KC1 – Corporate Financial Reporting

December 2019

Examiner's Comments

NOT FOR SALE

The overall performance of candidates on this examination was very poor. Since this is the core subject in the CA curriculum, the marking examiners were alarmingly concerned about the performance level of the candidates.

The question paper structure was more or less the same as before, except for some parts in Question 02 that tested financial instruments. Due to less exposure, some candidates may have found such parts difficult. Other questions were all quite workable. The main reasons why candidates failed in the examination are as follows.

- Explaining the general principles in the relevant accounting standards without any application to the scenario.
- Spending a disproportionate amount of time on some questions and hence not having sufficient time to attempt all the questions.
- No clarity and quality in the discussion of ratio analysis. Not using the pre-seen information to analyse and support the variations in performance of the company.
- Illegible, poor handwriting where the examiner could not read and understand what the candidate was trying to explain. Despite the effort put by the marking examiners candidates lost some marks.
- Answers not being relevant to the question. Some candidates had not spent time to understand the requirements of the examiner, and therefore their answers were either irrelevant or incomplete.
- Not having sufficient coverage when discussing relevant points in the question on corporate governance.
- Not paying attention to the action verb in the question.

Question 01

(a) This part on SLFRS 15 for 13 marks was not well answered by the majority of candidates. Although this is the second examination this standard was tested, candidates showed very poor ability to apply the standard on identifying different performance obligations in one contract, and on allocating revenue based on standalone prices. Some candidates explained the theory very well but failed in applying it correctly. In the computation of revenue to be recognised, very few candidates did the allocation properly.

More than 50% of the candidates incorrectly identified the data, voice and connection fee all as one performance obligation; but when accounting for the revenue they took a different approach and deferred and amortised the connection fees over the two-year contract period.

Some candidates identified that the connection fee is only an advance and not a separate PO, but in recognising revenue they took it all together and allocated it. As such, not even proportionate marks could be awarded, as the principles explained contradicted with the application.

The contract period was 24 months. However quite a number of candidates took only 12 months when allocating revenue for the first year. Another common mistake done by the candidates was to take the router as a discount; hence they deducted the router price from the total SSP calculation.

A few candidates mentioned that extra usage of data and voice was a modification to the contract.

Some candidates spent unnecessary time explaining the 5-step model, which did not address the question, and hence gained no marks.

(b) This part of the question on deferred taxation for 6 marks was fairly well attempted by the majority of candidates.

However, some candidates spent time explaining unnecessary details on what deferred tax is, how to recognise DTAs and DTLs, the criteria for assessing the probability that taxable profits will be available for setting off unused tax losses etc.

Some others spent time on unnecessary calculations on how much can be set off, without building an answer relevant to the question.

(c) This part of the question for 6 marks was on the Code of Ethics. A considerable number of answers were not related to the question. Candidates were required to explain the ethical responsibilities of the internal auditor, but quite a number of candidates explained that the CFO's actions were not ethical as he was a member of CA Sri Lanka. Easy marks were lost in this instance.

A few candidates identified the scenario as a situation of NOCLAR and their answers were built up based on that. They did not recognise the fact that the evidence provided was not sufficient to justify a NOCLAR situation. A few others also wasted time writing and explaining all the ethical principles in general. Some other candidates identified the relevant principles (integrity and objectivity in this case) but did not demonstrate the link of the principles to the scenario. Hence they lost some marks.

Question 02

Both parts (a) and (b) were on the topic of financial instruments, testing the application of LKAS 32 and SLFRS 9. The performance of candidates was very poor in this question.

(a) A very few candidates correctly applied LKAS 32 and analysed whether to establish the instrument as debt or equity.

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In Option 1, the participative units qualified the terms and conditions for the application of the exception to para 16. However candidates missed this and they identified the instrument as a debt.

The bonds in Option 2 were incorrectly identified as a compound financial instrument by the majority of candidates. The fact that the 'fixed for fixed' test is not passed and hence the conversion feature does not meet the equity classification, was not identified by many candidates. This was a costly mistake as the incorrect identification of the instrument led to the loss of a lot of marks.

