CA THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

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SUGGESTED SOLUTIONS

KC 1 - Corporate Financial Reporting

June 2016

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Answer 01

Relevant Learning Outcome/s:
1.1.1, Advise on the application of Sri Lanka Accounting Standards in solving complicated matters.
1.1.2, Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
1.1.3, Evaluate the outcomes of the application of different accounting treatments.
1.1.5 Evaluate the impact of the use of different expert inputs to financial reporting.

Suggested Detail Answer

(a) (i)

Deferred tax

	Acc Base	Tax Base	TD	Tax rate	DT Liability
PPE			196,700	28%	55,076
Revaluation surplus			1,500,000	28%	420,000
					475,076

DT expense resulting from PPE should be recognised in P/L.

DT charge resulting from the revaluation of the building should be recognised in OCI.

(ii) A deferred tax asset shall be recognised for the unused tax losses carried forward to the extent it is probable that future taxable profits will be available against which the unused tax losses can be utilized.

Existence of unused tax losses and the fact that tax losses will be there in the next year is strong evidence that the future taxable profits will not be available.

Therefore a deferred tax asset should be recognised in the P/L only to the extent of Rs. 475,076 (420,000+55,076).

The balance amount of deferred tax asset not recognised due to the existences of unused tax losses should be disclosed.

i.e. DTA on unused tax loss: 2,500,000 x 28% = 700,000

DTA recognized	(475,076)
Balance DTA not recognized	224,924

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(b) **Sale and Leaseback**

If a sale and leaseback transaction results in an operating lease and if the sale price is above the fair value, the excess over FV shall be deferred and amortised over the period in which the asset is expected to be used.

Sale price Rs. 5.6 mn
FV Rs. 5.0 mn
Excess Rs. 0.6 mn
Rs. 0.6mn to be amortised over 5 years

For 2015/2016 – 600,000/5=120,000
Profit to be recognised in the income statement
FV Rs. 5mn
Carrying amount Rs. 3.5 mn
Profit Rs. 1.5mn
Total amount to be recognised in income statement = Rs. 120,000 +1,500,000
Rs. 1,620,000
Deferred income = Rs.600,000 - 120,000
Rs. 480,000

(c) **Building classified as held for sale**

If an entity has classified an asset as held for sale, but criteria in paragraphs 7-9 in SLFRS 5 are no longer met, the entity shall cease to classify the asset as held for sale.
Since it is highly unlikely that the buyer will purchase the building as agreed initially and directors have decided to use that building for the company's business, the company should cease to classify the building as held for sale.
SLFRS 5 para 27 requires the entity to measure the non-current asset that ceases to be classified as held for sale, at the lower of;

- Its carrying amount before the asset was classified as held for sale adjusted for any depreciation, amortisation, revaluation that would have been recognised had the asset not been classified as held for sale
- Its recoverable amount at the date of the subsequent decision not to sell

Accordingly, the building should be reflected in the financial statements for the year ended 31 March 2016, at the lower of;

1. Carrying amount had it not been classified as held for sale Rs. 11.2 million
   Cost 1.4.2013 13 mn
   Accumulated Depreciation 13mn/20*3 = 1.95mn
   Carrying amount as at 31.3.2016 11.05 mn

2. Recoverable value of Rs. 11.5 mn

   The lower amount is Rs. 11.05 mn.

Difference between the opening carrying value of Rs. 12 mn and Rs. 11.05 mn (i.e. 0.95 mn) to be recognised in profit or loss.

(d) Events and circumstances may extend the period to complete the sale beyond one year. An extension of the period required to complete a sale does not preclude an asset from being classified as held for sale if the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset.

Accordingly, even though there are legal restrictions, those will be removed and it is highly likely that the purchase will be made. If the management is still committed to sell, this can be considered as an event/circumstance beyond the management's control. Therefore, the building can be reflected as an asset held for sale.

The building should be continued to be measured at the lower of carrying amount and the fair value less cost to sell. Impairment of Rs. 0.5 mn to be recognized in P/L

Carrying value	12mn (no change from 2015)
Recoverable value	11.5mn
Difference (P/L)	0.5mn

(Total 25 marks)

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Answer 02

Relevant Learning Outcome/s:
1.2.1 Apply Sri Lanka Accounting Standards in solving moderately complicated matters.
1.2.2 Recommend the appropriate accounting treatment to be used in complicated circumstances in accordance with Sri Lanka Accounting Standards.
1.2.3 Demonstrate a thorough knowledge of Sri Lanka Accounting Standards in the selection and application of accounting policies.

Suggested Detail Answer:

(a) The type of share-based scheme that will have to be introduced is a cash-settled-share-based payment scheme.
For **example**, we might grant share appreciation rights to employees, whereby the employees will become entitled to a future cash payment (rather than an equity instrument), based on the increase in the company's share price from a specified level over a specified period of time. Or the company might grant to its employees a right to receive a future cash payment by granting to them a right to shares that are redeemable, either mandatory (e.g. upon cessation of employment) or at the employee's option.

