

## **KC1 – Corporate Financial Reporting**

**June 2017**

### **Examiner's Comments**

#### **Question 01**

All the candidates had answered this question. Some had given the calculations first and then commented on them later. A few had started their answers by commenting on whether the given accounting treatment was acceptable or not, writing the definitions and referring to the correct LKAS. However, in some instances candidates had explained the facts given in the question without giving the conclusion or correct accounting treatment.

Since this is an open book examination, candidates must ensure that they do not repeat all the points given. They also need to understand the examiner's expectation with reference to the marks allocated. Candidates must ensure they understand LKASs by practicing past papers and understanding how to apply the standards to a given practical scenario.

(a)

1. Most of the candidates identified the preference shares as compound instruments but failed to comment on the validity of the given accounting treatment.

Some had wrongly identified preference shares as a liability, whilst some candidates had calculated the dividend payable amounts too.

Some candidates had ignored the fact that the date of redemption was not in the contract.

A few candidates had also explained the fair value calculation and defined the term financial liability without calculating the PV and FV.

2. Impairment – the dual approach was not written and the general and specific provisions were not explained. Some candidates also failed to identify the requirements of individual and collective impairments correctly.

Some candidates had given general answers based on 50% and 100% provisions being made.

3. Although most candidates had stated that the loan should be measured at amortised cost, they failed to give the correct accounting treatment for the interest difference and charge it to the statement of comprehensive income. Some candidates also did not calculate the loan at fair value, and a few did not select the correct interest rate of 8%.

A few candidates also failed to answer the recognition criteria: initial recognition and subsequent recognition.

- (b) Some candidates only commented on the impairment indicators.

Most of the candidates had not understood the concept of highest and best use.

Some candidates had explained the fair value adjustment of investment property without explaining the highest and best use valuation.

- (c) Candidates had confused the name of the joint venture and thought it was SM Ltd and answered accordingly.

The joint operation was also not properly understood by most candidates. They had wrongly identified it as a related party.

## Question 02

Answers to this question were satisfactory and most candidates had presented their answers with calculations and supported them with comments.

- (a) Candidates were not able to understand that on 1 April 2016, the use of the property was undecided and the land could be recorded as investment property.

Some candidates had just mentioned whether it could be capitalised or not, without clearly understanding the question. According to the question the candidate needs to advise to the finance manager regarding the accounting of borrowing costs during the loan tenure.

The last paragraph said the management expected to sell 50% of the apartments to third parties, but some candidates had written that 50% will be accounted for under investment property.

- (b) Candidates misunderstood the fact that terminated costs were not identified correctly and future restricting costs were not yet committed.

Most of the candidates did not clearly understand the action verb "Advise". Therefore, the required calculations have not been performed on the different facts given.

### Question 03

Candidates need to have a thorough understanding of accounting standards and how to link them to practical scenarios. They need to remember the pre-seen material and also read the facts given in the question paper before starting to answer the questions. There were a few instances where ratios were calculated based on data given in the pre-seen.

A common mistake observed was the failure to identify the difference between joint venture and joint operations.

Some candidates simply discussed the accounting implications straightway without giving analysis or interpretation.

Lecturers should teach how to analyse the facts given in a scenario. The same answer was noted for the ratio analysis part, with most of those answers being similar word to word. This may be due to the ratio analysis being given by the lecturers in a printed document based on the pre-seen and candidates simply reproducing it at the exam without even reading the new information given. Lecturers should only provide guidance and not the exact answers.

- (a) Some candidates misunderstood this part and incorrectly thought the examiner's expectation was to select the best option.

Most did not understand that options 1 and 2 need to be evaluated in isolation and the financial impacts had to be given separately. Some candidates had just concluded to go ahead with Option 2 and that the 60% holding will result in controlling power, without analysing the other facts given.

A significant number of candidates were unable to identify the existing relationship of the parent (SFP) and the associate (SSPL). Instead they had concluded that it was a joint operation by both SFP and SSPL.