(b) There were two mistakes commonly observed in the answers to this part. Firstly, the application of the concept of FVTOCI in SLFRS 9 for debt vs. equity was not properly understood by many candidates. Secondly, they were also confused with the principles of the 12-month expected credit loss and the lifetime expected credit loss. As a result, the overall mark obtained for this part was very poor.

(c) This part of the question for 5 marks on corporate governance was also not attempted well. Usually corporate governance questions have been part of Question 03 (which is based on the pre-seen). Therefore candidates have come prepared for them in class (and hence scored good marks). However, in this examination they failed to do the analysis on their own for a given short scenario.

Candidates need to develop their ability to independently analyse a scenario and build an answer. The majority of candidates only mentioned the director's responsibility with regard to the financial statements. Some candidates just reproduced some of the paragraphs in the corporate governance code. None of the candidates provided good coverage in building their answers. Repetition of the same point over and over again is only a waste of time and does not attract additional marks. Many candidates confused this part with the Code of Ethics and wrote irrelevant answers.

Question 03

(a) This part on consolidation with two subparts carried a total of 18 marks.

Candidates were first required to advise the management on how the share disposal should be reflected in the consolidated financial statements.

Quite a number of candidates did the computations for determining the gain/loss, but they did not provide advice; and thus lost some of the marks allocated. When answering questions where you are required to advise, candidates should always explain the relevant principles that underpin their answers. Marks are always awarded firstly for an explanation of the principles and then for their application. Explaining the principles alone will not attract the total marks allocated. Therefore candidates need to practice building up their answers in a step-by-step basis covering only the principles that relate specifically to the question.

It was noted that most candidates did not spend adequate time on the second subpart on the disclosure requirements. The disclosures to be made had to be drawn from several standards (SLFRS 10, 12, 5, 7 etc.). Candidates did not perform well on this subpart.

(b) In this part although the requirement was to evaluate the impact of the two scenarios separately, some candidates mixed both scenarios and provided one answer. Most candidates were misguided by the call option exercisable at FV at any time and established control based on that fact; thereby ignoring that the information relevant for exercising the right had to be obtained from the third party.

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(c) In this part candidates were required to comment on the accounting treatment under SLFRS 16 for a leasehold right to a bare land of JEDB/SLSPC. In the statement of financial position provided in the pre-seen, the land was shown under non-current assets. Candidates did not fully explain the impact of SLFRS 16 compared to current practice. The majority of candidates identified the ROU asset, but did not explain the liability. Quite a number of candidates reproduced a table with a general comparison of treatment under SORT and SLFRS 16, without any link to the scenario.

(d) The ratio analysis in this part carried 22 marks. The examiner specifically requested to include measures for improvement of the ratios of the company, but the majority of candidates did not address this in their answers.

Quite a number of candidates did a general evaluation without linking it to the pre-seen information. They gave explanations such as "the ratio has increased or decreased", but did not give any reasoning as to why. No marks were awarded for identifying that there was a change in the ratio, without reasoning out the causes (analysis). There were numerous points for analysis, which were given in the pre-seen, hence why 22 marks were allocated for this part. Due to this poor demonstration of analytical skills candidates scored very low marks for this part. A common answer (most probably discussed in a class) was observed, but it attracted only about 4 – 5 marks.

Although the ratios were computed and given in the question paper, some candidates spent unnecessary time re-computing them. Some others explained how to compute and what is measured by each ratio, as if in a theory lesson. This only wasted time and did not attract any marks.

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KC2 – Corporate Finance and Risk Management

December 2019

Examiner's Comments

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Overall student performance in the December 2019 examination was not satisfactory at all.

When examining the answer scripts it was evident that most candidates had sat for the examination without much preparation. Only about 55% of the total number of candidates who sat for this examination earned at least 30 marks. Candidates need to improve their subject knowledge, application, planning and time management skills in order to do well on this examination.

Question 01

This question was based on working capital management and foreign exchange exposure. It was a straightforward question without any complications. Almost all the candidates attempted this question, but the majority (approx. 80%) only earned between 10 – 15 marks. Only a limited number of candidates were able to earn more than 20 marks. This poor performance was mainly due to a lack of focus and poor planning.

(a) In this part the examiner expected candidates to comment on the finance manger's viewpoint using relevant calculations and working capital ratios.