For cash-settled share based payment scheme, the company shall measure services received and liability at fair value of the liability. Until the liability is settled, liability should be re-measured at its FV at the end of the each reporting period and at the date of the settlement. Any changes in FV should be recognised in Profit or loss.

(b) (i) By retaining responsibility for recoverability of the assigned debtors, the company has not transferred substantially all risks and rewards of ownership of the transferred debtors.
Therefore the company should continue to recognise the transferred debtors as assets. The amount received of Rs. 27.5 mn to be recognised as a liability.

(ii) If the bad debts risk is transferred, then it can be considered as significant risks and reward are transferred.

The carrying amount of the receivables can be derecognised. The loss of Rs. 2.5 mn (30-27.5) to be recognised in profit or loss.

(c) As per LKAS 40, if an entity has previously measured an investment property at FV, it shall continue to measure the property at FV until disposal (or until the property becomes owner occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of the business) even if comparable market transactions become less frequent or market prices become less readily available.

Therefore the company cannot change the accounting policy for investment property from the FV model to cost model.

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LKAS 08 requires a change in accounting policy if it is required by another SLFRS or if the change will result in financial statements that are more reliable. It is highly unlikely that changing the accounting policy from the FV model to cost will result in more reliable financial statements.

(d) As per SLFRS 10, consolidated financial statements should be prepared using uniform accounting policies for like transactions and events in similar circumstances.

If a member of a group uses accounting policies other than those adopted in the consolidated financial statements, appropriate adjustments should be made to that group member's financial statements in preparing consolidated financial statements.

Accordingly, DocMed should estimate the revalued amount for the building for preparing consolidated financial statements.

The other subsidiary should estimate the revalued amount for both land and building for the purpose of consolidation.

(Total 25 marks)

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Answer 03

Relevant Learning Outcome/s:
2.1.1 Compile consolidated financial statements for a group with more than two subsidiaries, sub-subsidiaries or foreign subsidiaries.
2.1.2 Recompile a consolidated set of financial statements, post-acquisition, merger or divestment.
3.1.1 Evaluate the reasonableness of financial statements relative to the actual financial status of an entity.
4.1 Corporate governance and sustainability reports including integrated reporting
5.1 Recent ethical issues

Suggested Detail Answer:

(a)

RPE Group
Consolidated Statement of Financial Position (Rs'000)
As at 31 March 2016

			Adjustments		BBB rated		50% disposal	Futures	Contract with	
Non current assets	Parent	CAL	Goodwill		Debt instrument		of RPS	Contract	Car Mart (Pvt)	Group
Property, plant and equipment	8,776,683	494,250	45,000				- 717,492			8,598,441
Investment Properties	680,000									680,000
Intangible assets	67,258	52,500	2,500							122,258
Goodwill			25,385							25,385
Investment in Associate							150,000			150,000
Prepayments	87,825									87,825
Other Non Current Assets	119,726									119,726
Current Assets										
Inventory	474,378	386,500					- 57,135			803,743
Trade and other receivables	929,611	65,780	- 300,000				- 12,390		-16200	666,801
Prepayments	34,981	6,000								40,981
Other Financial Assets	3,328									3,328
Cash and cash equivalents	1,628,186	48,520					- 3,000			1,673,706
Total Assets	12,801,976	1,053,550	- 227,115		-	-	- 640,017	-	- 16,200	**12,972,194**
Equity and liabilities										
Equity										
Stated capital	3,285,000	50,000	- 50,000							3,285,000
Reserves	(338,325)									(338,325)
Revaluation Reserve	72,958						(1/2)			72,958
Retained earnings	3,652,568	229,575	- 229,575			- 12,274	- 66,281	-2500	-16200	3,555,313
							(1/2)			
Non Controliing Interest	155,857		18,000				- 45,000			128,857
Non Current liabilities										
Interest Bearing Loans and Borrowin	994,000				- 140,000					854,000
8%cumulative preference shares		350,000								350,000
Financial Liability at FVTPL					140,000	12,274				152,274
Employee benefit liability	43,274	78,605					- 45,000			76,879
Deferred tax liability	601,567	123,650	1,960							727,177
Refundable deposits	1,228,855									768,855
							- 460,000			
Current liabilities										
Trade and Other Payables	2,183,455	198,520					- 23,736			2,358,239
Refundable deposits	116,930									116,930
Income Tax Payables	77,877									77,877
Provision for contingent Liability			4,500							4,500
Dividend Payable			28,000							28,000
Interest Bearing Loans and Borrowin	727,960	23,200								751,160
Derivative Contract								2,500		2,500
Total Equity and liabilities	12,801,976	1,053,550	- 227,115		-	-	- 640,017	-	- 16,200	**12,972,194**

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Working 1 - Goodwill Computation

			Rs. 000
Purchase Consideration			300,000
NCI	(5000*30%*Rs.12)		18,000
			318,000
FV of Net Assets			
Stated capital		50,000	
Retained earnings		229,575	
FV increase in license		2,500	
Dividend Payable		- 28,000	
Contingent liability		- 4,500	
FV increase in land		45,000	
DT liability		1,960	292,615
*	(4500*.28)		
Goodwill			25,385

* Assumed that there is a tax impact on the contingent liability.