- (b) This part required candidates to assess both the board balance and appointments to the board. However, a considerable number of candidates had attempted to assess only the board balance. They also failed to write the requirements of SLFRS, corporate governance, Code of Ethics etc.
- (c) A considerable number of candidates had identified the CEO as a chartered accountant, instead of Group finance director.
- (d) Candidates were required to assess the profitability of SSPL by analysing revenue, GP, OP and NP. However, most had tried to evaluate efficiency, working capital and solvency.

## KC2 – Corporate Finance and Risk Management

### June 2017

#### Examiner's Comments

#### Question 01

- (a) (i) Most of the candidates did not know how to present the SWAP ratio E.g. 24% rounded up as 4:1, SWAP ratio not used to allocate shares from A PLC to C PLC.

A few candidates considered the PE ratio as earnings divided by price.

To calculate the value of synergy, instead of considering the combined value of A and C, some candidates only considered A's value. A few had calculated the value based on the EPS, and some others had worked out the synergy value per share.

- (ii) Some candidates had not understood the term "synergy", whilst some had written the impacts of a negative synergy. Most of the candidates had answered in point form without explaining.
- (b) Only a very few candidates were able to do the required calculations to a reasonable level. This showed a lack of technical knowledge in the area tested. Most of the answers were limited to the number of contracts.

#### Question 02

- (a) Candidates were required to analyse the factors impacting the returns to shareholders. However, most were confused over the question. Some had calculated many ratios that had no impact on shareholders' return. E.g. current asset ratio, quick ratio.
- (b) Candidates were required to discuss three options to raise financing, but some had only listed out the options. Most of the candidates considered retained earnings as a method of raising finance. Also, some had considered a bonus issue as a method to raise funds.
- (c) Almost all the candidates earned full marks for this part.
- (d) Although this part required evaluation, answers were limited to calculations. Most of the candidates had calculated the valuation of price/book value multiple as 1.2 x 10 per share.
- (e) Most candidates had not properly planned the answer to this part.

### Question 03

- (a) Macroeconomic factors were elaborated at length, but the impact on the project were not discussed.
- (b) The following mistakes were observed:
- Ignoring the volatile nature of the investment and risk thereon.
  - Not properly interpreting the sensitivity analysis and not identifying critical factors. Some candidates had done unnecessary arithmetical calculations and ratios that were not relevant.
  - Several candidates had calculated a sensitivity analysis without using the analysis given in the question.
- (c) Candidates were required to evaluate the finance director's concern over the volatile nature of the new project and the sensitivity analysis given by the examiner. However, some candidates had:
- Not discussed the volatile nature of the business
  - Not calculated free cash flows
  - Not differentiated the cash flows of the two businesses
  - Evaluated both projects under one appraisal.
  - Not properly taken Year 1 and Year 2 cash flows in the re-investment option
  - Not taken into account 60% of the equity holding
  - Not done the comparison
  - Confused the net realisable value (NRV) and investment of the project
  - Considered depreciation in cash flow
  - Considered the incremental net cash flow of Rs. 15 million for perpetuity as a cash flow.
- (d) (i) Some candidates were not aware of capex and opex. Justification was not done properly.
- (ii) Several candidates had failed to calculate the cost savings resulting from the minimising of delays in invoicing.
- They had taken the total revenue instead of the SBU revenue to calculate the cost saving.
  - Ignored the probability calculations.
- (e) Market value of the geared company and un-geared company were not calculated properly.
- Some candidates had explained the MM Theory without calculations.
  - Only a few candidates were able to draw the graph properly.



## KC3 – Corporate Taxation

June 2017

### Examiner's Comments

#### General

Overall performance of the candidates was satisfactory.

Majority of the candidates had a methodical approach to questions and were thereby able to produce reasonably focused, relevant answers addressing the principal and core components of each requirement.

It appeared that the candidates had finally understood the importance of the key attributes related to the Corporate Level curriculum. They had displayed their ability in reporting, communicating, understanding the industry and business circumstances and applying the skills of analysing and decision-making based on various information collected.

