THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB 1 – Business Financial Reporting

June 2017

SECTION 1

Answer 01

Relevant Learning Outcome/s:
1.1.1 Demonstrate the knowledge of the conceptual framework of Sri Lanka Accounting Standards, with emphasis on: – Objectives of general purpose financial statements – Underlying assumptions – Qualitative characteristics of financial statements – Elements of financial statements – Recognition and measurement of elements of financial statements – Concepts of capital and capital maintenance. 1.3.1 Demonstrate the awareness of provisions in Corporate governance, companies Act (sections 56, 69,148 to 171 and 192) and SEC regulations and rulings.
Study text reference: Pages 14, 40 – 43

(a) **Conceptual framework**

The Conceptual Framework for Financial Reporting states that financial statements should provide a faithful presentation. Faithful representation of a transaction is only possible if it is accounted for according to its **substance and economic reality**. Therefore, although it appears that the shares are held/ possessed by Wealth, they are in fact held by Wealth on behalf of Prudent. Therefore, if Wealth were to record the shares they hold on behalf of Prudent, it would not reflect the economic reality as the investments belong to Prudent although they are possessed by Wealth. Therefore Wealth should not recognise the listed shares referred to in the scenario.

Further as per the definition provided in the Conceptual Framework, an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Wealth does not control the investment's future economic benefits. The benefits from the investments flow to Prudent, and Wealth earns a fee for holding the shares regardless of how the shares perform. The listed shares do not therefore meet the criteria of an asset in Wealth's balance sheet.

(4 marks)

(b) **Board composition**

- Balance of executive and non-executive directors of a Board – it is preferable for the Board to have a balance of executive and non-executive directors such that no individual or small group of individuals can dominate the Board's decision making.

- Non-executive directors of a board – the Board should include non-executive directors of sufficient caliber and number for their views to carry significant weight in the Board's decisions.

- Number of non-executive directors to be included on the Board – the Board should include at least two non-executive directors or such number of non-executive directors equivalent to $^{1}/_{3}$ of the total number of directors, whichever is higher.

- In the event the Chairman and the CEO are the same person, non-executive directors should comprise a majority of the Board.

- Appointing a senior independent director (SID) – in the event that the CEO and Chairman are the same person, a SID is to be appointed.

- Appointment of independent non-executive directors (INEDs) – where the Board includes only two non-executive directors (NEDs), both of them need to be INEDs. In all other instances, 2 or $^{1}/_{3}$ of NEDs, whichever is higher, need to be INEDs.

(6 marks)

(Total: 10 marks)

Answer 02

Relevant Learning Outcome/s:
2.1 Sri Lanka Accounting Standards (Level A)
Study text reference: Pages 594 – 602

	Rs. '000
Cash flows from operating activities	
Profit before tax	503
Depreciation **(W1)**	575
Profit on disposal of property, plant and equipment	(10)
Amortisation of intangible assets (200 – 170)	30
Impairment of PPE	75
Dividend income	(15)
Finance expenses	47
Operating cash flow before working capital changes	1,205
Increase in inventory	(90)
Decrease in trade and other receivables	120
Increase in prepayments	(30)
Increase in trade and other payables	50
Cash generated from operating activities	1,255
Interest paid	(47)
Income tax paid **(W2)**	(123)
Net cash flow from operating activities	1,085

W1: Depreciation	**Rs. '000**
PPE as at 31 March 2016	3,150
Less: Impairment	(75)
	3,075
PPE as at 31 March 2017	(2,500)
Depreciation	575

W2: Income tax paid	**Rs. '000**
Opening income tax liability	20
Charge for the year (180 – 35)	145
Tax paid	(123)
Closing income tax liability (192 – 150)	42

(10 marks)

Answer 03

Relevant Learning Outcome/s:
2.2 Sri Lanka Accounting Standards (Level B)
Study text reference: Pages 342 – 352

(a) **Initial recognition**

This loan should be recognised as **loans and receivables** on 1 April 2016. Loans and receivables shall be recognsied at **fair value** on 1 April 2016, which is calculated as follows**:**

[10,000,000/ (1.1) ^5)] = Rs. 6,209,213

The loan's initial fair value is the present value of the future payment of Rs. 10 million discounted using the market rate of interest for a similar loan of 10% for 5 years. The consideration of Rs. 10 million is given for two things: the fair value of the loan of Rs. 6,209,213 and Jay (Pvt) Limited's right to obtain other future economic benefits.

i.e. Rs. 10,000,000 – Rs. 6,209,213 = Rs. 3,790,787

The above difference of Rs. 3,790,787 shall not be recognised as a financial asset, since it is paid to obtain expected future economic benefits other than the right to receive payment on the loan asset. Jay (Pvt) Limited could recognise that amount as an expense unless it qualifies for recognition as an asset under LKAS 38, or as part of the cost of investment in the subsidiary, if Kay (Pvt) Limited is a subsidiary of Jay (Pvt) Limited.

