THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

KC1 – Corporate Financial Reporting

December 2018

Examiner's Comments

Overall performance on paper

The overall performance of candidates was better than the two previous exams. Unlike in the previous exams, among the candidates who passed, there were many who scored above the marginal mark of 50 – 52 marks. A considerable number of candidates attempted all the questions.

Question 01 and Question 02 tested very basic understanding and application of the standards. However, candidates did not demonstrate adequate knowledge on applying principles and making a judgment in a given scenario.

Common weaknesses and shortcomings

However, as in previous exams, the following shortcomings and weaknesses were observed.

- Giving answers that were very general in nature – some candidates simply repeated the information given in the question without explaining how it impacts the financial statements and decisions/judgments. Some others just quoted facts from the standards without any reference to the question.
- Failing to read the question clearly and therefore providing irrelevant or incomplete answers, which did not address all the points in the given scenario.
- Dealing with numerical aspects only, without providing the necessary explanations, and thereby not addressing what the action verbs require.
- Poor application of knowledge to the scenario.
- Poor time management – spending too much time writing unnecessary details and therefore not being able to attempt all the questions.
- Trying to do two almost-perfect questions – there were a few candidates who scored 38 – 42 marks by attempting only two questions. If they had they managed their time and attempted at least the easy parts of a third question, they would have been able to secure a pass mark.
- SLFRS financial statements are based on estimates, judgments and models. Candidates need to have awareness of judgments and estimates. Question 01 and Question 02 were based on the application of the fundamental principles within IFRS. However, it was a concern to note that some candidates did not understand the application of the standards to the required level.
- Very illegible handwriting – some scripts were extremely difficult to read and thus award marks for.

SECTION 1

Question 01

(a) This part tested knowledge on the subsequent measurement of investments in associates. The scenario provided information about a private company. The examiner expected candidates to apply full SLFRS in their answers. However, as the question was silent about it, candidates could have even taken the SME standard approach to answer too. Marks were awarded equally for choosing either one of the methods.

Most candidates scored well on this part and used the equity method (applying full SLFRS). About 12% – 15% of candidates answered applying the SME standards.

The weaknesses found in the answers of some candidates who stated that the equity method was the method to be followed for the subsequent measurement were as follows.

- The question provided information about the fact that the investment in Chips was accounted for as an investment in associate based on significant influence. However, many candidates wrote in detail about the criteria for identifying the company as an associate/existence of significant influence. This was a waste of time, as it did not earn any marks.
- Some candidates did not clearly understand the exemption requirements under which the company does not need to use the equity method. The company has to comply with all the four (04) criteria. However, some candidates concluded that since the company's debt instruments are not traded in the market (one criteria only), it is exempt from the use of the equity method. This again was an instance where the candidates did not understand the relevant standard properly.
- Errors were made in the computation of the carrying value of the investment, by not adjusting it retrospectively (i.e. some candidates only adjusted the 17/18 loss to the cost).
- Some candidates added the share of losses to the cost of the investment by considering it as profits.
- Most candidates did not limit the recognition of the share of loss up to the cost of the investment. In the given scenario, the investment balance becomes zero and hence no liability should be recognised thereafter. Most candidates did not address this properly. For example, some explained the treatment correctly, but showed a negative investment balance in the final answer, demonstrating a lack of application).
- Some candidates limited their answers only to calculations. The question required candidates to 'advise'. These candidates lost considerable marks, as their answers were not comprehensive with explanations.

(b) This part was based on fair valuation, and it tested knowledge on valuation methods used by the company.

- Most candidates gave the definition of fair value and explained the background of the question; but they did not make any conclusion or evaluation about whether the valuations used by the company were correct or not. These candidates did not address the requirement of the action verb in the question, and hence lost valuable marks.

- This part was well answered by most candidates, except for the Ratmalana property valuation. A few candidates mentioned that as this Ratmalana property was for renting purposes, the company cannot use separate valuations for land and building, and both should be valued as one unit based on the income approach. This analysis was acceptable and marks were awarded accordingly.
- Some candidates tried to highlight the input levels without having clear knowledge of them as disclosures.
- As multiple valuation methods were followed in respect of the Ratmalana property, some candidates mixed up the situation and wrote unnecessary details.
- Candidates' knowledge on the income approach was fairly good.

(c) This part was on provisions/contingencies, and it was the part in Question 01 where candidates scored the least amount of marks.

- Some candidates did not understand the question properly.
- Similar to previous examinations, candidates were not aware of provisions/contingencies separately (e.g. most said a contingent liability cannot be recognised… there is a liability but no provision….).
- Contingent liabilities were identified as amounts to be recognised in the financial statements.
- None of the candidates referred to IFRIC 23.
- Some candidates wrote the criteria to be satisfied for recognition of a provision/ contingent liability. However, these were not linked properly to the given scenario in order to build a proper flow of judgment.

(Total: 25 marks)

Question 02

(a) This part required candidates to evaluate how SLFRS 9 will impact the classification of two financial assets, namely a portfolio of quoted shares and a portfolio of government treasury bills.

