



# KC1 – Corporate Financial Reporting

## June 2018

### Examiner's Comments

#### GENERAL

##### Overall Performance-

The overall performance of candidates was very weak. It was observed that the level of knowledge and ability demonstrated by final level candidates, both in identifying and solving issues, in relation to the given subject matter, was far below expectations. The key weaknesses observed were as follows.

- Although it had been indicated at the Lecturers Meeting that Q1 and Q2 would be directly from Standards, candidates' responses in Question 2 were far below acceptable levels.
- Some students scored between 0-10 marks for Q 3. This demonstrates poor technical knowledge.
- It was noted that several candidates who had answered Q3 first, scoring more than 27 marks for this question, scored less than 10 marks for Q 1 and less than 5 for Q 2. It appears that they had an inadequate grasp of time management.
- Others who answered well in Q1 and Q2, failed to score adequate marks in Q3, resulting in the overall total being insufficient to obtain a pass, in this paper.
- It was observed that candidates did not spend adequate time reading and understanding the questions.
- Some candidates merely reproduced the relevant sections of the Standard, without linking it to the given scenario. Others lost marks due to submitting incomplete answers. (i.e. not comprehensive enough.)

The points summarized above are elaborated below, in relation to candidate responses to each question.

##### Question 01 (25 marks)

This question was comprised of three parts which were directly based on LKASs. Three separate standards were tested through questions relating to stated scenarios.

First part	(a) – LKAS 37, <i>Provisions, Contingent Liabilities and Contingent Assets</i>
Second part	(b) – LKAS 36, <i>Impairment of assets</i> (VIU Computation)
Third part	(c) – LKAS 12, <i>Income Taxes</i> (Deferred Tax)

Overall performance in this question compared with that of the other 2 questions was satisfactory and the marks obtained averaged between 10 -14 out of a possible total of 25 marks.

Almost all candidates had answered all three parts and there were none who had not attempted this question. However, of the three parts, students scored very well in part (b), whilst lower grades were obtained in part (a).

The following points were noted in the answer scripts;

Part (a) LKAS 37, *Provisions, Contingent Liabilities and Contingent Assets*

- Some candidates were unable to identify the past events resulting in a present obligation, based on the given information.
- A few students had stated that there was no present obligation as at 31.03.2018, but that such an obligation would arise only in the financial year 2018/2019.
- As the lawyers' opinion was received after the end of the accounting period (in April 2018), per the information given in the question, some candidates incorrectly identified this is an adjusting event.
- Almost 25% of the candidates did not know the difference between a provision and a contingent liability.
- Even though most candidates were aware of the recognition criteria for a provision (i.e the theory component), application of this technical knowledge was not at a satisfactory level.
- Some candidates incorrectly identified the scenario as a contingent liability as at 31.03.2018, but concluded that a provision should be made in the financial statements for the contingent liability.
- Many of the candidates' demonstrated a lack of comprehension regarding disclosure requirements related to provisions and contingent assets.
- The computation of amount of the provision was incorrect, in some instances.  
E.g. In the given scenario, the lawsuit against the company was for a claim of Rs. 1 billion. However, the lawyers estimate was that payment of 80% of the claim is highly probable.
  1. A few had identified the provision needing to be equivalent to Rs.1 billion.
  2. Some however, had netted off the Rs. 0.8 billion provision with the 'insurance claim receivable', a contingent asset as per the given information.

Part (b) LKAS 36 *Impairment of assets* (Value In Use Computation)

- Most of the students had mentioned the theory relating to the VIU calculation as per the standard, but hadn't applied them to the given scenario properly/completely.
- Further the theory relating to VIU, regarding restructuring, discount rate used and future growth rate were incomplete in most cases, resulting in the loss of some marks.

E.g.: Candidates answered in general, i.e.

1. Managements' commitment to future restructuring was not referred to, in some instances. Instead candidates made general reference to the fact that cash flows from restructuring should not be included in VIU calculations.
  2. Similarly, some candidates merely wrote that a steady or declining growth rate would have to be used, without giving reasons as to why a higher growth rate was not justifiable.
- Only a small number of candidates had said that the “asset should be tested for impairment, in its current condition”.

#### Part (c) LKAS 12, *Income Taxes* (Deferred Tax)

- A few students had mentioned that land should not be revalued, and that the given revaluation was only for the building component.
- Only one candidate was found to have calculated the Deferred tax liability on Revaluation, at the rate of 10%, (tax rate for capital gains), and not at the rate of 28%.
- The reason for not calculating deferred tax on Goodwill, upon acquisition, was not described correctly /completely, in most answers.
- Even though some students demonstrated knowledge that, when there is a history of recent tax losses, the whole amount of deferred tax asset could not be set off against the deferred tax liability available, they hadn't applied it correctly in the computation.
- The need for disclosure in the financial statement, of the deferred tax asset portion which exceeds the available taxable temporary differences, was omitted in most of the answer scripts.

#### Question 02 (25 marks)

A majority of the candidates fared poorly in responding to this question. Of all three questions, the lowest average marks were obtained for this question. Once again, as in question 1, this too had several parts, to test students on specified Accounting Standards, and the Corporate Governance Code.

- |             |  |
|-------------|--|
| First part  | (a) – LKAS 40, <i>Investment property</i>                    |
| Second part | (b) – Corporate Governance                                   |
| Third part  | (c) – SLFRS 15, <i>Revenue from contracts with customers</i> |
| Fourth part | (d) – SLFRS 13, <i>Fair Value measurement</i>                |

The main reasons identified, for loss of marks, could be grouped, as follows.

In part (a) the question set, was on investment property, with several scenarios being given, and candidates being required to propose the required changes to the accounting treatment in the Consolidated Financial Statements.

There were 10 marks allocated for this part. The following mistakes made by candidates, prevented them from obtaining adequate marks for this part.