Candidates should be able to compile comprehensive tax computations at this stage. They should also be able to display knowledge of tax planning and decision-making related to minimising tax expenses, mitigating risks and carrying out effective communication with tax authorities, clients and the management. Therefore, simply displaying technical knowledge is not adequate at this level.

Given that it was an open book examination, the candidates' level of presenting answers in line with the required standards (in terms of technical and legal aspects) was not fully met.

Candidates should be more focused on the structure of the paper since the three questions are based on scenarios. Therefore the answers should be presented in a manner that is in line with expectations. Candidates are recommended to address the action verbs, expected learning outcomes, knowledge process, knowledge dimension etc.

Reasons for adverse performance could have been the following:

- Lack of study of the pre-seen material
- Lack of understanding of the requirements of the questions
- Producing irrelevant facts and thereby wasting time
- Lack of study of recent amendments to the Inland Revenue Act.
- Lack of communication and presentation skills.

## Question 01

Overall performance on this part was poor and below the satisfactory level. Candidates who scored well had carefully read and interpreted what the question was asking for and made their points clearly and concisely. Others had spent a significant amount of time, writing a lot of detail about a subject based on their knowledge, which if not relevant to the question and scenario outlined, did not score marks.

The commonly observed weaknesses of candidates were:

- Lack of knowledge in chargeability of income tax on non-resident persons
- Inability to support the answer by giving facts
- Poor references to the relevant sections of the Inland Revenue Act
- Misunderstandings and careless mistakes in calculations

(a)

Although many candidates knew that a non-resident person is assessable for income tax in Sri Lanka, they were not able to identify the residency status in the given scenario. Many failed to carefully go through the extract of Article 5 of the DTA between Sri Lanka and India readily given in the question paper itself.

In the case of creation of a permanent establishment under the double tax agreement, the identification of the consequent tax liability of the contracting state (in accordance with Art. 7 and Art. (5)(3)(b) of the DTA) was the knowledge area tested.

Even though the contents of Art. (5)(3)(b) were mentioned by many and connected to the KYC scenario, these candidates had no idea about the contents of Art. 7 and thereby lost some easy marks allocated.

Most candidates had identified the entitlement to a tax credit in India for taxes paid in Sri Lanka and thereby scored marks. However, most were ignorant of the fact that the credit will be limited to the amount of tax payable in India on the same income on which tax was payable in Sri Lanka.

(b)

Candidates had done this computation part of the question reasonably well. A pleasing number of candidates fairly computed the required income tax liability and remittance tax liability.

However, some commonly observed weaknesses were:

- Not identifying the head office expense limitation as 10% of the total income or actual expense, whichever is lower
- Applying the incorrect income tax rates
- Completely omitting the calculation of remittance tax
- Instead of calculating remittance tax, just stating the applicable remittance tax rate as the answer
- Calculating the remittance tax before the income tax calculation

(c)

On the whole, this part of the question was answered reasonably well with a large majority of candidates managing to achieve the full allocated marks. However, a few candidates did not mention that KYC has created a permanent establishment and therefore services are performed through a fixed base. Those who scored well did so by demonstrating a good knowledge and ability to set out the answers in a logical order.

(d)

A very high proportion of candidates were unable to give the exact answer that was expected. Answers were varied for this question. Many candidates did not understand the question and the answers given were not relevant, and they thereby lost marks.

Candidates who did best were those who had carefully gone through the scenarios presented by the question separately, rather than trying to combine the scenarios. Furthermore, those who identified that there was an impact on transfer pricing, as the question required, scored well (sometimes attracting bonus marks). This was because they had addressed applicable section contents, and in doing so, had picked up more technical marks.

(e)

This part was generally well answered with a number of candidates scoring full marks. The most common error was not knowing the fact that the percentage, shall in no circumstance, be less than 6%. This resulted in candidates losing some easy marks.

## **Question 02**

Overall performance on this question was within the satisfactory level.

Commonly observed weaknesses of candidates were:

- Lack of knowledge of treatment for VAT on financial services
- Misunderstandings and mistakes in calculations

(a)

Candidates who had attempted this part generally made a reasonable attempt at computing the VAT liability. They were generally aware of the issues involved and demonstrated some relevant technical knowledge. Most candidates scored 5 or more marks on this part.