Subsequent measurement

This loan shall be measured at amortised cost**.** At the balance sheet date 31 March 2017, it should be carried at as follows:

Period	**Opening amortised carrying value (Rs.)**	**Interest @ 10%**	**Amorised cost at the end of the year (Rs.)**
1 April 2016	0		6,209,213
31 March 2017	6,209,213	620,921	6,830,134

(5 marks)

(b) (i)

(1) Since this asset is to be classified as an available-for-sale (AFS) asset, Pay (Pvt) Limited should recognise the asset at its fair value plus transaction cost (i.e. purchase commission). Accordingly, the value per share on 1 April 2016 should be Rs. 102 per share.

(2) As at 31 March 2017, in deriving the fair value of the equity instrument, the fair value shall be considered as Rs. 105 per share, without any regard to the commission of Rs. 4 payable per share on sale.

(3) The change in fair value of Rs. 3 per share shall be recognised in other comprehensive income, which includes the purchase commission of Rs. 2 payable at the acquisition.

(3 marks)

(ii) When a decline in the fair value of an available-for-sale (AFS) financial asset has been 6ecognized directly in other comprehensive income, and there is objective evidence that the asset is impaired, the cumulative loss that had been 6ecognized directly in other comprehensive income should be reclassified from equity, and then 6ecognized in the profit or loss even though the financial asset has not been derecognized.

(2 marks)

(Total: 10 marks)

Answer 04

Relevant Learning Outcome/s:
2.2 Sri Lanka Accounting Standard (Level B)
2.3 Sri Lanka Accounting Standard (Level C)
Study text reference: Pages 384, 401

(a) The share options should be measured at fair value of the grant date.
i.e. 1,000 * 50 * Rs. 2 = Rs. 100,000

This should be **spread equally over each year of the vesting period** giving an expense in the year ended 31 March 2017 of Rs. 25,000 (Rs. 100,000/4).

(3 marks)

(b)

(i) Computation of actuarial gain/loss

	Asset **Rs. '000**	**Obligation** **Rs. '000**
Fair value/present value on 1 April 2016	1,900	1,980
Interest [(1,900*11%), (1,980*11%)]	209	218
Current service cost		560
Contribution received	700	
Benefits paid	(150)	(150)
Actuarial loss/gain (balancing figure)	(659)	(458)
Fair value/present value 31 March 2017	2,000	2,150

(4 marks)

(ii) The following amounts should be recognized in the profit or loss and OCI respectively.

In profit or loss	**Rs. '000**
Current service cost	560
Net interest on net defined benefit liability (218 – 209) (Interest (1,900 * 11% = 209), (1,980 * 11% = 218))	9
In OCI (659 – 458)	201

In the statement of financial position

The net defined benefit liability of Rs. 150,000 should be recognized

(3 marks)

(Total: 10 marks)

Answer 05

Relevant Learning Outcome/s:
4.1.2 Interpret relevant financial ratios, including profitability ratios, liquidity ratios, efficiency ratios and gearing and solvency ratios.
4.2.1 Outline the progress towards non-financial reporting standards, including sustainability reporting and integrated reporting.
Study text reference: Pages 69, 650 – 655

(a) **Liquidity**

The current ratio has improved in 2017 when compared to 2016 and is marginally higher than the industry average. This might be due to the maintenance of a higher inventory by the company than in the industry, and it could be verified through a lower inventory turnover as well. However, the current ratio is lower than what is generally regarded as satisfactory (2:1).

The quick ratio has improved in 2017 compared to 2016. It is also better than the industry average of 1:1 and is in line with the generally accepted level of 1:1

Working capital management

The accounts receivable period has improved compared to the previous year and is better than the industry average. Although the supplier payment period is better than the industry average, it has reduced by 10 days compared to the previous year. Due to this, the gap between the supplier payment period and the receivable collection period has reduced by 3 days than that in the previous year. This might cause a negative effect on the cash flows of the company than in the previous year.

Inventory turnover has fallen and is much slower than the industry average. This could either be due to stocking up ahead of an increase of sales or due to obsolete items that may require write-off.

(6 marks)

(b) **To the entity**

- Promote a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organisation to create value over time.
- Support integrated thinking, decision-making and actions that focus on the creation of value over the short, medium and long term.
- Enhance accountability and stewardship for the broad base of capital.
- Integrated reporting adds value to a company by highlighting how green and ethical values drive long-term growth.
- Create better relationships and understanding across the organisation fostering more 'integrated thinking'. There is so much more interaction between different departments as a result of integrated reporting.