- A considerable number of candidates discussed in detail the accounting entries in the individual companies, and had even written journal entries. However, the requirement was to discuss how the scenarios were to be treated in Consolidated Financial Statements. They were unable to score any marks, for their responses.
- Some answers were assessed as incomplete and hence they lost the opportunity to obtain full marks. E.g.: The Kalutara property, which had been transferred, changed from being an owner occupied property to an investment property. The transfer had taken place in the middle of the year, and marks were allocated for correctly explaining the treatment of this transaction, up to the date of transfer, at the time of transfer, and in valuation at year end. Most candidates directly commenced their answers with the treatment at the time of transfer, and how the fair value gain should be treated. A majority were silent on how it should be measured at year end. Candidates therefore lost marks, as the answers were not sufficiently comprehensive.
- There were some others who missed out in discussing the main points. The examiners expected that the application of the Investment Property Standard would be addressed, but candidates answers focused on the elimination of rent income in consolidation ( where the property has been rented to the subsidiary for use as the head office) and reversal of over depreciation ( where there was a change in use from PPE to investment property).

In part (b) - the examiner was testing the student's understanding of the application of the Code of Best Practice on Corporate Governance. Whilst this was a relatively easy question with an allocation of 5 marks, many irrelevant answers were given. It was observed that even in previous examinations on the same topic, candidates tended to write all they could remember of the Corporate Governance Code, without actually addressing what was required in the question.

- The question focused on Board Responsibilities and an evaluation of CEO's Performance. Without understanding the question, some candidates wrote that, the CEO failing to meet the set target, was not considered good professional behavior, and went on to discuss the code of ethics. These answers were not at all relevant, as the question specifically mentioned the need to resolve the problem, applying the requirements of the Code of Best Practice on Corporate Governance.
- There were others who said that, not achieving set targets would be a risk to the company, and then went on to discuss in detail, the responsibility of the Board of Directors re risk management and internal controls.
- A considerable number of candidates wrote that having a good talent pool on the Board would assist in overcoming the problem of the CEO not being able to achieve set targets.

Candidates failed to score an easy 5 marks, due to not reading and comprehending what was asked for specifically, in the question, and responding accordingly.

In part (c) - which carried six marks, the question required candidates to advise the management regarding the performance obligations of a contract.

- Many of the candidates wrote the theory – the need to identify each promise as a performance obligation and the criteria to be met for a good or service to be considered distinct, and scored about a third of the allocated marks. However, they failed to score on application. Some had incorrectly concluded that as some competitors also regularly sell many services separately (i.e. 1st criteria met), these should be billed separately.

In part (d) –

- It was noted that the application of the fair value hierarchy was not understood by many candidates.
- Some candidates just commented that the classification is either correct or incorrect but did not provide justification and thereby lost valuable marks.

### Question 03 (50 marks)

The overall performance was disappointing. Only a few candidates gained marks above 26. The main reasons for weak performance can be attributed to: students not understanding the question properly, lack of technical knowledge, unstructured answers, and answers given not being relevant to the question asked.

Some of the more common mistakes are discussed below.

In part (a)

- Candidates lacked knowledge on how to adjust for change in % holding (from Joint venture (JV) to Subsidiary) which results in a disposal gain/loss.
- Since it was a step acquisition, the change in % holding of NCI (from 30% to 40%) needed to be considered in the goodwill computation. This was not addressed, by many.
- In the computation of goodwill, instead of taking the fair value of the Joint venture, most candidates had taken the carrying amount of equity.
- A few candidates had incorrectly identified ETD PLC as an Associate, without giving a proper basis for doing so.

In part (b)

- The candidates were required to advise on principles relating to the accounting treatment of a merger. It was noted that familiarity with SORPs relating to mergers and the scope of applicable SLFRS, were lacking, in many of the answers submitted by candidates.
- The candidates failed to identify the common control transaction and to construct their answers accordingly. Instead of the principles of accounting, they discussed the benefits of the merger, such as improving efficiency, staff reduction etc.
- Others mainly addressed the pros & cons of merger- strategies, and factors to be considered in mergers, rather than the required accounting perspective.

In part (c)

- The examiner required an explanation to the Board, regarding the implications of applying the SLFRS 16 *Leases* Standard. A considerable number of candidates were able to clearly identify the impact of application of SLFRS 16. However, it was observed that some candidates did not have a clear understanding of this Standard, at all.

- Some were confused, referencing an earlier version of the standard (Type A and Type B).
- Although there was no such classification, some mentioned requirements pertaining to operating and finance lease classifications.

In part (d)

- Students were required to evaluate the suitability of the classification of the given segments. However, candidates had not linked the given scenarios to the appropriate standards.
- Most answers were focused on criteria for reportable segments, aggregation criteria, disclosures etc.

In part (e)

- This was a question on ethics. Candidates had identified the possible threats to integrity and objectivity. However, many had failed to link these to the requirements as stipulated in Section 320 of the Code of Ethics.
- Some candidates built their answers around the concept that the Board's view on the impairment of related party receivables, was that of Mr. Norman Subasinghe. Some others wasted time unnecessarily by addressing the safeguards available in this situation, which was not asked for, in the question.
- Instead of evaluating the given scenario, some candidates had reproduced the principle involved in the Code of ethics

In part (f) - Evaluating the performance of ET Finance PLC

- Most candidates mistakenly took 2017 comparatives of ETD PLC data for EPS and PE calculations. These candidates did not secure the 1 mark allocated for the EPS computation, but marks were awarded for the PE computation given, to ensure there would not be double penalization.
- It was observed that quite a number of candidates only commented on the Net Interest Margin, per the figures which were given in the unseen. The EPS and PE ratios were to be obtained from pre seen material, which had not been addressed in the answer. This resulted in a significant loss of marks.
- As non-financial factors, some candidates discussed factors which were common to both companies, such as regulations, industry norms etc.



## KC2 – Corporate Finance and Risk Management

June 2018

### Examiner's Comments

#### Overall Comments

On average, the performance on questions 1 & 2 were satisfactory. Except for a few, all other candidates were unable to understand part (b) of question 3.