- It was observed that candidates had some understanding and knowledge of SLFRS 9.
- Some had memorised the classification by way of a diagram and reproduced that in their answer and explained in general how the classification should be made, without linking it to the given information. These candidates scored some of the marks allocated for explaining the theory, but lost the marks allocated for evaluation of the scenario.
- Some candidates were confused about the concept of the business model and the characteristics of the instrument. Without a clear understanding they went on mixing up the two in their evaluation.
- Candidates were not clear that it is the characteristic of the instrument that is considered when testing for SPPI. They said that quoted shares satisfy SPPI, as there is a capital gain and dividends.
- There were a considerable number of candidates who did not make a judgment based on the information given. Instead they provided "if" answers covering all the possible scenarios, leaving the marking examiner to decide how applicable the answer actually was.

(b) This part of the question required candidates to evaluate the accounting issues in the scenario. It tested knowledge on deciding what the functional currency of a company should be, and the treatment of exchange differences arising in raw material purchases where the settlement is made usually after 30 days.

This past also tested the applicability of deferred tax where the company enjoys a tax holiday period that will end in 2019.

- Many candidates were confused and misunderstood the question. Their answers were built taking the scenario points in isolation.
- Quite a number of candidates did not address the need to evaluate the appropriateness of the functional currency. They directly explained how the exchange differences should be accounted for.
- Some others concluded that the functional currency is USD, without explaining any basis for that conclusion, and then went on to answer how exchange differences should be accounted for in translation.
- Many candidates missed out on commenting on the treatment of deferred tax.

(Total: 25 marks)

SECTION 2

Question 03

(a) Some candidates misunderstood the question because they had not read the unseen carefully. The unseen provided information that PHPL had control since 2015. However most candidates considered TWPL to be an associate of PHPL until 31 March 2018. About 40% – 45% of candidates took this approach. Some others commented from the side of BET along with calculations.

Although the question required a briefing note to the PHPL board, a considerable number of candidates only did the calculations.

Most candidates did not state the impact on the consolidated reserves, which is an important fact to consider in these types of transactions. Therefore these candidates lost some marks for this.

When calculating the goodwill on the acquisition of TTL, most candidates used Rs. 60 million as the consideration/investment from the point of view of PHPL, disregarding the effective holding of PHPL.

Although the question required candidates to comment on how this transaction affected **PHPL's** financial statements, some evaluated the transactions from BET's point of view.

Even though some candidates identified the fact that PHPL had control over TWPL since 2015, they calculated the goodwill as at 31 March 2018 instead of the goodwill on the date of control (i.e. 2015) (Note: retained earnings of TWPL in 2015 were given in the unseen as Rs. 175 million). These candidates did not know that no goodwill calculation is needed when the shareholding is increased in a situation where they already have control. Candidates lost a lot of marks for not knowing the correct principles.

Candidates performed well in calculations. However, they must improve their analytical and evaluation skills.

(b) This part included an open question where candidates could easily pick corporate governance issues from the list given in the pre-seen to suggest improvements. Most candidates obtained at least 75% of the marks allocated for this part.

However, some candidates quoted sections from the corporate governance Code without relating them to the scenario, assessing the existing practices that prevailed in TWPL and making recommendations.

In some answers, there was no proper link between the issues identified and the recommendations given.

(c) Some candidates did not have knowledge on how to calculate the given ratios.

A few candidates made mistakes in computing the ratios. The calculations required were very basic and therefore it seemed like these candidates lacked technical knowledge.

Some candidates provided irrelevant and inappropriate recommendations to improve the ratios of the company.

Several candidates also wasted time unnecessarily explaining the ratios and comparing the ratios over the last few years. This was clearly out of the scope of the question, and thus valuable time was wasted without gaining any marks.

(d) Most candidates quoted the ethical principles in the Code of Ethics without explaining the same and linking them to the scenario given in the pre-seen.

Some answers were also very general – facts given in the question were not linked to the principles when formulating the answer. These candidates failed to score marks.

(Total: 50 marks)

KC2 – Corporate Finance and Risk Management

December 2018

Examiner's Comments

Question 01

This question carried 25 marks and tested the basic concept of the working capital cycle and the issues that arise due to changing macroeconomic variables such as the government strategy on essential drugs, and the calculation of a bid value of a business based on two proposals. On average, the performance on this question was satisfactory. Most candidates were able to understand the question and obtain high marks.

(a) This part required candidates to discuss their views (as a management consultant) on the government's strategy over price controls on essential drugs, including its pros and cons.

Several stakeholders would be impacted by such a decision including consumers, drug importers and the government. Therefore, candidates could have discussed the strategy from different viewpoints as the question openly asked to comment only on the strategy.

Overall, most candidates discussed both organisational and consumer level pros and cons of the government's decision on essential drugs, and were able to obtain high marks for this part.

(b) This part tested knowledge on the working capital cycle of a company and how it would be impacted by the price controls on essential drugs. Candidates were required to calculate and analyse the working capital cycle of the company.

Most candidates answered this part satisfactorily and obtained high marks.

However a few candidates did not know how to calculate the inventory and creditors turnover period. They used the incorrect denominator and numerator and lost marks.

For example, some candidates used ***Sales – gross profit + depreciation*** to derive the cost of the sales value.