However, a few candidates struggled to calculate VAT and NBT based on the total value addition amount prior to tax, and incorrectly applied the effective VAT rate directly to the value addition prior to tax figures.

Some candidates had totally ignored the 2% NBT, which should have been considered as a part of tax when arriving at the 100% of total value addition.

(b)

This part of the question tested new changes made to the VAT Act with regard to the submission of VAT returns, annual adjustments, payments etc. The common failing here was the lack of pre-study in relation to recent amendments to the Value Added Tax Act.

A very high proportion of candidates did not know that after 1 January 2017, the return of VAT on financial services is to be filed on a yearly basis within 6-months from the end of the taxable year.

Many candidates demonstrated a good understanding of the annual adjustments and payments of VAT on financial services.

(c)

This part of the question was answered well, with the majority of candidates achieving the full allocated marks.

Many referred to the regulations published in the Gazette Notification No: 1857/8 of 9<sup>th</sup> April 2014 and incorporated this into their answer.

Almost all the candidates were successful in identifying the treatment when financial instruments are derecognised.

(d)

This part of the question was also answered well, with the majority of candidates achieving the full allocated marks.

### **Question 03**

The overall performance in this question was satisfactory when compared to previous examinations.

(a)

In this part, the tax computation of a limited liability company was given and candidates were required to assess the income tax liability for the year of assessment 2016/17 and calculate the dividend tax on dividends distributed.

As this question was a computational question, candidates scored well on it, particularly in relation to the disallowable items, capital allowances etc.

Majority of the candidates were successful in forming a methodical answer. Only a very few candidates seemed to have struggled a bit to identify the two different business sectors (manufacturing and fuel & lubricants), which should be separately taken into consideration when computing the adjusted profit from business.

### Common mistakes observed

- Not being aware of the applicable 10% tax relief given to manufacturers who were in business since 1970 under Section 59K of the Act.
- Calculating profit on disposal of fixed assets by taking the full capital allowances including depreciation in the year of disposal, which is the incorrect treatment when the tax written down value is ascertained.
- Misunderstanding market research and treating it as R&D expenses, and thereby applying a triple deduction, ignoring the fact that it is not a kind of research that upgrades trade and business. Only a handful of candidates knew that market research should be allowed, as the Act does not disallow it, though not given a triple deduction. Despite the fact that it related to noodles production, which had not yet commenced, it is an expenditure incurred in the production of income.
- Not identifying that an advertisement published in the newspapers to find a suitable land for setting up a new factory is capital in nature and hence fully disallowed for tax purposes.
- Missing scoring easy marks allocated on individual impairment (which is an allowable expenditure).
- Not recognising that a donation made to a community project is entitled for qualifying payments.
- Adjustment to the rent-free apartment given to the CEO
  - Not being aware of the fact that rent paid to the landlord should be compared to the rental value, and the higher amount selected.
  - Incorrectly taking Rs. 120,000 as the statutory limit even though the total employment income was more than Rs. 1.8 million.
  - Despite displaying knowledge of the applicable 75% disallowance on expenditure over the amount of rent value under employment income, candidates struggled to calculate the relevant excess.
  - Erroneously deducting the rental value from the amount of gross rent paid to the landlord to arrive at the applicable excess.

(b)

This part tested knowledge of the tax implications of compensation payments to employees under a voluntary retirement scheme.

Almost all the candidates had mentioned the applicability of Section 8(1). However, most did not describe in detail how such benefits are taxed under different situations based on uniformity of the retirement scheme, and thereby lost easy marks.

A few candidates had also misunderstood the question and explained the internal procedures that are carried out at the Department of Inland Revenue on the application of tax directions with regard to such retirement benefits

(c)

This was the best-answered part of the question, with a large number of candidates scoring the full allocated marks. Almost all the candidates successfully mentioned the applicable case of “Hayley & Co Ltd Vs Commissioner of Inland Revenue”.