Interpretations were done satisfactorily using ratio analysis for both financial years. However, many candidates failed to identify the real problem, which was some other issue and not the economic slowdown as stated by the finance manager. Most candidates proved only the presence of severe working capital issues and failed to identify features such as overtrading, disparity in financing etc.

(b) In this part, candidates had to evaluate the finance manager's proposals to enhance the overdraft facility, change the re-order quantity of stocks, and make a lead payment for a foreign currency payment. However, candidates had not understood the examiner's expectations.

The examiner did not explicitly specify that calculations should be performed. However, the question carried adequate information with regard to the calculations that are required for the answer. Candidates who recognised the examiner's expectation earned high marks. Most candidates had done the EOQ level calculation, the forward market hedge calculation and the lead payment calculation correctly. However:

- Candidates did not consider the current stock level in their calculations. Only the new ROQ and EOQ levels were considered. In order to form an opinion the current position is also important.

- Most candidates did not consider the ordering and holding cost at each level.
- Many candidates neglected buffer stock.
- In the foreign exchange exposure calculation, most candidates identified only the lead payment and forward market calculation. The money market hedge option was totally ignored.

The following common mistakes were also observed.

- Incorrect application of the EOQ formula and inability to resolve the EOQ formula.
- Inability to do the money market hedge calculation correctly.
- Applying the wrong exchange rates in calculations.
- Using incorrect interest rates (e.g. Some candidates used USD rates. Some even used deposit rates in adjusting the interest component as part of the evaluation).
- Inability to recommend the best option.

Question 02

This question was mostly based on calculations and comprised three parts for which information was given in separate paragraphs. The calculations were not complicated and were assigned a lot of marks. However most candidates only obtained 10 – 15 marks for this question. Once again only a few candidates were able to earn high marks for this question.

(a) This part of the question tested equity valuation based on the CAPM module. It was very straightforward and no ambiguities were observed. Candidates who knew the CAPM equation alone with little mathematical skills earned full marks. When analysing candidates' answers the following observations were noted.

- Almost all the candidates wrote the CAPM formula and substituted the numbers per the given data. Only a few candidates obtained incorrect answers when resolving the mathematical equation.
- A number of candidates took transaction costs into consideration only at the purchase point. A very few candidates took transaction costs at both the purchase and sale of stock.

(b) and (c)

These two parts of the question further tested the application skills of the candidates with regard to the expansion of the business to South Africa. Many candidates worked these two parts out correctly and obtained full marks. However some of the following mistakes were common.

- Some candidates misunderstood the net profit applicable to the South African segment and applied the 20% margin across the full entity.
- Some candidates valued the business based on total earnings and arrived at a high market value. There were candidates who valued the business based on PE multiples and the growth formula.

In addition to the calculations, the examiner asked for advice on whether to retain or sell the shares in part (c). Most answers to this were not satisfactory. Candidates should have realised that the examiner was simply expecting a logical answer to this, as it was only assigned 3 marks.

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(d) This part of the question was about NPV and the discounted payback calculation. Since the question was very easy, had the candidates worked out the relevant cash flows correctly, marks would have been easily earned.

- Most candidates misunderstood the saving value on the electricity bill. Instead of Rs. 20,000 per month they worked out savings as Rs. 5,000, and ended up with an incorrect answer.
- Candidates also took financial cash flows into consideration without understanding the fundamentals of NPV analysis.
- Further, it was clearly visible that most candidates did not know the constraints of solar energy, and wrote CSR initiatives as a non-financial factor.

Only a very few candidates worked out both NPV and discounted payback correctly and obtained high marks.

Question 03

This question aimed to assess knowledge in two areas: project evaluation of the two proposals and analysis of the risk mitigation actions in the international commodity market. Almost all the candidates attempted this question, but the performance was not at a satisfactory level.