A few candidates took the bid valuation data given in part (c) to derive the working capital cycle of 2018.

(c) This part required candidates to calculate the bid value of a business and advise the board on the offers made by each company.

Candidates were given some variables to consider the bid value. For this, asset values had to be assessed, considering the variables provided in the question. The acquisition companies provided different options for inventory and trade debtors in order to arrive at the final financial value. The goodwill valuation was also given two different methods such as EBITDA and average sales.

Most candidates did not understand how to consider the variables to arrive at the correct bid value of inventory and trade debtors. Most candidates worked out considering 75%, which is 12 months.

Further when arriving at the debtors less than 90 days, some candidates only considered 35% instead of 90%.

Another common mistake was noted in the goodwill valuation. Some candidates used 2018 data to calculate EBITDA and ended up with incorrect answers. The creditors' value was also considered as a cash outflow instead of an inflow for the bid value.

In addition to the above, some candidates did not comment on the compensation value of employees and how the final decision would be impacted by this.

However, some candidates calculated the bid values correctly while commenting on the compensation payable to employees, and obtained full marks.

(d) This part required candidates to state the advantages the acquisition (part c) would bring to the business, in order to create value in the long-term.

Most candidates obtained good marks for this part. Those who attempted the part commented on market leadership and distribution networks of Sun Healthcare, and how it would bring value. Others generally commented on synergies and how these would bring value to the business.

Question 02

This question carried 25 marks and was based on the transactions of a foreign branch of a medium-sized listed company of a local family-owned group company. Almost all the candidates attempted this question, but the overall standard of answers was poor.

(a) This part required candidates to identify the areas/transactions that would have resulted in forex losses/gains, with specific actions to minimise such exposure. Overall, the answers were well planned and presented. However, some candidates gave general remedies and ignored the question.

(b) In this part, candidates were required to apply the leading and lagging approach on two specific transactions, and the requirement for calculations was specifically mentioned. The answers were very poor and candidates earned the least amount of marks for this part in comparison to the other parts of the question. Most described leading and lagging correctly, but were unable to identify the correct approach to be used in each given transaction. Even though the question specifically required calculations, about half of the candidates did not provide them. Those who did provide calculations made the following common mistakes.

- Most candidates did not know the correct approach for the calculation (e.g. in excess cash to be received, they calculated the forex rate of SLC as 32.3 (dividing 42 by 1.3)).
- Some candidates used SLC 40 (i.e. average of the 12-month range of 30-50 SLC) instead of SLC 42.
- When computing excess cash, most candidates missed the fact that SLC would appreciate against SLR by 30% in June. Hence, instead of considering the period as January to May, most candidates took January to June.
- When computing the administration cost most candidates did not consider the full period. Instead they took only one month.
- There were a few candidates who misinterpreted appreciation and depreciation of the foreign currency with SLR (e.g. to calculate the administration cost, instead of Euro 1 = SLC 9,600 candidates used Euro 9,600 = SLC 1).

(c) Candidates were required to evaluate whether shareholders' wealth will be maximised, if the proposed dividend policy is implemented.

Most candidates calculated the cost of capital correctly, and computed the average growth and dividend valuation model based share price. However, the following common mistakes were observed.

- Candidates did not calculate the growth rate using the given information (50% x 14% = 7%).
- Almost all the candidates made mistakes in computing the earnings growth model. Mistakes were made in computing the formula. For example, 50% dividend per share was taken as 50% earnings per share. The return on retention was also not taken into the computation.

Question 03

This question carried 50 marks and was based on the common pre-seen. It was a standard question but the performance of candidates was far below the expected level.

(a) (i) This part required candidates to evaluate the proposed expansion project and decide whether it was worthwhile under the volatile macroeconomic conditions, on the assumption that debt financing will be used. Although most candidates attempted this part, they made a lot of common mistakes in several calculations.

- The candidates did not understand the expansion project clearly and the incremental EBIT resulting from the expansion. They simply considered the existing annual increment of 10% as a result of the expansion.
- In the working capital calculation, some candidates did not take the incremental working capital requirement by years. Instead they stated the total annual working capital requirement as the annual working capital requirement.
- Discounting factors – although a lot of candidates considered the cost of debt, they did not adjust it for the tax (k_d = (1 – t)).
- Some candidates made mistakes in identifying the cash inflows and cash outflows. For example, working capital was not taken as a cash outflow and inflow, and depreciation was not added back at the end of the project.
- Some candidates also did not do the probability calculation properly, and missed out on the marks allocated for the probability analysis.

(ii) In this part, candidates were required to explain two key strategies that could be used to manage profitability under inflationary conditions.

Majority of candidates stated an increase in ticket prices as a remedy to face inflation. Some candidates just wrote to reduce overheads, increase the selling price, and give discounts in order to increase sales. Only a few candidates presented proper answers such as undertake investments in fixed assets, inventories etc.

(b) (i) In this part, candidates were required to comment on the viewpoints of the managing director and the CEO.

Most candidates did not properly compare the MD's view with the CEO's view. And a lot of them did not consider other ways of valuing shares.