#### Question 01

Three different financial criteria were tested in this question. Part (a) of the question was based on import costing. Part (b) covered shareholder investor ratios. Part (c) was based on zero coupon bonds.

#### Observations:

Almost all candidates attempted this question. Detailed observations for each part of the question are given below.

- (a) (i) The candidates were required to calculate the landed price of a 'can of imported fruit juice'. Due perhaps to insufficient time being allocated for reading and understanding the question, several mistakes had been made by the candidates. Some candidates were unaware of the components of landed cost, and hence totally disregarded both insurance and freight costs. Further, the percentage of tax – 64, had been considered a value, instead of multiplying the relevant variables at the applicable exchange rate by this percentage.
- (ii) Candidates were required to assess the profits realised by the importer and the supermarket. Some students used incorrect formulae to calculate gross profit, i.e. some dividing gross profit by cost instead of selling price. Students had also made mistakes in computing finance cost related to working capital. i.e. instead of deducting creditors from debtors, they had added both together. Some had considered annual interest as finance cost/ income.
- (b) (i) Candidates were required to calculate the share price and the price earnings multiple of the given company. Most students earned full marks for this part. However, some students had taken profit before tax, for the computation of earnings, and dividend per share. Some students had not considered the correct growth rate in computing market price, using return on equity of 15% and the growth calculation based on the 'rb' model (6%). Some had used wrong formulae in market price calculations.

- (ii) Candidates were required to calculate the dividend yield and to give an opinion on the investment. Most students earned full marks for this part. But some made mistakes in the formulae. Some were unable to express an opinion.
- (c) (i) Students were required to identify the Bond proceeds (Zero Coupon) raised by the Property Development Company listed on the Singapore Debt Market. Most students had not correctly calculated the Bond proceeds due to an apparent lack of knowledge of Zero Coupon Bond valuation.
- (ii) Candidates were required to discuss the rate offered on the above Bond, as compared with the recent 5 year USD Bond issued by the Government of SL. They were also required to identify the steps the company could take, to mitigate the foreign exchange risk involved. Only a very few candidates were able to give the correct rates, as expected by the examiner. Also exchange rate mitigation strategies had not been correctly identified for the issue, by most of the candidates.

## Question 02

The candidates were required to write a formal Memo covering 4 points given in the question. It was noted that those who had attempted question No.02 first, earned more marks, compared to those who had attempted this, after completing question No 03, due possibly to their having insufficient time, to carefully read and answer the question because of poor time management.

Point (1): From the perspective of ABC, as an investor, the company selection sequence should have used both NPV based on each company's risk profile and profitability index, as well as the amount of capital available.

Most candidates had attempted this part, and had earned higher marks as compared with those who had attempted the other 3 parts of the question. However, the following deficiencies were noted;

- I. Some candidates had shown confusion in selecting "Risk Free" rate. Some had taken WACC as the risk free rate and calculated the "Cost of Capital" of the projects using the CAPM formula. Others had taken the WACC of 12% of ABC as the Cost of Capital to calculate NPV of the three investment companies.
- II. Although the examiner had expected the candidates to take the average Treasury Bill Rate as the Risk Free rate, most candidates had considered a single Treasury Bill Rate, at a particular period, as the Risk Free Rate. E.g.; 90 days, beginning of the year rate of 9%.
- III. A few candidates had shown poor knowledge in calculating "Net Present Value (NPV)" of each investment. Some candidates had taken the proposed cash inflows and outflows, as is, (i.e. without discounting) and had taken the net cash flows as NPV.

Point (2): Discussion of whether investment should be made in undervalued companies, stock market or money market.



Most students had shown poor knowledge in calculating the return from the investment in the share market, using the growth % of the share market Indices. Also, most of them had not compared the Return from Investments in 3 Companies with Money Market and Share Market investment returns nor selected the best option as being the investment in 3 Companies.

Most of the candidates had not explained the Money Market Investments and Share Market Investments appropriately. Candidates had only mentioned that the Risk in investing in the Share Market was higher.

Point (3): Looking for debt capital or extra capital in accepting both companies from a financial management perspective.

Relying on the comments of the Chairman, most candidates had treated ABC Company as a highly geared Company, and recommended not opting for further debt financing. However most students did not pay heed to the information given in the question, that the "Company seems to be an ungeared Company".

Some candidates had not been able to identify that Debt financing is cheaper and that it would bring down the WACC of the Company.

Point (4): The Chairman's attempt to repay Debt, at the cost of foregoing Profitable Projects, or gaining Equity Market return or Money Market return.

As in part 3, most candidates had treated the ABC Company as a highly geared one and answered accordingly.

They had not identified the advantage of having Debt Capital in the Capital Structure of the Company.

### Question 03

(a) As in Part (a) of the question candidates were required to discuss the effectiveness of Operational Risk Management in the company. They were also required to calculate the DOL.

Not all candidates attempted to answer this part of the question. Those who did, calculated the DOL using the correct formula and were able to arrive at the correct DOL.

$$\text{DOL} = \frac{\% \text{ change in EBIT}}{\% \text{ change in Revenue}}$$

However, since DOL for the 3 companies ended up with negative values, these answers were limited only to the calculation. It appears that the negative figures had confused them, as this type of situation was not common.

Another group of candidates calculated DOL using the formula

$$\text{DOL} = \frac{\text{Contribution}}{\text{Revenue}}$$

Even though the contribution was not given in the question, the gross profit was used instead.

Other candidates lost at least 4 marks as they had not read the question thoroughly, and calculated DOL for the Group, instead of for 4 companies in the Group.

- (b) It appears that a fair number of candidates either had not attempted to answer this part of the question, or that their answer was limited to a few lines, and was insufficient.

As per the question, candidates were required to “write a report.....with an approximate value for the joint venture investment.....”. The intention of the Examiner was to have the Student calculate the value of the J/V on a Residual Basis.

Since emphasis had been on the J/V, some candidates had attempted to calculate the J/V value using the values given for the J/V in Annexure 6 of the pre-seen.