To investors

- Integrated reporting has the potential to bridge the information gaps between a company's management and investors.
- It provides greater insight into an 9rganization's business model, strategy and long-term outlook (helping to clarify a company's approach to its long-term strategic opportunities and risks).
- Lead to better engagement between the financial investment community and company management around material issues and the drivers for performance and value creation.
- Assist engagements and help carry out more informed decision-making.
- Helpful for understanding stocks and flows of capital, leading to better capital allocation and decision time.

(4 marks)

(Total: 10 marks)

SECTION 2

Answer 06

Relevant Learning Outcome/s:
3.1 Consolidated financial statements
2.2 Accounting Standards (Level B)
Study text reference: Pages 485 – 537, 568

	Panda	Sanda			Adjustments							onsolidated	
	Rs. Mn	Rs. Mn			Rs. Mn							Rs. Mn	W/Re
			Fair value at acquisition	associate Post acquisition profit	Fair value of property	URP - Sanda to Panda	URP - Panda to Amda	goodwil l	Impairemen t of investment	NCI Profit since acquisitio n	Total		
ASSETS													
Non-current assets													
Property	9,750	6,250	2,000	-	(150)	-	-	-	-	-	1,850	17,850	W2
Plant and machinery	3,975	1,875	-	-	-	-	-	-	-	-	-	5,850	
Investments	7,500	-	-	-	-	-	-	-	-	-	-	-	
Goodwill	-	-	200	-	-	-	-	(100)	-	-	100	100	W1
Investment in associate	-	-	2,500	360	-	-	(24)	-	(460)	-	2,376	2,376	
	21,225	**8,125**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**4,326**	**26,176**	
Current assets													
Inventories	2,875	1,500	-	-	-	(100)	-	-	-	-	(100)	4,275	W4
Trade receivables	1,650	1,450	-	-	-	-	-	-	-	-	-	3,100	
Cash and cash equivalents	250	600	-	-	-	-	-	-	-	-	-	850	
	4,775	3,550	-	-	-	-	-	-	-	-	(100)	8,225	
Total assets	**26,000**	**11,675**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**4,226**	**34,401**	
EQUITY AND LIABILITIES													
Equity													
Stated capital	10,000	5,000	-	-	-	-	-	-	-	-		10,000	
Retained earnings	7,300	4,425	(1,000)	360	(90)	(60)	(24)	(60)	(460)	(1,370)	(2,704)	9,021	W3
	17,300	9,425										19,021	
Non-controlling interest	-	-	3,200	-	(60)	(40)	-	(40)	-	1,370	4,430	4,430	
Non-current liabilities													
Borrowings	2,500	500	-	-	-	-	-	-	-	-	-	3,000	
Current liabilities											-		
Trade payables	3,400	1,750	-	-	-	-	-	-	-	-	-	5,150	
Borrowings	2,800	-	-	-	-	-	-	-	-	-	-	2,800	
	6,200	1,750	-	-	-	-	-	-	-	-	-	7,950	
Total equity and liabilitie	**26,000**	**11,675**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**34,401**	

W1

Goodwill on acquisition of Sanda	**Rs Mn**	**Rs Mn**
Consideration transferred		5,000
Non-controlling interest		3,200
Net assets acquired:		
- Stated capital	5,000	
- Retained earnings	1,000	
- Fair value adjustment	2,000	(8,000)
Goodwill on acquisition		200
50% Impairment		100
Goodwill impairment		

W2

Depreciation of fair value adjustment

Additional depreciation (2000*50%/40*6)	150

W3

Profits of NCI since acquisition	
Retained earnings at 31 March 2017	4,425
Retained earnings at the date of acquisition	(1,000)
Post acquisition retained earnings	3,425
40% of profit	1,370

W4	**Rs Mn**
On sales by Sanda to Panda	
(500*25/125)	100

(19 marks)

(b) LKAS 28 defines an associate as follows:

''An associate is an entity over which the investor entity has significant influence.''

The standard gives examples of how an entity could demonstrate that it has significant influence over an investment. Some of those that are relevant to this scenario include:

- Representation on the board of directors or equivalent governing body of the investee.

- Participation in policy-making processes, including participation in decisions about dividends or other distributions.