(a) **Option 1**

- In this part candidates had to value the company using the free cash flow method. They should have started from unaudited earnings after interest before tax (EAIBT) in 2018/19 and adjusted the performance based on the given growth rates. However almost half the candidates used the 5-year forecast EAIBT in the common pre-seen. This implied that candidates had not understood the question properly.
- Most candidates took the net changes in working capital as cash outflows in each year and the cumulative amount was considered as cash inflows at the end of the 5th year.
- Value of the investment in the subsidiary was not considered in calculating the value of the company.
- Further candidates failed to deduct the value of debt in calculating the value attributed to equity holders.
- Per the question, sales proceeds on the disposal of Jerad's and Gayan's equity stake was settled in three equal bi-annual installments. As such candidates had to compute the present value of cash flows. However the majority of candidates failed to calculate the bi-annual discount rate to discount the cash flows.

Option 2

- Instead of calculating the free cash flows of the company for 2023, 2024 and thereafter, candidates calculated the free cash flows for the next five years starting from 2019/20.
- The investment in subsidiaries was not added and the value of debt was not deducted from the calculated PV.
- Further the correct percentage of the ownership of Jerad and Gayan (i.e. 47%) was not considered. No one calculated the PV of the aforesaid value (i.e. not discounted the Y3 value).

Most candidates gave a conclusion based on their computations. However, there were some who ignored it. These are the marks that could have been earned easily.

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(b)

(i) Most candidates failed to analyse the application of the commodity hedging technique to UEL engaged in international trade. Candidates misunderstood the concept and applied it to mitigate the risk of foreign currency exposure.

(ii) This part asked candidates to interpret the profit recorded from a long position. Only a very few candidates understood that the examiner expected the computation with respect to the profit earned from hedging. Candidates who understood the requirement did the calculation properly; but the others wrote irrelevant answers.

(iii) Candidates simply mentioned that the risk of the commodity market could be mitigated by futures/forward contracts. Most identified the risk as fluctuations of the exchange rate (not the change in price). However, answer related to commodities and examples were mentioned rarely.

(iv) Same answers given for (i) and (iii) were repeated here. Other matters mentioned in the model answer were not written by the candidates.

(c)

In this part the examiner asked candidates to explain the impact of the given highlighted points in the macroeconomic report if they used the second option. However most candidates explained in general without applying to the given scenario.

- Majority of the candidates mentioned the base rate reduction would lead to the deduction of the WACC, without applying it to the given scenario.
- Even though the examiner clearly mentioned that the inflation rate was low and expected, it is to be stabilised in the future. Candidates erroneously explained the impacts of the higher inflation rate.

(d)

- Majority of the candidates failed to answer this part properly. They just explained what the normal upward sloping bond yield curve was. They did not explain the liquidity preference and expectation theory.
- None of the candidates explained the steepness of the bond yield curve.
- Candidates also did not mention the situations where the bond yield curve may be inverted.

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KC3 – Corporate Taxation

December 2019

Examiner's Comments

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Question 01

The overall performance on this question was poor and below the satisfactory level. The majority of candidates were unable to present their answers clearly and concisely. As a result they were only able to score just 50% or less of the marks allocated for this question.

Some candidates had spent a significant amount of time writing a lot of details that were not relevant to the question and the given scenario.

Commonly observed weaknesses were:

- Lack of knowledge in deciding facts related to the chargeability of income tax of non-resident persons.
- Inability to support answers by giving appropriate facts.
- Poor references to the relevant sections of the Inland Revenue Act and building the answer accordingly.
- Misunderstandings and careless mistakes in calculations.
- Not interpreting and connecting the relevant articles of DTA – Singapore.

(a) Many candidates were unsuccessful in applying the DTA agreement provisions compared to the Inland Revenue Act provisions. Candidates did not notice that the DTA agreement provisions supersede the Inland Revenue Act provisions. Many of them limited their answers to the extent of the Sri Lankan PE definition mentioned in Section 195, and did not focus on DTA – Singapore Article 5(3).

(b) Candidates were not successful in analysing the facts on whether PHP is required to pay income tax in Sri Lanka for the income earned from the supply and delivery of equipment.

Many candidates failed to note that this particular transaction was directly done between PHP and GBL, and the profits on this were not attributable to the PE in Sri Lanka. Only a handful of candidates were able to support their answers citing the decided case of Anglo Persian Oil Co. v CIT.

Most candidates wasted their time producing unnecessary facts unproductively and earned less marks.

(c) Candidates' conclusion on whether PHP creates a PE in Sri Lanka had a big impact on the answer to this part. Many candidates did not identify the fact that PHP is only liable to pay income tax in Sri Lanka to the extent of the foreign component of the design income.