Candidates had made various irrelevant calculations and not given proper answers to the question – requiring a Net Assets calculation of two companies.

In the question, candidates were expected to write a report to The Management of the company. The responses demonstrated a lack of adequate knowledge in constructing ‘findings’.

- (c) Candidates were required to evaluate the offer received, using NPV techniques, and to compare it with the cash offer received, giving reasons for the recommendation made. There were no ambiguities in this question. Unfortunately, the answers given were not considered satisfactory, for this level of examination.

The candidates’ knowledge of application of annuity and terminal value was poor, in the given answers.

Additionally, candidates failed to get a satisfactory level of marks for this part, due to the following errors.

- I. The number of preference shares to be issued ignored the 5% premium. In place of the premium, some candidates calculated this as a discount ( $100 - 5 = 95$ )
- II. Failure to identify that ETD owns only 70% of ET Finance.
- III. Redemption value of 112.50 after 15 years not being considered.
- IV. Failure to understand the risk associated with preference shares due to the 15-year long duration.
- V. Ignoring the importance of receiving cash now.

- (d). Candidates were required to comment on the proposed dividend policy. On average, a fair number of candidates were able to score 3 – 4 marks, by referring to the theories of dividend policies such as residual theory, traditional value and irrelevancy theory. However, a proper evaluation of the given Company had not been made in most answers. Candidates had merely mentioned the theories attached to dividend declaration, without connecting their relevance to the practical situation at ETD PLC, demonstrating poor applicability of the stated theories.

In addition to the above, some had also argued that there had been no necessity to borrow funds, to pay dividends, as per financial statements, as enough funds were available. To justify

this line of thinking, they had cited the further investments as shown in loss making J/E in the year 2017 and 2018.

However, most of the candidates failed to mention factors such as;

- I. The need to meet the solvency test requirement
- II. The legal position regarding borrowing funds

NOT FOR SALE

## **KC3 – Corporate Taxation**

**June 2018**

### **Examiner’s Comments**

#### **General**

Overall, the candidates made a good attempt at completing the questions and answers were satisfactory, when compared with previous examinations.

Most of the candidates had approached the questions methodically, and so producing focused and relevant answers, addressing the core components of each requirement.

Examiners required more from students than merely displaying technical knowledge, as this was considered inadequate for corporate level examinations. It was expected that students would be able to compile comprehensive tax computations, demonstrate tax planning capability, strategize on minimizing tax expenses & mitigating risks, as well as the ability to effectively communicate with tax authorities, clients and managers etc.

Given that this was an Open Book Examination, the high standard expected from students, in terms of their ability to present answers which highlighted the relevant technical & legal aspects, was not fully met.

Students needed to be more focused on the structure of the paper, since the three questions were prepared based on practical scenarios. The answers should have been more constructive and presented as per the examiner’s expectations outlined above. Students should focus on technical accuracy, actions recommended i.e. action verbs, expected learning outcomes, knowledge of process, and knowledge dissemination.

The under-mentioned reasons could have a negative impact on student performance;

- Lack of pre-study connected with the pre seen case study materials.
- Lack of understanding of the requirements in the questions (not focused on action verbs)
- Focusing on irrelevant facts and thereby causing a time constraint
- Lack of pre study connected with recent amendments to Inland Revenue Act.
- Lack of communication and presentation skills.

## QUESTION-WISE COMMENTS

### Question 01

**General Comment:** This question was answered reasonably well by candidates, when compared with other questions, in particular, the elements of the question dealing with assessing the income tax liability of a non-resident person, double tax treaties & personal taxes.

Those candidates who had scored high marks, had carefully read and interpreted what the examiner asked for, and were succinct in their responses. They had made their points clearly and concisely.

Some candidates spent a significant amount of time writing lots of details about a subject based on their knowledge, which was neither relevant to the question nor the scenario outlined, and therefore did not score any marks.

Commonly observed weaknesses of candidates were;

- Lack of knowledge in chargeability of Income tax on non-resident persons.
- Inability to support an answer by giving relevant facts.
- Poor and irrelevant references to relevant sections of IRD Act, building the answer accordingly.
- Misunderstandings & careless mistakes in calculations.

#### **Part-(a) (i)**

Many candidates had successfully attempted this part of the question and had identified that “Ambal” is a non-resident company as per Sec.79 of the IRD Act, and that accordingly “Ambal” would be liable for income tax on profits and income arising in or derived from Sri Lanka.

Most candidates knew that technical services rendered by “Ambal” were liable for income tax.

Only a handful of students had referred to clause 1 of Article 7 of the Double tax treaty (DTA) between Sri Lanka and India, and developed constructive answers, explaining the impact on income tax liability, when it is created as a Permanent Establishment (PE) in Sri Lanka.

#### **Part-(a) II**

A majority of the candidates had answered this question well and successfully defined “Royalty” as per Article 12 of the DTA, explaining that payment of a running royalty fee and brand usage charges to a non-resident company would incur a liability for income tax. Unfortunately only a few candidates demonstrated their knowledge on accurate income tax rates applicable to such Royalty payments.

The Examiner wished to determine whether candidates would apply the appropriate income tax rate applicable to royalty fees and brand usage charges, as per DTA (10%), despite the income tax rate given in the Sec.94 & 95 in the IRD Act. Many candidates failed to identify the need for application of different tax rates in different situations.

Most candidates were not aware of the practicalities of obtaining clearances for sending foreign remittances. Only a couple of candidates knew about the requirement to withhold 10% on gross Royalties, remitting only the 90% of the balance payment.

## **Part-(b)**

Though many candidates attempted this part, some had not understood the requirement and inadvertently missed extracting relevant facts from the question itself to construct a methodical answer.

Common mistakes seen were calculation errors. By oversight, some candidates had taken both Sri Lankan Rupee values as well as US \$ values when preparing Ambal Company's taxable profit/ (loss), forgetting to convert the US \$ values to Sri Lankan Rupees, at the appropriate exchange rate.