The pressure on the exchange rate, interest rate and inflation in volatile market conditions were not highlighted by candidates, and most did not do a risk analysis based on the above factors in relation to investors' expectations and considerations to maximise their wealth (e.g. invest in less risky investments, expectations of higher returns etc.).

(ii) In this part, candidates were required to explain three critical factors that should be considered when attempting to value shares in an IPO.

A lot of candidates wrote irrelevant answers to this part. Instead of the factors to be considered when *valuing shares* in an IPO, they considered the factors to be considered when *going for* an IPO. Further, although the question clearly states to ***explain*** three (03) factors, some candidates just wrote the factors without explaining properly. This was basically a theoretical question on share valuation, and a lack of studying may have been the reason for underperformance.

(c) (i) In this part, candidates were required to compute the value of the business post-expansion and capital infusion.

Most candidates just calculated the net assets plus net private placement (Rs. 600 million). However, the question asked for the post-expansion and capital infusion value of the business. A lot of candidates did not consider the value derived from the expansion for the valuation of the company, even though this fact was mentioned in the question.

A significant number of candidates also took total assets and fixed assets as the value of the existing company, instead of taking net assets.

(ii) In this part, candidates were required to comment whether the value computed in (c) (i) above could be compared with the potential P/E-based valuation.

Candidates knew that the P/E and business value calculated based on net assets and NPV of the projects cannot be compared with each other. However, they did not know the differences in the two methods. Some candidates considered them both as the same.

(d) In this part, candidates were required to assist the board of directors on a working capital related disagreement.

Almost all the candidates attempted this part, but a few common mistakes were made as follows.

- Some candidates assumed that all the sales were on credit basis. However, the question clearly stated that 35% of sales were from their own cinemas. Therefore the receivable collection period was incorrect. Further, some candidates did not show how the accountant arrived at the receivable collection period.
- When calculating the inventory holding period, some candidates took the total cost of sales, which included film hiring. However, the question clearly stated that inventory only consisted of food and beverages. Therefore they calculated the inventory holding period as 12 days.
- As a result of the above calculations the working capital cycle was a minus figure.
- Candidates did not state the effects of poor working capital management for an organisation, such as the cost of increased working capital due to long outstanding periods for debtors, loss of supplier confidence, the impact on the supply chain, and the obsolesce of stocks due to large stock holding periods.
- A lot of candidates were also unable to analyse the 2% discount given to trade debtors. They did not compare the cost of the discount with the loan interest rate of 10%.

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KC3 – Corporate Taxation

December 2018

Examiner's Comments

General comments on paper

The overall performance of candidates was not satisfactory compared to previous examinations.

Majority of candidates were unsuccessful in applying a methodical approach to questions. As a result, they were not able to produce reasonably focused, relevant answers addressing the principal and core components of each requirement.

Candidates must develop the ability to compile comprehensive tax computations. They should also be able to carry out tax planning, make decisions on minimising tax expenses and mitigating risks, and effectively communicate with tax authorities, clients and the management. Therefore, displaying mere technical knowledge is not adequate at this level.

Being an open book examination the candidates' level of presenting answers in line with the required standards (in terms of technical and legal aspects), did not fully meet expectations.

Candidates must be more focused on the structure of the paper since the three questions are based on scenarios. Answers should be presented in line with expectations and it is recommended that candidates address the action verbs, expected learning outcomes, knowledge process, and knowledge dimension.

The following reasons could have been reasons for poor performance.

- Lack of pre-study in relation to the pre-seen case study materials.
- Lack of understanding of the requirements of the questions (not focusing on action verbs).
- Producing irrelevant facts by ignoring the mark allocation and thereby wasting time unnecessarily.
- Lack of pre-study on provisions (including transitional provisions) under the Inland Revenue Act No. 24 of 2017.
- Lack of communication and presentation skills.

Question 01

General comments

On the whole, this question was not dealt with well. Majority of candidates were not able to submit a complete answer. Candidates were only able to score 50% or less of the marks allocated for this question (in general).

Some candidates spent a significant amount of time writing a lot of details about a subject based on their knowledge, which was not relevant to the question and scenario outlined, and thus earned no marks.

(a) (i) Visa application fees

Most candidates did not identify that visa application fees were an income of MoFA. They erroneously stated that it was an income of DMS-India, ignoring the fact that the said fees are collected by DMS-India on behalf of MoFA.

(ii) Service fee

Many candidates got confused when it came to service fees and thought it was an income of DMS-India. Candidates unfortunately missed the important fact that DMS-SL is a company incorporated in Sri Lanka and thereby the service income derived from Sri Lanka becomes an income of DMS-SL.

(iii) Royalty

Many candidates successfully identified that royalty is an income of DMS-India. However they did not know that such royalties are subject to tax because these payments are derived from Sri Lanka (source). As a result of missing this point many candidates lost easy marks.

(iv) Capital repayments

Most candidates successfully answered this part and achieved the full marks allocated for it.

(v) Interest

Candidates were successful in identifying that interest is an income of DMS-India. However, most did not know that interest is subject to tax because it is derived from Sri Lanka (source). Only a very few candidates knew that per the double tax treaty the WHT shall not exceed 10% of the gross interest. However, most successfully identified that the interest is subject to a deduction of 5% WHT per the provisions of the Inland Revenue Act.