Although the question required computing the income tax payable by PHP, many candidates considered the local component of the project in the computation, forgetting that it was income of PHP Lanka.

A very few candidates erroneously identified that GBL creates a PE in Sri Lanka giving the reasoning that GBL is a dependent agent.

(d) This part was highly topical and candidates scored fairly good marks especially in part (i) as anticipated. However a considerable number of candidates missed the important fact that Mr. Perera was an employee of the company.

Although many candidates specified the provisions of sections 126 and 195, they were unable to connect such provisions to the given scenario and give advice based on the facts. Those who identified that the approved accountant was an employee and the accounts were prepared by him, were distracted by this fact and therefore formed their answer in line with auditing standards, professional ethics etc.

Question 02

The overall performance on this question was average and did not exceed the satisfactory level.

About 85% of the candidates were unable to submit a complete answer and were able to score only 50% or less of the marks allocated to the whole question.

(a) Almost half the candidates successfully computed the VAT liability in a proper manner, identifying the applicable taxable supplies and input tax credits.

However, some candidates mixed up the information given in the question. Some of them struggled to identify and categorise applicable supplies as liable, exempt or excluded.

Candidates either struggled or were unsuccessful in calculating the disallowed portion of the input credits and arriving at the allowable common input tax when exempt supplies were concerned.

Candidates did not recognise the fact that the supply of services deemed to have occurred at the time of occurrence of the applicable situation earlier. Hence, many candidates ignored the fact that the rent income (office rent) invoice is issued upfront in the month of January 2019 covering the future period of 6 months from January 2019. Therefore, the particular supply is deemed to have taken place in the month of January when the invoice was issued. It had to be identified as a supply for VAT purposes in the quarter ended 31 March 2019 and not in the quarter ended 30 June 2019. Thereby a surprising number of candidates missed their decision due to incorrect judgment.

By oversight some candidates treated the VAT paid upfront on imports as monthly installments. Thereby they lost easy marks allocated to applicable input credits.

On the other hand some candidates erroneously treated the monthly installment payments against the VAT labiality as an input credit, which was very unrealistic.

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These kinds of shortcomings were a clear indication of candidates being negligent when reading the information given.

(b) Answers to this part were varied. A considerable proportion of candidates were able to answer some of the points very well.

Irrespective of the fact that MSL is a non-manufacturing entity, some candidates did not identify that it is liable to pay VAT on a bi-monthly basis. This badly affected their answers in determining the applicable penalty thereon.

Candidates displayed their knowledge on the time bar provisions to issue VAT assessments, but they ignored instances where returns were not filed on the due date and the resulting consequences and effects on the time bar.

(c) The majority of candidates did not understand this part of the question and gave irrelevant answers.

It is noted with regret that many candidates failed to identify that outward freight has a source in Sri Lanka. Almost all the candidates were unable to mention the relevant gazette notification prescribing the WHT rate of 2%. However in general, many of them were successful in outlining filing compliance and penal provisions for non-payments.

Question 03

The overall performance on this question was within the satisfactory level. On the whole this **question was well received by the candidates** and they attempted all parts of the question.

Most candidates were able to produce excellent answers to the computation part, which required them to assess the balance tax payable.

Candidates were able to score an average of 60% or less of the marks allocated to the question.

(a)

The computation part was generally answered very well. A considerable number of candidates did score well. However, the following shortcomings were observed.

- The specific adjustment related to replanting was not identified by many candidates. It was quite surprising to see that candidates were not prepared for such adjustments when the pre-seen was given well ahead of the examination.

- However, many candidates successfully adjusted the fair value gain on consumable biological assets and amortisation, since they were basic accounting adjustment treatments.

- A good number of candidates were unable to display their knowledge on the adjustment required for R&D expenses.

  Most candidates were ignorant of the fact that R&D expenses are specifically allowed 100% under Section 15, and incorrectly treated the R&D expenses of Rs. 3.8 million charged to the income statement as deductible under the main deductions.