Many had no idea which items were to be included, to arrive at Profit before tax of the Company. Only a few candidates knew that Profit before tax must consist of income sources, taking into account initial set up cost + Royalty+ Brand Use Charges.

In most cases only a single source had been considered, ignoring the other two aspects. A fair number of candidates, knew of the applicable 10% restriction on allowable Head Office Expenditure. Many of them however, had not known that 10% could have been computed on adjusted Profit, before Head Office Expenditure was charged.

Most candidates therefore were able to obtain marks up to the calculation of profit before tax, with relative ease, but none had adjusted head office expenses subject to the 10% restriction, and the 10% withheld for royalty fee in Sri Lanka, when calculating taxable profit.

Profits available for remittance to India had not been calculated accurately. As Royalty & Brand Usage Fees had already been deducted, the 10% could have been left out when computing Profits available for remittance. Many demonstrated their knowledge on applicable tax rates for remittances concerned.

A considerable number of candidates had applied a concessionary income tax rate of 12% under Sec.59B of the IRD Act, but some candidates had not identified this relief, and had incorrectly applied the higher tax rate of 28%. A few candidates had incorrectly applied the 10% tax rate - by considering this as an agricultural undertaking.

## **Part-(c)**

Most candidates had answered this part of the question by simply calculating net savings of US\$ 50,000 (USD 300,000 – USD 250,000), and had not explained important facts such as “Ambal” Company's taxable presence in Sri Lanka, though they had operated through an Agent in Sri Lanka. Some candidates had concluded that “Ambal” was not liable for tax in Sri Lanka, since they had subcontracted the assignment.

Many had not evaluated the tax exposure on the option re Initial set-up process on subcontract. Instead answers were limited to a mere calculation of profit made on the subcontracted option. In general, it was observed that focusing too much on computation and not enough on explanations resulted in a loss of easily obtainable marks.

### **Part-(d)**

Almost all candidates had understood that employees of “Ambal” were deemed to be resident in Sri Lanka as per the Inland Revenue Act and were liable for tax in Sri Lanka. Very few candidates had explained the impact of Article 15 “Dependent Personal Services” of the DTA, read in conjunction with the IRA, and listed out the three conditions required to be satisfied.

Students had sadly missed the contents that were readily available in the question paper itself on Article 15 “Dependent Personal Services” of the DTA, and were unable to score the marks allocated.

### **Question 02**

**General Comment:** On the whole, this question was dealt with well and the majority of candidates were able to complete it. Most candidates scored relatively high marks on this question.

The Commonly observed weaknesses of candidates were;

- Lack of knowledge of changes taking place due to amendments.
- Misunderstandings & mistakes in calculations.

### **Part-(a)**

This part of the question was intended to test the knowledge of students on quarterly self-assessment payments and any penal provisions applicable for non-compliance.

Almost every student had clearly described quarterly Income tax payments and the requirement to make the payment based on current year basis, indicating the due dates for the payments and penalty provisions applicable for noncompliance.

However, many students were ignorant of the fact that SPL had not been able to follow the current year basis for its quarterly tax payments, due to the delay in preparation of its final accounts and as such, that it had to take the information of the preceding year as a base for computing its quarterly tax payments for the Y/A 2017/18. Further, some were not aware that, if the previous year basis is taken for computing quarterly tax payments, then to avoid the penalty, SPL would have to pay the balance tax, if any, before 30th Sept of the following year.

A majority of the students were not aware that BOI exemptions enjoyed by SPL in the previous year did not constitute a valid reason for not paying quarterly taxes, based on the immediately preceding year. They should also have known that SPL could have worked out its tax liability ignoring the impact of the BOI exemption available in the preceding year. However, the overall performance in this part was satisfactory, as 90% of the allocated marks had been earned by many students.

### **Part-(b)**

While it was expected that a detailed answer would be needed to earn full marks, a majority of the students had not described the reasons as to why the relevant income source was liable for VAT or not. Some students had tried to expand their answer covering what is mentioned in the Act, without paying attention to the specific income tax sources given in the question,.

It is pertinent to note that some materials in the question were VAT exempt at the time of Import whereas the same would be liable for VAT at the time of supply in the local market. No one had distinguished this specific area of knowledge, as tested for, in the question.

Some had confused the VAT liability on Brand promotion fee, stating it was zero rated, without giving attention to the significant fact that “**services are consumed in Sri Lanka**”, which is the main reason VAT liability would arise on the said Income.

### **Part-(c)**

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

A few candidates however, had not known that the current rate of VAT was 15%, and instead had incorrectly applied a wrong rate. Also it was noted that only a few students could compute the Disallowable Input VAT in an appropriate way. Instead, they had tried to showcase their knowledge, using various formulas, which were not relevant at all.

### **Part-(d)**

A very few students had recognized the nature of business of APPL as being a manufacturer, and also the applicability of monthly payments basis for VAT, which is to be paid on or before 20th of the following month.

Those who had not identified APPL as a manufacturer, had incorrectly mentioned that the VAT is to be paid in two installments before 15<sup>th</sup> and 30<sup>th</sup> of the following month, which resulted in losing the marks allocated.

A high proportion of candidates however, knew of the requirement to File VAT returns for the quarter, before 30<sup>th</sup> April, and earned full marks on it.

## **Question 03**

### **General**

The overall performance in this question, was satisfactory compared with that of previous examinations.

### **Part (a)**

This part of the question was intended to test the knowledge of students on the computation of tax on a Limited Liability Company for the Year of Assessment 2017/18.

Most candidates performed well and demonstrated a good knowledge in the areas tested. However a few candidates had struggled with key concepts.

### **Candidates showed a strong performances in the following areas:**

- A majority of the candidates were successful in formulating logical answers and had followed the correct format to derive adjusted Profit from Trade.
- On the whole, the calculation of allowable/disallowable expenses was dealt with well.