Note:

Land transferred by RPE to CAL remained within the combined entity after the business combination. No gain or loss on such assets is recognised and should be measured at their carrying amounts immediately before the acquisition date. (para 38 of SLFRS 3) (No adjustment is required as lands are already in RPE's books) If any adjustment is made to the purchase consideration, the relevant marks for purchase consideration and correct goodwill should not be awarded.

Plan to restructure a subsidiary following an acquisition is not a present obligation of the acquiree at the acquisition date. Not a contingent liability.

Working 2 - Debt Instrument designated as FVTPL

Year		CFs	DR 10.5%	PV
2016	1	14,000	1	14,000
2017	2	14,000	0.9050	12,670
2018	3	14,000	0.8190	11,466
2019	4	154,000	0.7412	114,139
FV of the liability as at 31.3.2016				152,274

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Finance cost for the year is Rs. 14 mn

	Opening	Finance cost	paid	FV change	Closing FV
2016	140,000	14,000	-	1,726	152,274

Working 3 - Divestment of RPT

Sale proceeds	460,000
FV of retained interest - 30%	150,000
NCI	45,000
	655,000
Less:	
Net Assets	721,281
Goodwill	-
Loss from disposal	- 66,281

Working 4 - Futures Contract
Derivative Contract

Profit or Loss	Dr.	2,500	
(Rs.5,700-5,200)*5000			
Financial Liability	Cr.		2,500

Working 5 - Contract with Car Mart (Pvt) Ltd.

Based on the terms of the contract, RPE is acting as an agent.
Therefore, RPE's revenue from this contract is only the commission income.

Revenue	Dr.	18,000	
Trade Receivables	Cr.		18,000
(Reversal of Gross revenue)			
Trade receivables	Dr.	1,800	
Revenue	Cr.		1,800
(Recognition of net revenue/commission)			

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(b) Plan to restructure a subsidiary following an acquisition is not a present obligation of the acquiree at the acquisition date. Neither does it meet the definition of a contingent liability. Therefore RPE should not recognise a liability for restructuring cost as part of allocating the cost of combination. Recognising a provision as suggested by Sanath results in creative accounting. RPE cannot setup a provision for restructuring the subsidiary and then release this to P&L in subsequent periods to smooth the profit.

If the Finance director were to accept Sanath's instruction for creative accounting it's a breach of integrity (i.e. that he Finance director is honest in his professional conduct). That also displays lack of objectivity i.e. the requirement that an accountant should not allow bias, conflict of interest or influence of others to override professional judgment objectivity becomes more relevant if the finance director would benefit from the manipulated profit figure. The Finance Director should behave professionally and display professional competence and due care (that he must comply with applicable professional standards and regulations).

(c) (i) There should be a clear division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision making.

A decision to combine the posts of chairman and CEO in one person should be justified and highlighted in the Annual Report.

In the event the chairman and the CEO is the same person, non-executive directors should comprise a majority of the board.

(ii) **Role of the Chairman**

As the person responsible for running the Board, the chairman should preserve order and facilitate the effective discharge of Board function.

The Chairman should conduct Board proceedings in a proper manner and ensure that:

- effective participation of executive and non-executive directors is secured
- all directors are encouraged to make an effective contribution
- a balance of power between executive and non-executive directors is maintained
- the views of directors on issues under consideration are ascertained
- the Board is in complete control of the company's affairs and alert to its obligations to shareholders and other stakeholders.

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(d)

Revenue increase 15%

Possible Reasons

Even though the sharp drop in crude oil prices has exerted downward pressure on LPG its clear that the company had been able to increase revenue through increase in demand at reduced prices.

The company taking several initiatives to enhance product availability throughout the island

Increase consumption due to the increase in per capita from $ 3625 to $3819 which results in changes in lifestyle of urban and rural people.

Initiating different marketing strategies to promote rural communities using LPG instead of other traditional energy sources.

Industry growth in cylinder market by 20% even though the bulk market has reduced.

GP increase 59% and GP% increase from 12% to 16%.

Possible Reasons

Revenue growth

Reduction in crude oil prices

Operating profit increase 25%, OP margin increased from 14% to 15%

Possible Reasons

Revenue growth

Improved GP margin

Possible cost reduction strategies

Increase in finance cost 190%

Possible Reasons

Increase in non-current liabilities indicate increase in borrowing possibly for new investments.

Increase in PBT by 19%

Possible Reasons

Revenue growth

Improved GP margin

Bottom line was badly affected due to increase finance costs. However, profit from new investments is yet to realise .

Increase NP margin

Bottom line was badly affected due to increase finance costs. However, profit from new investments is yet to realise.

No change in NP margin (i.e, 13%)

Could also be due to marketing costs incurred during the year to improve revenue. Results of such initiatives may realise next year.

(Total 50 marks)

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