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Capital expenses on machinery (R&D)

Those who identified that R&D expenses could be claimed under Section 15 sadly missed the fact that an additional deduction of 100% was available under Schedule 6 of the Act. Some candidates overlooked this and missed the capital nature of the transaction. Thereby they lost marks allocated to such additional deductions available under temporary concessions.

Some candidates claimed both the R&D concessions and the capital allowance for R&D on machinery, which was not permitted under the prevailing Act.

- Candidates were ignorant on easy marks allocated for the depreciation allowance on Class 5 intangible assets.

  They did not identify this particular long-term lease right, which was amortised based on the actual lease period and hence should be treated as no deviation, with the depreciation allowance referred to in Schedule 4.

  Although many candidates added back the accounting adjustment of lease rentals paid during the year, they did not consider the depreciation allowance entitlement.

  Only a very few candidates identified that there is no adjustment required since the actual lease payment basis is equal to the actual useful life.

- Almost all the candidates failed to refer to the actuarial loss of Rs. 213,000, which was readily available in the pre-seen. This mistake was repeatedly noted and it showed that candidates were not familiar with actuarial gain/loss adjustments. This badly affected the ascertaining of the actual gratuity payment.

- Candidates were not familiar with some vital provisions in the IRD Act, such as deciding on the sources of income based on the theme “Effectively connected with the Business” (Ref: Section 6(2) g)

  Candidates had not carefully read the information given in the question. If they carefully considered all the facts they could have easily recognised the fact that ground rent income would be classified under investment income.

  However, a considerable number of candidates incorrectly treated the said ground rent as business income, forgetting the fact that the telecommunication tower was erected intentionally to earn investment income.

  On the other hand, a few candidates categorised the profit on sale of trees, refused tea, diversified crops and firewood etc. as a separate income under ‘assessable income from other sources’. Even though it did not affect the scoring of marks, it clearly showed a lack of knowledge on selection criteria that related to effective connections to the business.

- Due to errors made in arriving at the adjusted profit from business, many candidates ended with a business profit instead of a business loss. Thereby, claiming the current year business loss adjustment was not noticed by them. As a result of this they missed the possible opportunity to transfer the current year business loss against the current year investment income. A considerable number of candidates deducted the trade loss brought forward from total assessable income not knowing the prevailing provisions to set off trade losses when calculating the income of a person from business.

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- The majority of candidates were unsuccessful in applying the Section 18 provisions related to the deduction of finance costs. Most candidates failed to apply the applicable provisional requirements to the practical aspects of the scenario.

  Some candidates incorrectly applied 4 times in the formula stating that this particular entity is a non-manufacturing entity. Some candidates erroneously took the bank charges also into finance costs, and all of this resulted in the loss of allocated marks at each step.

(b) This part required candidates to advise on whether there are any tax exemptions/qualifying payments or any other tax benefits available on the given proposals.

Many candidates failed to focus on the requirement as a whole in line with tax exemptions and any other benefits.

Most of them sadly limited their answers by focusing only on the qualifying payments aspect. Thereby they tended to describe the reasons why any qualifying payments were not entitled per the provisions in Schedule 5.

The above shortcomings were not expected from corporate level candidates. Candidates are highly advised to focus more on the requirement and pay attention to action verbs in the future.

On the other hand, per the context it was required to evaluate different options to make the investment, including whether to incorporate a separate company to operate the said outlets or not. Only a handful of candidates were able to address the tax benefits based on the possible options mentioned.

Furthermore, many candidates overlooked the part of advising on the applicable income tax rates on different options, which was a basic criterion to decide the most beneficial option.

(c) Overall, candidates displayed reasonable knowledge on the withholding tax (WHT) obligations covering liability, rates and exemptions. There were a lot of fairly good answers to this part of the question and candidates scored well.

However some candidates limited their answers only to the extent of obligations and applicable rates, and overlooked the applicable exemptions and inclusions to the service fees that are liable to WHT.

(d) A considerable number of candidates failed to highlight the transfer pricing laws and regulations and advise on whether the entity complied with such laws and regulations.

Even those who were able to highlight the transfer pricing laws and regulations were unable to present suitable and appropriate advice, since they were unsuccessful in applying it to the given scenario.

(e) This part was also answered fairly well. A considerable number of candidates understood the question and successfully exceeded the expectation of the learning outcome.

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