- Most candidates who had applied the correct rates to compute capital allowances, attained close to full marks.
- Many displayed a good understanding of adjustments to expenses, such as Advertisements, Entertainment, Donations, Royalty, Amortization of intangible assets, Foreign Travel, Market research, impairment of related party receivables, warranty claim and debtors general provisions etc.
- Most candidates showed competence in making adjustments related to other sources of income.
- Many also applied the correct income tax rates.
- Most candidates had identified donations to approved charities as a qualifying payment and knew how to make a claim within the permitted time limits.

**Common mistakes observed were as follows:**

- It was a surprise to see some candidates had incorrectly started with “Net Profit after Taxation” instead of “Profit before Tax”, when computing adjusted Profit from Trade.
- Students were confused about the adjustment in claiming capital allowances on locally purchased software. Many of them had overlooked or were ignorant of the fact that it had to be locally **developed**, to be entitled to the 100% capital allowance rate.
- A few candidates had misunderstood and incorrectly disallowed amortization of leasehold land.
- Some candidates had not properly identified that the air tickets provided to joint venture partners, were not related to ETD PLC, and should therefore be disallowed, in full.
- Only a few candidates had figured out that there was an actual gratuity payment which would have been allowed for tax purposes.
- A majority of the candidates had not recognized the portion of amortization applicable to intangible assets, of EDT Electricals.
- Some candidates had failed to calculate the amount that should be ‘written back’, of the loan provided by ET electrical.
- Other candidates had failed to demonstrate their knowledge of limitation on qualifying payments i.e. 1/5<sup>th</sup> of Assessable Income or Rs.500, 000/- whichever is lower, and incorrectly deducted the entire expenditure of 1,600 to an approved charity, as a qualifying payment.
- Most candidates had not calculated and identified separately, the WHT tax credit element and instead deducted the whole amount as Self-Assessment payments, without mentioning that it includes the WHT tax credit.
- Royalty Expense - This adjustment was not accurately dealt with due to a lack of knowledge about recent amendments made to the Inland Revenue Act. Many candidates were ignorant of the amendments made to Section 25 which allowed Royalty deductions on an accrual basis.

Not knowing that the total amount of Royalty payable was allowed under Section 25, they were seeking Section 32 deductions on it.

## **PART (b)**

This part of the question tested knowledge on Section 25 and 26 and was very well answered, with most students scoring almost full marks. Loss of marks was generally attributable to the answer simply stating “Allowable” or “Disallowable”, even though the question required the students to analyze the position taken by the Assistant Commissioner.

### **Good performances that were observed are as follows:**

- Most candidates had answered this part successfully.
- They had correctly identified expenses as allowable or disallowable.
- They had valid arguments, supported by relevant facts.
- The descriptions included relevant case law.

### **Common mistakes identified were as follows:**

- Students failed to identify whether expenditure is Allowed or Disallowed based on the given facts.
- Students were unable to support the answer by giving facts.
- They were unable to describe and support with relevant case law.
- They failed to analyze the Assistant Commissioners decisions, and to comment on the validity of same.
- Whilst candidates were able to identify the scenarios and clearly knew the facts, they unfortunately omitted to give the Case Law references and thus justify the Assistant Commissioners decisions.
- Most candidates seemed to struggle with the part which was about treatment of Cash Loss as a result of a fraudulent act. Many failed to refer applicable Case Law or to support the decision with logic which was relevant, reasonable, and commercially justifiable.

## **Part (c)**

The Question required students to advise the Board of Directors as to concerns raised regarding the upgrade of HR policy, considering the regulations issued under section 212(2) (c) of the IRD Act no 10 of 2016.

Most candidates had answered this part successfully.

### **Responses that were correct and comprehensive were observed in the following:**

- Most had identified the relevant gazette notification
- Most had described the facts relating to employee and corporate income tax.

**Commonly made mistakes included the following:**

- A very few candidates had, in fact, not identified the relevant gazette notification.
- Some candidates had argued the scenarios incorrectly and merely mentioned that they were allowable or disallowable.

**PART (d)**

The Question called for the preparation of a brief Memo, to present to the Board of Directors, addressing the transfer pricing transactions and recommendations.

This question was not as well answered by candidates, when compared with the other questions.

Some candidates spent a significant amount of time writing lots of details about a subject based on their knowledge which was not relevant to the question.

Commonly observed weaknesses of candidates were;

- Poor references to the relevant sections of IRD Act and Gazette Notifications and constructing their answer accordingly.
- Most responses did not include identification of the relevant transfer pricing mechanisms.
- Many failed to present their recommendations on how to prevent transfer pricing issues.
- Some had unnecessarily elaborated on Transfer Pricing Calculation Methods, giving this as their recommendations.



# KC4 – Corporate Governance, Assurance and Ethics

## June 2018

### Examiner's Comments

#### General Comments

The examination consisted of two sections. Section 1 contained two questions of 25 marks each and section 2 was based on the pre-seen which carried 50 marks. As in previous examination sessions, in order to score high marks in the exam, candidates needed to demonstrate good technical knowledge. The overall performance in the exam was disappointing as many candidates had apparently not prepared in sufficient depth, and were therefore unable to apply their knowledge to the scenarios described and respond to the specific requirements of the question. None of the candidates had written an outstanding set of answers. It may either be due to not reading and understanding the pre-seen well in advance, or not reading the questions properly.

Candidates at this examination, seemed to have had insufficient time, and appeared more pressured than at previous sittings. It was observed that candidates seemed to spend more time in answering question number 3, and less time in answering the other two questions.

It was very clear that most of the candidates had not studied the prescribed text or practiced any question papers sufficiently, assuming that they can obtain a pass mark, by depending on open book referrals and other publications of CA Sri Lanka which were allowed at the exam. Most candidates demonstrated poor planning when answering the questions. Candidates were advised to focus on the marks available for each part of the question and plan the answer. Some were unable to comprehend the question, and as a result, had failed to write relevant answers. Other candidates were disorganized, and were unable to write the relevant question number in the answer script.