The other criteria given in LAKS 28 include the following, and they will not have a direct application to this scenario:
- *Material transactions between the entity and the investee*
- *Interchange of managerial personnel*
- *Provision of essential technical information*

Usually when the shareholding is above 20% it is considered that the investor has significant influence over the investee. However, in this case, despite the fact that Sonic (Pvt) Ltd owns 20% of the voting rights and has representation on the board of Bean (Pvt) Ltd, the existence of other shareholders holding a significant proportion of the voting rights prevents the entity from exerting significant influence. Whilst it appears that Sonic (Pvt) Ltd should have the power to participate in the financial and operating policy decisions, the other shareholders prevent Sonic's efforts and stop Sonic from actually having any influence. Therefore in this situation Bean (Pvt) Ltd should not be considered as an associate of Sonic (Pvt) Ltd.

(6 marks)

(Total: 25 marks)

Answer 07

Relevant Learning Outcome/s:
2.1 Accounting Standards (Level A)
2.2 Accounting Standards (Level B)
Study text reference: Pages 109, 255, 331, 239

(a) Under the provisions of LKAS 32 *Financial instruments: Presentation*, the loan needs to be split into its liability and equity components.

The liability component is the present value of the future cash outflows discounted at 15%.
This is Rs. 3,991.5 million [(5 million x Rs. 1,000 x 0.10 x 5.019) + (5 million x Rs. 1,200 x 0.247)].

The equity element is therefore Rs. 1,008.5 million (5 million x Rs. 1,000 – Rs. 3,991.5 million). The equity component will be unchanged over the life of the instrument but the liability component will be measured at amortised cost using an effective interest rate of 15%.
The finance cost for the year ended 31 March 2017 will be Rs. 598.725 million (3,991.5 x 15%)

The closing liability is Rs. 4,090.225 million [(3,991.5 million + 598.725 million) – (5,000 million x 10%)].

(7 marks)

(b) The computer and Windows 10 licence are treated as tangible assets (given that the computer cannot operate without an operating system) and depreciated over the useful lives of four years.

The other software (Microsoft Office and AutoCAD) will be treated as intangible assets and amortised over their useful lives (2 years for Microsoft Office and 4 years for AutoCAD)

<u>Statement of financial position extract as at 31 March 2017</u>	<u>Net carrying value</u>
Property, plant and equipment	
Computer equipment ((2.72 + 0.73)	Rs. 3.45 million
3.45 – (3.45/4 * 3/12))	Rs. 3.24 million
Intangible assets	
MS Office [1.725 – (1.725/2 * 3/12)]	Rs. 1.51 million
AutoCAD [8.625 – (8.625/4 * 3/12)]	Rs. 8.086 million

<u>Income statement extracts for the year ended 31 March 2017</u>

Depreciation: Computer equipment	Rs. 0.215 million
Amortisation: MS Office	Rs. 0.215 million
Amortisation: AutoCAD	Rs. 0.54 million

(6 marks)

(c) The assistant's view is incorrect. It is necessary to consider the two parts of this issue separately.

The claim made by the customer needs to be recognised as a liability in the financial statements for the year ended 31 March 2017.

LKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision should be made when at the reporting date:

i. An entity has a present obligation arising out of a past event
– There is a probable outflow of economic benefits
ii. A reliable estimate can be made of the outflow

All these conditions are satisfied here, and so a provision is appropriate. The provision should be measured as the amount the entity would rationally pay to settle the obligation at the reporting date.

Where there is a range of possible outcomes, the individual most likely outcome is often the most appropriate measure to use.

In this case a provision of Rs. 26 million seems appropriate, with a corresponding charge to the profit or loss.

The insurance claim against the loss is a contingent asset.

LKAS 37 states that contingent assets should not be recognised until their realisation is virtually certain, but should be disclosed where their realisation is probable. This appears to be the situation we are in here.

Therefore the contingent asset would be disclosed in the 2017 financial statements. Any credit to the profit or loss arises when the claim is settled.

(6 marks)

(d) A government grant of Rs. 4 million is received permanently to purchase the production plant.

According to LKAS 20 the government grant received relating to an asset could either be recognised as deferred income or could be deducted from the carrying value of the asset.

If we recognise it as deferred income, it should be charged for P/L over the useful life of 05 years of the asset. Accordingly, Rs. 4 million / 5 = 0.8 million will be recognised as an income to profit or loss statement per year over next 05 years. And the depreciation charge of (Rs. 10 million/5 years) = 2 million will be also recognised in profit or loss statement.

If the government grant is deducted from the cost of the asset.
The cost of the asset is (10mn – 4mn) = 6mn.
Depreciation (6mn/5 years) = 1.2 mn

Further, the government has approved a 100% reimbursement of the training costs of the company. Accordingly the grant, that compensates expenses incurred by the company for the purpose of giving immediate financial support, should be recognised in the profit or loss statement in which the related expenses were recorded.

In this case Rs. 3 million will be recorded in profit or loss statement as other income or will be deducted in reporting the related expenses on training.

(6 marks)

(Total: 25 marks)

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