(b) As this part was related to part (a), an adverse effect was created on scoring marks here due to failing to correctly recognise the respective person liable to pay the income tax with regard to the five (05) items mentioned above. Majority of candidates did not understand the requirement of this part. Instead of identifying whether the given items were allowable or not for corporate tax purposes in Sri Lanka, many tended to explain the tax treatments thereon.

(c) Although almost all the candidates knew that DMS-India will be able to claim a tax credit, they ignored outlining the following facts to earn better marks.

- The extent to which the tax credit could be claimed.
- The applicable type of payment (i.e. royalty/interest) from which the tax credit is derived.
- The requirement to have a tax credit certificate issued by the Inland Revenue Department.

(d) (i) Only a handful of candidates knew that appointing the auditor as the authorised tax agent will create threats to the independence of the firm.

(ii) Candidates were successful in identifying that there is no such restriction on the auditor to not prepare tax returns of a client. However, many failed to describe the reason for this (i.e. providing such services do not create a threat to independence).

(iii) Many candidates stated that the appointed authorised agent can sign the tax return by quoting Section 126 (4). However none of them mentioned, "they cannot sign because of inherent limitations of the audit, and are unable to provide absolute assurance".

Question 02

General comments

Candidates scored around 50% of the marks allocated for this question, which represented an average performance. The commonly observed weaknesses were:

- Lack of knowledge on the VAT liability in relation financial services.
- Inability to apply provisions/transitional provisions under the new Inland Revenue Act in order to decide quarterly installment payment estimates including penalties, and interest thereon on non-compliance.
- Misunderstandings and mistakes in calculations.

(a) Calculation of VAT on financial services.

- Most candidates were unsuccessful in identifying and segregating items between financial and non-financial services.
- A few candidates erroneously applied the depreciation allowance rates instead of applying the economic depreciation rates specified in the gazette.
- About 25% of candidates displayed a lack of knowledge on computing VAT on financial services. This was made evident by the incorrect use of a 15% tax rate on each and every line item, and the incorrect allowing of a deduction for input VAT.

(b) (i) Many candidates did not understand the requirement for giving advice with regard to ascertaining the quarterly income tax installment payment procedure in accordance with the Inland Revenue Act No. 24 of 2017.

Some candidates were not familiar with the quarterly installment tax payment calculation based on estimates, per the transitional provision method (i.e. based on the previous year's tax liability, increased by 5%).

A considerable number of candidates were not aware of the easy option available by applying the transitional provision as set out in Section 203(5). They instead spent unnecessary time calculating the estimated income from incomplete information given in the question.

(ii) Most candidates successfully answered this part of the question. However a few candidates overlooked the requirement by not focusing on the relevant sections (i.e. Sections 179, 157 or 159) and incorrectly focusing on Section 180 (there was no indication in the question for possible negligence or fraudulent underpayment).

(c) A large number of candidates gave incomplete answers for this part. Most were unable to correctly identify the transfer pricing issues in the given scenario.

Some candidates did not recognise the fact that the given transactions were domestic in nature. Instead they incorrectly treated them as international transactions.

A very few candidates correctly identified the transfer pricing issues in the given scenario and wrote the applicable provisions in Section 77, and stated how to address these issues.

A considerable number of candidates explained that the transfer pricing audit and subsequent procedure with the Inland Revenue Department, rather than explaining how to overcome the transfer pricing issues.

Question 03

General comment

The overall performance was below average 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 2018/19.

Most candidates were successful in forming a methodical answer. Unlike in previous examinations, they duly started to compute the adjusted business profit using the "net profit after taxation" figure.

Although a few candidates made mistakes in recognising allowable and disallowable expenses, majority of them successfully identified the changes in accordance with the provisions of the new Inland Revenue Act.

The capital allowances computation was dealt with very well and most candidates obtained close to full marks for this.

Many candidates displayed their knowledge on the accurate adjustments on the provision for gratuity, and also made correct adjustment in respect of other sources of income.

Some candidates clearly indicated that the pastry shop rent income was part of business income, and hence there was no need to show it as a separate source of income.

Most candidates knew that donations made to the government were 100% allowable qualifying payments.

Candidates also correctly identified the ESC payment as a tax credit.

Almost all the candidates clearly identified the applicable income tax rate as 28% when calculating the income tax liability per the scenario of the business.

However, some common mistakes were made by the candidates. These were:

- Not being familiar with the appropriate statutory wordings such as assessable income on business, assessable income on investment and total assessable income per the new Inland Revenue Act.
- Misinterpreting the cost of theater equipment as sale proceeds when calculating the profit from disposal.
- Not identifying that the entertainment tax is not a specified levy and therefore is an allowable expenditure.
- Making mistakes in calculating repairs and maintenance adjusted for tax purposes.
- Not knowing that amortisation of leasehold land is an allowable expense.
- Making mistakes when calculating the interest on bank loans (thin capitalisation adjustment).
- Incorrectly calculating WHT tax credits on rent by not knowing the applicable rate is 10%.
- Not identifying the profit on exempt profit elements under Section 24A of the Inland Revenue Act No. 10 of 2006.
- Not identifying that the building-WIP, building not used and the motorcycle are not claimable for depreciation allowances.