#### Specific Comments

##### Question 01

The overall performance of the candidates in this question was not satisfactory.

Part (a) In this part of the question candidates were required to comment on the appropriateness of the benchmark used by the Manager in charge of the audit, in determining materiality. Some candidates wrote satisfactory answers. They wrote that the loss before tax could not be taken as a benchmark when the company is asset driven, and according to the given information, China Co., did not expect profits within three years. Some candidates had reproduced the facts given in the scenario.

Other candidates had written other appropriate benchmarks for materiality such as revenue expenses and assets, without commenting on the appropriateness of the benchmark used by Kasun. As a result, they were unable to score full marks. A majority of the candidates were unable to relate the benchmark to the materiality level, and comment that if the benchmark was based on loss before tax it would have resulted in low materiality, which would have required detailed tests to be performed. Some candidates who had misunderstood the requirement in the question, had written lengthy answers, explaining the use of benchmarks in determining materiality in financial statements referring to SLAuS 320.

Part (b) In this part of the question the examiner expected to test the knowledge of candidates on audit risks. Candidates were required to evaluate five audit risks that should be considered when developing the overall audit strategy.

Many candidates demonstrated a good knowledge in identifying audit risks but most of them failed to identify the main audit risks in transfer of leasehold assets to SLPL, i.e. the existence of assets and the depreciation/amortization of each component of asset.

Most of the candidates incorrectly recognized the transfer of assets as a classification error in the Financial Statement of Accounts. They discussed the overstatement of assets due to wrong classification, as an audit risk. Many candidates stated that taking leasehold assets to the Balance Sheet, considering as a finance lease, was wrong, because at the end of 99 years, the assets would be transferred back to the lessor. According to LKAS 17 buildings and equipment could be classified as under finance lease. There is no reasonable certainty that the lessee will obtain ownership of them by the end of the lease period, as the economic life of the asset is less than the lease period. The land can be classified as a leasehold asset in terms of SoAT and amortized over the lease period.

Although some candidates had given reference to the LKAS 17 and SoAT, they were unable to identify the relevant audit risk. They had ignored the fact that the company only had the right of use, over 99 years. It was noted that not even one candidate had addressed the issue regarding the existence of the assets (cargo handling equipment, cranes etc.,) as an audit risk.

Many candidates had not recognized functional currency as an audit risk, only focusing on the exchange difference.

A large number of candidates had identified contingencies arising from employment compensation, and capitalization of borrowing costs, as risks, but had been unable to give adequate explanations, as expected by the examiner.

Others had identified deferred tax as an audit risk, but had not mentioned the effect during the tax holiday period.

Some candidates had not understood what was asked for in the question, and had written about general audit risks, such as management override, going concern issues, transactions with joint ventures etc. - which were unrelated to the given scenario.

A few candidates had identified the audit risks, but wasted time in writing audit procedures, which was not required by the examiner.

Those candidates who had not understood the requirements in the question had written re risk areas by reproducing the facts given in the question. Some had even written about considerations in establishing an overall audit strategy, which was not required in the question.

Part (c) In this part of the question candidates were required to advise the audit team on audit procedures that should be carried out on related parties and relevant party transactions of SIPPL, for the period ended 31<sup>st</sup> March 2018. Many candidates had submitted satisfactory answers. Some candidates had ignored the fact that the company has been established only in November 2017, and wrote general audit procedures, which were not relevant to the period. i.e.

- Review prior year working papers (which were not available to them)
- Review investment transactions (which were not relevant to the given scenario)
- Enquire about pension and other trust funds (not in the given scenario)

Part (d) In this part of the question the examiner expected to test the knowledge of the candidates on events occurring after the balance sheet date, up to the date of signing of the audit report, referring to the SLAuS 560 and LKAS10. Whilst some candidates wrote satisfactory answers, others had stated that Management should be requested to make the needed correction, ignoring the impact on the audit report, which is what was required in the question. Candidates who had not understood the question, and lacked the technical knowledge, wrote about the auditor's responsibility, and that the audit report should be based on a review engagement.

Most candidates were unable to understand that the auditor should assess the impact of any subsequent event, to determine whether such events are adjustable or nonadjustable. Only a few candidates had identified the two types of events as adjusting and non- adjusting events. The requirement was to evaluate the issue in respect of audit procedure. Some candidates had written audit procedures, such as test of details and test of controls. Most candidates had given the steps to making the adjustment, without writing the audit procedure.

## Question 02

Part 1; In this part of the question, the examiner expected to test the knowledge of candidates about Sri Lanka Standards on Quality Control which apply to all firms of professional accountants, in establishing and maintaining systems of quality control. The examiner expected the candidates to analyze the given scenario and (evaluate) determine the **significance of the matters arising**, in respect of providing assurance services, to the client.

Although many candidates had attempted this part, only a few candidates had been able to provide satisfactory answers. This was mainly due to answering the question without having clearly understood what exactly was required. They could have picked the answer straight from the scenario and applied the elements of a system of Quality Control as per SLSQC. Some candidates had referred to the SLSQC and written the elements of a system of quality control, and explained them, without making reference to the given scenario. This may be due to the fact that they had ignored the words **matters arising** in the question. Some candidates had identified the issues, but had not applied to them, the elements of a system of Quality control, and as a result, earned lower marks.

Part 2; In this part of the question, the examiner expected the candidates to (advise) offer suggestions, about the best course of action, to enhance the quality control at the firm level. It was disappointing to note that candidates had failed to understand the basic requirement. Candidates were expected to apply the elements of quality control where applicable, to overcome the issues in providing the assurance service to the client. Some had understood what was required in the question, but had just written the elements of quality control and explained them, without addressing the issues in the given scenario, and as a result obtained less marks.

