184,477	**199,477**

The group statement of financial position as at 31 March 2018 would be as follows.

As at 31 March 2018	**Group**	**Alternatively**
Assets	**Rs. '000**	**Rs. '000**
Non-current assets		
Property, plant and equipment	1,237,397	
Intangibles	7,500	
Goodwill	72,044	87,044
Investment property	3,500	
Investments	25,464	
Deferred tax assets	50,500	
	1,396,405	
Current assets	696,008	
Total assets	**2,092,413**	
Equity and liabilities		
Equity		
Stated capital (Rs. 10 per share)	950,000	
Revaluation reserve	80,121	
Retained earnings	131,161	
Non-controlling interest (NCI)	184,477	199,477
Non-current liabilities	398,442	
Current liabilities	348,212	
Total equity and liabilities	**2,092,413**	

(b) Even though TWPL is a private limited company, it would be better if it could adopt good governance practices, which in turn will help it attract investors and expand the business.

The following are some areas where the company lacks good governance practices, and ways to improve them.

- Board balance – it appears that TWPL does not have a balanced board, where there is a balance of executive and non-executive directors. The board has only one non-executive director. Hence, it could appoint more non-executive directors with sufficient knowledge and expertise to improve the board balance.
- Financial acumen – it appears that the board does not contain a suitably qualified finance professional who can guide it on matters related to finance. It could consider appointing a suitably qualified and experienced finance professional, so that company could overcome the financial irregularities it is facing.

- Absence of audit, remuneration and nomination committees – it appears that TWPL does not have such committees as prescribed by the Code of Best Practice on Corporate Governance. The board could consider appointing such committees if a listing is planned.
- Lack of an internal audit function – the board should ensure that an independent internal audit function is in existence. It should take necessary measures to ensure a proper internal audit function is carried out.

(c) (i) At present, TWPL has the following ratios.

Ratio	**Required**	**Actual**	**Decision**
Gearing	40%	66.85%	Not qualify
Current ratio	1.2 times	0.76 times	Not qualify
Interest coverage	3 times	0.9 times	Not qualify
Operating margin	15%	11.65%	Not qualify

Gearing = (101,465+325,000)/637,907*100 = 66.85%
Current ratio = 238,362/313,472 = 0.76 times
Interest cover = (61,596 + 9,564)/ 68,374 = 1.04 times, or 61,596/68,374 = 0.9 times
Operating margin = 61,596/528,654*100 = 11.56%

(ii) Possible ways of improvement

Gearing
- Use the proceeds from the share issue as an investment in TWPL. This could improve the debt to equity ratio.
- Get rid of unwanted assets or properties, if any, and use the proceeds to settle the liabilities from financial institutions.
- Revalue properties, which could effectively improve the equity and hence the gearing.

Current ratio or liquidity
- Effectively manage the working capital cycle.
- Convert some of its current liabilities as long-term dues. However, the company should ensure that it satisfies the gearing threshold stated above.
- Part of the investments by the parent (PHPL) could be used to improve the working capital of TWPL.
- Negotiate with customers and suppliers to revise the repayment period.

Interest coverage
- Reduce its effective interest cost by reducing the interest bearing borrowings. This could improve the gearing as well. Strategies suggested above for improving gearing could be used.
- Margin improvement strategies such as price revisions and cost controlling techniques could be introduced.

Operating margin

- Seek profitable segments of the market.
- Invest in new technology to improve the turnover.
- Cost monitoring and controlling mechanism could be introduced.
- Negotiate with film producers to provide better terms for the company, so that it could improve its margin.

(d) *The accountant is a chartered accountant and as such:*

- *Should be aware of the requirements of SLFRSs and apply those to achieve fairly presented financial statements.*
- *Is bound by the CA Sri Lanka Code of Ethics.*

The accountant should not accept what the marketing director has said. If she does, she would breach integrity by not being honest in her professional conduct.

Further, it will breach objectivity i.e. the requirement for the accountant to not be biased, have a conflict of interest or influence others to override professional judgement. It is clear here that she would benefit through the salary increase more than the recommended %.

LKAS 39 requires a reduction in the carrying value of impaired receivables by recognising an adequate impairment allowance. The accountant must comply with the professional standards and regulations and avoid any discredit to the profession. As such she should behave professionally and display professional competence and due care.

The accountant has a threat to compliance with the fundamental principles i.e. (intimidation threat to integrity, objectivity, professional competence and due care) as she is pressurised by the marketing director not to make an impairment allowance for the receivables.

(Total: 50 marks)

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