(b) The part tested knowledge on taxable supplies and exempt supplies per the provisions of the VAT Act. Only a handful of candidates were able to answer this part successfully.

Those who correctly identified taxable supplies and exempt supplies of the film industry argued with the correct facts.

However, some common mistakes were made by the candidates. These were:

- Describing many VAT liable and exempt criteria with input credits commonly in use, which were not relevant to the question at all.
- Mixing up liable and exempt sources.
- Failing to give clear and relevant facts.

(c) Most candidates answered this part successfully and only a few were not able to score marks.

A lot of the candidates identified the correct sections of the new Inland Revenue Act and also described the facts that focused on the thin capitalisation rule and capital gains tax.

Candidates successfully identified that the acquisition of theatre equipment and a projector on finance lease (to be used in the new cinema under construction), is a leased asset where you can transfer the legal ownership to the lessee. Many candidates noted that under the new act, capital allowances can be claimed and the interest portion thereon could be treated as an allowable expense limited to the thin capitalisation rule.

Most candidates identified the cost of investment assets acquired prior to 30 September 2017 are to be considered at the market value as at 30 September 2017, when computing the realisation of the investment assets and arriving at the capital gains.

However, some common mistakes were made by the candidates. These were:

- Incorrectly stating that the issue of shares is subject to capital gains tax instead of saying that the issue of shares might increase the ability to claim interest as an allowable expense under the thin capitalisation rule.
- Not being able to define capital assets and investment assets.

(d) This part required candidates to advise the board of directors on two tax planning proposals.

Most candidates did not attempt this part of the question.

Only a handful of candidates identified the relevant tax law cases. However, most candidates mentioned the relevant sections of the new Inland Revenue Act.

Some common mistakes made by the candidates were:

- Not identifying that the sale of land in Rosemead Place is capital in nature and liable for capital gains tax.
- Not displaying clear knowledge regarding the tax impact of repairs and improvement cost adjustment.

KC4 – Corporate Governance, Assurance and Ethics

December 2018

Examiner's Comments

General comments on paper

This paper consisted of two sections. Section 1 contained two compulsory questions for 25 marks each. Section 2 contained one question for 50 marks, which was based on the common pre-seen.

Being an open book examination many candidates were able to score marks in Section 2.

The overall performance of candidates in this examination was satisfactory.

Those who were unsuccessful demonstrated poor subject knowledge. A number of common issues arose in candidates' answers that contributed to their poor marks. These included:

- Reproducing the points from the question with little development.
- Not following the action verbs.
- Using vague phrases such as, "perform analytical procedures", "check the relevant documents", and "per the code".
- Losing focus on the requirement or failing to explain in detail.
- Not knowing the exact standard (SLAuS and SLFRS).

For candidates preparing for this examination, it is very important to focus on tailoring the number of points written to the marks allocated, and taking note of the areas that are not essential.

Section 1

Question 01

(a) In this part, candidates were required to evaluate business risks that the management of GVP should consider in its business operations. This part was well attempted and most candidates had the ability to identify the relevant business risks. Some candidates answered this part very well and were able to use the details in the scenario to evaluate the risks in relation to compliance and regulations, and their implications on business operations.

Weaker candidates tended to just repeat the facts given in the scenario with little improvement, and failed to identify the impact on business operations.

There were some candidates who did not read the question properly and wrote all the possible business risks without paying attention to the scenario, such as:

- Due to poor credit controls, unable to generate funds for business expansion.
- Due to technological developments machinery will be obsolete.

Some candidates did not understand the concept of business risks. They wrote the risk areas without stating the impact on the business. Some others just wasted time explaining the concept of business risks and wrote lengthy answers.

Some candidates identified business risks such as reputation risk, compliance risk, and fraud risk, but wrote irrelevant impacts such as:
Due to strict compliance with money laundering regulations, the company will witness an adverse impact on its reputation

Candidates are advised to read the question carefully and plan their answer without being hasty to write the answer straightaway.

(b) In this part, candidates were required to propose mitigating measures for the identified business risks. Some candidates answered this part well. However some others did not understand the question requirement and answered in a matrix (high, low, avoid and accept).

A few candidates confused business risks with audit risks and wrote audit procedures as responses to the risks (without writing mitigating measures).

There were also some candidates who wrote general answers such as "comply with regulations" and "sign an agreement".

(c) In this part, candidates were required to explain the importance of the Three Lines of Defence model for risk management. The examiner expected candidates to explain how the Three Lines of Defence model aligns accountability, oversight and assurance, and how it assures effective and transparent risk management by making accountabilities clear.

Some candidates understood the question requirement and wrote that the Three Lines of Defence model gives executives and the board a clear view of which risks are being overseen and how they are being managed; thus providing them with confidence that the business has identified key risks and is managing them.

Although almost all the candidates attempted this part, many wrote and explained only the three lines. They were unable to explain the importance of the three lines on corporate governance. There were only a few candidates who referred to corporate governance. Most wrote that the three lines are important for risk management. They failed to note that a company with good corporate governance is likely to be well managed with strong controls, and these in turn reduce risks.