(d)

(i) This part required the candidates’ views on the exemption claimed. Even though the question specifically made reference to the Section 16B exemption, many candidates argued that the production of branded coffee also falls into the category of primary processing of seeds.

(ii) Answers to this part were very satisfactory. Many candidates had understood the question properly, explained the applicable sections and stated the fact that a mere investment in fixed assets would not be considered as a qualifying payment.

However, a few candidates wrongly explained the departmental procedure of sending intimation letters and how to appeal in such occasions.

# **KC4 – Corporate Governance, Assurance and Ethics**

## **June 2017**

### **Examiner’s Comments**

#### **General**

The paper consisted of two sections: Section 1 and Section 2. Section 1 contained two questions carrying 25 marks each and Section 2 was based on the pre-seen and carried 50 marks. The examination was conducted as an open book examination. As in the previous examinations, in order to score well, candidates were required to demonstrate sound technical and practical knowledge. However some candidates were still unable to demonstrate good time management. Many candidates also appeared to have lost the focus of the question requirement. They had started to answer Question 03 first and written lengthy answers for it (which ended up being a waste of time), thereby not having sufficient time to complete Question 01 and Question 02.

#### **Question 01**

(a)

- (i) Candidates were required to evaluate 5 risks the management of OSPL should consider as part of its risk management framework.

Majority of the candidates obtained 4 or more out of the 10 marks allocated for this part. They demonstrated practical knowledge in the hotel sector gained from annual reports of beach hotels. Most candidates identified the risks relating to the hotel industry, but some were not able to score full marks as they had not evaluated the risks by stating the impacts. For example,

- Unable to provide sufficient supplies → impact on business not written
- Skilled employees leaving the company → impact on quality not written
- Dumping waste → adverse effect on reputation not written

Some candidates had written audit risks such as:

- Misstatement of revenue due to complex situation
- Foreign currency transaction → exchange loss
- Fraud risk (as the main objective was maximising profits)

The following shortcomings were also observed in some of the answer scripts.

- Without understanding the question, mentioning the categories of risks as strategic risks, operational risks, finance risk etc.
  - Correctly identifying and explaining the risk, but not stating the impact on the entity.
- (ii) Candidates were required to propose an appropriate risk-mitigating plan. Majority of the candidates produced satisfactory answers for this part. There were some candidates who linked risks to the risk management framework and wrote about the likelihood/consequences matrix, and risk acceptance, risk transfer and risk reduction, without properly addressing the risk mitigating plan. However some candidates had wasted time writing lengthy answers and several mitigating actions, and thereby faced time management issues.

(b)

- 1 Candidates had to advise D&Y Associates on any changes required to the initially determined audit strategy in the given scenario. Some candidates had produced satisfactory answers. However, some others had not understood that the original strategy was based on test of controls. There were shortcomings in the answers produced by many candidates such as:
  - Writing general answers such as, “determine the overall responses to address the risk of material misstatements in order to assign experts and provide more supervision”
  - Many wrote the changes to be made without mentioning the impact to the originally planned strategy.
- 2 Candidates had to recommend further audit procedures for the matters given in the scenario. Some had produced satisfactory answers. However, the majority did not understand the further audit procedures that were required and wrote general audit procedure such as:

Accounts receivable

- Do reconciliation
- Obtain management representation

Revenue

- Check cut-off testing

Misplaced assets

- Do physical verification
- Inquire from management
- Check purchases and disposal procedures

The following shortcomings were also observed in many scripts:

- Not properly identifying audit procedures to address the going concern issue
- Only mentioning cut-off testing in the case of incorrect revenue recognition

## Question 02

(a)

Candidates were required to compile a checklist of matters to consider when assessing the potential risks associated with the acceptance of a client. This part could have been easily answered by referring to SLSQC 1, which covers the following three major areas:

- Ethical requirement
- Competency
- Integrity

Those who had referred to the particular standard wrote relevant answers. Some had referred to SLAuS300 and written irrelevant answers. Some others had written general answers such as:

- Auditor's responsibility
- Objective of the engagement

Many candidates had written only 10 points, as the question requirement was to provide at least 10 matters. It is advised to write more points so that the marking examiner can pick up the relevant points. Some candidates had written certain points given in SLSQC, but they were not applicable to the scenario. These included:

- Identifying business reputation of related parties
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible
- Experts are needed if available

(b)

Candidates were required to evaluate factors to be considered when accepting the client's audit in the given scenario. The examiner expected the candidates to apply the points given in the checklist to a practical situation. Many had misunderstood the question requirement and just copied the points in SLSQC 1. Some had given completely irrelevant answers such as:

- SEC requirement not followed
- Purpose of the engagement
- Material misstatement
- Corporate governance
- Gather sufficient and appropriate evidence

(c)

Candidates were required to propose three areas that are important to be formalised at CPA. Majority of the candidates had either not understood the question or had poor technical knowledge. They had produced irrelevant answers such as:

- Maintain independence
- Market professional services
- Comply with laws and regulations
- Corporate governance practices
- Identify the reporting framework

### Question 03

This question carried 50 marks and consisted of 5 parts (some of which were based on the pre-seen). Many candidates easily scored about 20 marks from part (b) and part (d). However, there were some candidates who demonstrated poor time management by writing lengthy answers unnecessarily.

Candidates should have been able to identify issues in relation to the particular requirement from the scenario itself. They must ensure that they answer the specific question requirement and focus their answers on the scenario. Candidates are encouraged to practice past exam question papers and carefully review the model answer and examiner's comments given.

(a)

- (i) Candidates were required to evaluate the professional services sought from the partner in terms of the Code of Ethics.

#### **Investment decision**

Many had ignored the part on ethics in the question and only considered providing a professional service. As a result they wrote irrelevant answers such as to provide:

- Due diligence
- Review engagement
- Agreed upon procedure

Candidates had wasted time explaining such engagements. Those who had understood the question wrote it as a management activity.

#### **Implementation of changes to internal control**

Many had produced relevant answers.

#### **Identifying the level of opportunity and risk**

Many had not understood the question and written that it will create self-interest.

- (ii) Candidates were required to recommend suitable approaches to mitigate the issues mentioned in part (i). Many candidates were unable to put themselves into a position of an audit partner. In a practical situation an audit partner would not abruptly reject the service. Usually he will reason out and see whether the threat can be reduced to an acceptable level before rejecting the engagement. The examiner expected the candidates to know how to address such a situation. The common answer produced by many was to decline. They had not assessed that the threat cannot be reduced to an acceptable level. As a result they were unable to score the allocated marks.

(b)

This part was in relation to audit risks. Candidates were asked to propose areas of key audit risks that they plan to address in their audit plan, based on the pre-seen and the information provided. Many candidates provided relevant answers and obtained full marks. However, some wrote general areas of audit risks without referring to the pre-seen and the information given such as:

- Fraud risk
- Revenue recognition
- Trade receivables
- Impairment

Some candidates wrote business risks such as:

- Market risk
- Environment risk
- HR risk

(c)

Candidates were required to advise on areas to be included in the internal audit testing in relation to the quality of inputs and raw materials. Some candidates, without reading the question, wrote about the quality of finished products. Some others had ignored the question requirement and wrote about the duties of the internal auditor.

(d)

Candidates were required to advise the chairman on the benefits of an audit committee. Many scored full marks for this part. They demonstrated knowledge gained from studying the textbook and also gave points mentioned in the UK Cadbury Report. However, some candidates had simply written general answers such as:

- Facilitate auditors
- Reduce frauds
- Whistleblowing

(e)

Candidates were required to design specific audit procedures to address the audit of the implementation of the ERP system. This part aimed to test auditing knowledge on the implementation process of an ERP solution, as present entities are introducing ERP solutions. It was disappointing to note that many candidates demonstrated poor knowledge of ERP systems. Most of the scripts carried general answers such as:

- Board approval for the purchase
- Budgetary allocation
- Review the contract for conditions
- Check the payment with agreement
- Ensure the expected areas are covered
- Ensure it provides necessary reports for the audit