(d) This part of the question was on money laundering issues. Many candidates did not read the question properly. The examiner tried to test the knowledge on mitigating procedures to manage audit risks on money laundering.

Although this part was not based on the scenario, many candidates tried to link their answers to the issues in GVP and thus limited their scope. However, most candidates did appear to have an idea of money laundering issues.

There were some candidates who were confused with the procedures to be followed by the client, such as appointing a compliance officer instead of a MLR officer to the audit firm.

Some candidates wrote general audit procedures such as inquire from the management and examine board minutes, without specifying the relevant procedure.

Question 02

(a) In this part, the examiner tried to test the knowledge of candidates on ethical matters that a practising member should consider when bidding for an assignment.

The scenario mentioned that MAC Associates provided the service of developing internal control procedures relating to operations, as well as advisory services in relation to restructuring of loans. Further it was stated that the fees for such engagements were outstanding for over one year since completion of those engagements. The former partner of MAC Associates has also now joined the prospective client as the finance general manager.

Some candidates did not understand that the requirement was to evaluate three ethical matters arising from the non-assurance services provided to SA in the past. Candidates failed to analyse the services provided.

Many wrote and explained the fundamental principles such as integrity, objectivity, professional competence and due care, and professional behaviour, without addressing the question requirement.

Candidates should know that in order to provide assurance services, the auditor should be independent. The first thing that should be done before bidding is to assess whether such engagements will affect the independence of the auditor.

There were some candidates who understood the ethical matters to be addressed but did not analyse all the issues given in the scenario. They picked an issue in isolation, for example providing the service to develop internal controls, and wrote that it will amount to a self-review threat. As a result they were not able to obtain full marks.

There were a few candidates who were comfortable discussing the specific ethical issues relevant to the scenario. However, some candidates wrote threats to independence without referring to the scenario. Candidates should be conscious of the question requirement and plan the answer before writing.

(b)(i) In this part, candidates were required to evaluate the statement made by Ramesh Fernando in respect of accepting Airways as a client. The examiner aimed to test the knowledge of candidates on the auditor's considerations when accepting an engagement.

Some candidates understood the question, but demonstrated poor knowledge of analysing the issues in the given scenario. The examiner expected candidates to apply the theoretical knowledge on the acceptance of a client according to SLSQC, and evaluate the given scenario accordingly.

Some candidates explained the issues in the scenario without applying the ethical considerations. Some who lacked the technical knowledge wrote the elements of an assurance engagement such as the three party relationship, subject matter, suitable criteria, and engagement process, which were not relevant to the question.

Some candidates who did not understand the question wrote about the conflict of interest, which was not relevant to the question.

The overall performance on this part was average.

(ii) In this part, candidates were required to advice Tally Associates on the appropriate services it may provide in relation to the request made by the directors of Airways. The examiner aimed to test the knowledge of candidates on the types of assurance engagements and assess whether candidates knew the difference between reasonable assurance engagements and limited assurance engagements.

Since this part was related to the assurance service on operating expenses for the past three years, and the procurement procedure, the examiner was also aiming to test the knowledge on the engagement of specific elements of single financial statements for the three years' operational expenses, and the knowledge on agreed-upon procedures for the verification of contractual compliance.

Although most candidates knew that the required services were not audits (reasonable assurance engagements), they failed to apply the specific assurance engagement. Many candidates who did not know the particular assurance service to be provided wrote irrelevant assurance engagements such as due diligence, review engagements, forensic etc.

Some candidates who did not understand the question tried to find one service to provide both requirements and failed to give a satisfactory answer.

(iii) In this part, candidates were required to evaluate the ethical behaviour of Ramesh Fernando with regard to the non-disclosure of his relationship with the finance director of Airways. This question focused on the Code of Ethics. Most candidates understood the issue with the independence requirement, but were unable to relate that to the issues in the scenario.

Most candidates referred to the Code of Ethics and reproduced the ethics from the Code without linking them to and analysing the issues of the scenario.

Overall, most answers were inadequate.

Ethics is a subject regularly tested but it was disappointing to see that many candidates considered it to be an easy topic and had not studied it adequately for the exam.

SECTION 2

Question 03

(a) Per the given information SMP successfully completed the audit of financial statements for 2016, but the audits for 2017 and 2018 were yet to be carried out. SMP determined that there were no significant risk areas that required specific audit focus and decided to rely on internal controls.

In this part, candidates were required to evaluate the risk assessment made by SMP. The examiner aimed to test the knowledge of candidates on the assessment of risks and audit strategy determination. The examiner expected candidates to:

- Identify the risk factor
- Determine materiality where possible from the scenario
- Provide a clear comment on the appropriateness of the accounting treatment where relevant
- State the impact on the financial statements

Candidates should know that a risk assessment is done in order to obtain reasonable assurance that the financial statements are free from material misstatements. Most candidates did not explain why a risk assessment is done.

Per the given information the auditor decided that the internal controls in existence were adequate. In order to accept that decision, certain audit procedures should be carried to obtain an understanding of the entity and its environment including the entity's internal controls. Many candidates did not pay attention to the auditor's (SMP's) decision to rely on internal controls.

Candidates were expected to evaluate whether the internal controls were effective, whether there were deficiencies in their design, or issues in their implementation, or whether there was management override. In this part of the question candidates were expected to use their knowledge acquired from studying the study text on inherent risks and control risks, and apply that knowledge to a practical situation.

Candidates demonstrated poor knowledge in the assessment of risks and audit strategy determination. The common answer was to go for substantive tests. Some candidates who did not read the pre-seen properly wrote the following as strategies.

- Engage competent staff for the audit
- Maintain professional skepticism
- Evaluate estimates and judgments

Weak answers also showed poor explanations. Most candidates identified the range of risk areas but failed to develop their answers to demonstrate a clear assessment of risks and audit strategy determination by giving proper reference to the pre-seen.

(b) In this part, candidates were required to critically evaluate the appropriateness of the planned audit procedures. There were some excellent answers evaluating the planned audit procedures along with explanations and references to the given scenario.

However, there were some candidates who reproduced the planned audit procedures given in the paper. Some did not critically evaluate the given audit procedures and wrote general audit procedures such as increase the sample size, and check the relevant documents.

Candidates at Corporate Level are expected to describe why the planned audit procedures given are not sufficient, and suggest audit procedures. They also should have referred to SLAuS 330.

Some candidates wrote vague answers such as obtain relevant documents, obtain details, and discuss with relevant persons. Although most did identify that the planned procedures were not sufficient, they were unable to justify it.

(c) In this part, candidates were required to advise the senior in-charge of the audit the appropriateness of the auditor's report format for the years ended 31 March 2017 and 31 March 2018. The examiner expected to test the knowledge of candidates on the revised SLAuS 700, which is on forming an opinion and reporting on financial statements.

Some candidates misunderstood the question and wrote how to form the opinion; for example include an emphasis of matter paragraph regarding a going concern issue. The question was very clear and specific regarding the appropriate auditor's report format.

Some candidates misunderstood the effective date of the revised SLAuS 700 and wrote that as the audit for the year ended 31 March 2017 was carried out in 2018, the revised SLAuS 700 should apply.

There were some candidates who misunderstood the question and wrote the contents of the audit format of the revised SLAuS 700, without differentiating the applicability of the revised standard for the year ended 31 March 2018.

Some candidates wrote that a report similar to the format used in 2016 should be used for the year ended 31 March 2017 without justifying it. As a result, they failed to score full marks.

(d) In this part, candidates were required to evaluate three areas that the auditor should challenge when assessing the reliability of the forecasted income statements given in the pre-seen, which were based on the unaudited financial statements for 2017 and 2018.

The best answers to this part logically analysed and worked through each item of the cash flow forecast given in order to derive the appropriate procedure. These candidates made good use of the information given and gave procedures that were described well and relevant to the specific contents of the forecast. Some candidates performed analytical procedures to determine unusual trends and relationships.

Some candidates identified the areas need to be challenged, but limited it to inquiries with the management, and checking of assumptions. This restricted the marks that could have been obtained.

Many candidates misunderstood the question and related their answers to SLSAE 3400, and wrote the procedures to be designed to obtain evidence without analysing the trend of the variance of each assertion in the forecast. Candidates had to use their acquired knowledge in a practical situation, and many failed to provide satisfactory answers.

(e) This part was on corporate governance and candidates were required to evaluate the impact on governance and the control environment of TWPL by having an effective audit committee. The examiner expected candidates to evaluate the business environment, where there was no person to oversee the work of the accountant, no timely audits were carried out, and non-compliance of statutory dues and accounting errors existed.

Most candidates ignored the requirement and copied points from the audit committee charter of the Code of Best Practice on Corporate Governance 2017, without any evaluation referring to TWPL. Some candidates wasted time writing lengthy answers on the applicability of having an audit committee.

(f) In this part, candidates were required to evaluate the criteria that SMP should consider prior to relying on the work of the internal audit division of TWPL.

Most candidates just copied SLSAuS 610 without evaluating the criteria. Candidates are advised to follow action verbs when answering the questions. There were some candidates who misunderstood the question and wrote the steps that the external auditor considers when they plan to use the work of the internal audit division.

However most candidates were able to score satisfactory marks for this part.

(g) In this part, candidates were required to analyse the ethical dilemma faced by Anna Alwis and recommend actions that she should take to deal with the situation. Some candidates listed the procedures to evaluate an issue on ethical principles such as:

- Analyse the situation
- Recognise the ethical issue
- Explain the ethical guidelines relevant to the issue
- Consider options and recommend the best course of action
- Justify the recommendation

These are the steps that candidates should take when answering the question.

It was disappointing to see that although candidates had studied the study text and knew what to do, they still could not answer this part properly. The main reason for weak answers was the fact that most candidates were unable to *analyse and explain* the dilemma regarding the request of the CEO to manipulate financial statements by promising a bonus.

Many candidates demonstrated poor knowledge in analysing the issues relating to the Code of Ethics. Many just copied all the possible threats and safeguards without referring to the issue.

Conclusion

Candidates are expected to have broader technical knowledge and be able to link this knowledge to the appropriate audit issues in a practical situation. Candidates are advised to practise past exam papers and review the model answers given, together with the examiner’s comments.