Part 3; Candidates were required to evaluate five core areas to be reviewed - as a **quality control reviewer** of the audit of Dairy Lanka Plc. The candidates were advised that when the question mentioned the name of the client, they should understand that the answer should be linked to the issues arising in the company of the client. Many candidates had copied the functions of the quality control reviewer from the standard –SLSQC, without addressing the relevant issues, and as a result, got lower marks. Some candidates who lacked the technical knowledge, wrote the fundamental principles of the Code of Ethics, such as integrity, objectivity professional competence etc. Some candidates had misunderstood the requirement, and confused the areas to be reviewed by the **engagement partner**, when planning the audit, writing the following:.

- Whether the firm is competent to perform the engagement
- Whether they comply with ethical standards
- Consider the integrity of the client

Part 4; Candidates were required to evaluate the impact of the given unadjusted differences in the financial statement of the client. The examiner expected the candidates to apply the SLAuS 450, in answering this part of the question. Many candidates had not attempted this part. The few candidates who had answered - demonstrated poor knowledge in evaluating unadjusted differences. Some candidates who had not understood the requirements, in the question, had described the performance materiality level. Most failed to understand that, when there are unadjusted balances in the previous year, which are still material, it amounts to misstatements in the financial statements. Some candidates had added both balances and written that the overall materiality level is 33m, and that this should be reported. The common answer written by many candidates was that Management should be asked to make the correction, and if it was not done, this should be reported.

### Question 03

This question is based on the pre seen and carries 50 marks.

Part a

(1) In this part of the question, the examiner expected the candidates to advise the internal auditor on **4 criteria to bear in mind when identifying areas for investigation**. The well-prepared candidates answered well in this part. Candidates were advised to follow the action verbs used, as the examiner would expect candidates to write a few suggestions in a manner suited to the internal auditor. Many candidates had not paid due attention to the action verbs, and as a result, they had written answers in bullet form. Some candidates wrote the focus areas which should be the answer for part b)2. Some candidates had misunderstood the question and ignored the fact that the advice was required for investigation and wrote irrelevant answers such as;

- Review risk assessment policies
- Review internal control procedure
- Review compliance with laws

(2) Candidates were required to evaluate **5 key focus areas** likely to be identified by the head of internal audit. The examiner expected the candidates to identify the areas from the pre-seen, and the given information, and evaluate them, referring to each criteria for investigation purposes. Some candidates were able to identify the focus areas but were unable to link them to the criteria, and as a result obtained lower marks. Others had identified strategic control areas, like multiple dealerships and increasing competition, as focus areas, ignoring the fact that such areas are not under the purview of the internal audit for investigation purposes. If the candidates had read and analyzed the issues in the pre-seen, they could have obtained sufficient marks.

#### Part (b)

Candidates were required to comment on the level of compliance of ETD, with the code, in relation to Audit committee and meetings. Most of the candidates ignored the word **level** and reproduced the composition of an audit committee from the Code of Best practice on Corporate Governance 2017, which was an allowable publication under the open book system. The examiner expected the candidates to refer to the code and apply the principle to the given information. Some candidates had written relevant answers, referring to the pre-seen, and addressed the requirement of the code. Most were of the view that the chairman was not independent, due to his proposed marriage. It would have been more appropriate if they had referred to the code on independence criteria and explained the issue. Other than a few, most candidates failed to note that at least one member of the audit committee should have recent and relevant experience in financial reporting and controls.

Almost all candidates were able to refer to the scenario and address the requirement of the code about meetings, but most were unable to address the operational effect of not having regular meetings.

Part (c)(1) Candidates were required to outline 4 advantages of having a principle- based Code of Best Practice for Corporate Governance. The examiner expected the candidates to know why many Governance codes adopt this approach. Some candidates wrote advantages and obtained full marks, but other candidates wrote about the characteristics of a principle-based approach.

(2) They were required to comment on ETD's extent of compliance with three key principles relating to the Board. Candidates were expected to extract the points from the Code, which was available on the desk, and apply the principles to the given scenario. They were expected to extract the points which were relevant to the scenario i.e.;

- A 1 Headed by an effective Board
- A 2 Chairman and CEO
- A 4 Financial Acumen
- A 5 Board Balance

A 1 Most candidates wasted time in explaining the principle, and reproducing facts in the code, without analyzing the effects on the given scenario.



Many candidates failed to explain the effectiveness of the Board, other than the requirement of independence and the qualification of the Board members. Some had referred to the principle 1.1 regarding having regular meetings, but had not read the pre seen, and unseen, and therefore not referred to the Audit committee meeting that had not been held for two quarters.

- A 2 Many candidates gave the requirement of the code, but were unable to relate these to the pre seen and unseen. Most were unable to identify that there were two persons as Chairman and as CEO.
- A 4 A majority were unable to link the need for financial acumen, to the scenario.
- A 5 Some candidates were able to link the principle of 'Board Balance' to the scenario.

It was evident that most of the candidates had not read and analyzed the important areas of the pre-seen, and as a result, were unable to obtain sufficient marks.

Part (d) Candidates were required to advise the Board on four benefits of having a separate Risk Committee. They were expected to refer to the given scenario and explain the requirement for a separate risk committee, in addition to the available audit committee. Some candidates were able to write the benefits, but many were unable to link to the given scenario. Many candidates wrote re the general benefits, and obtained only a few marks.

Part (e) In this part of the question the examiner expected the candidates to explain 6 imperatives for high performance of ETD group. Candidate performance in this part of the question was 'average'. Some had not understood the question and had written the objectives of the internal audit, instead of identified imperatives for high performance by ETD.

Part (f) In this part of the question, the examiner expected to test the theory of Kohlberg in a practical situation. Candidates were required to evaluate the level of ethics and stage of moral development, as demonstrated by nondisclosure of material non-performing loans in the financial statement. Most of the candidates described the stages and levels of Kohlberg's theory, without addressing the specifics asked for in the question.

## **Conclusion**

The lack of understanding of the question in the described setting appears to be the main weakness observed in the level of performance, at the exam. Some candidates lacked the level of subject knowledge required for this exam. Examiners expect to see evidence of stipulated learning outcomes, as set-out in the study text based on the SLAuS, and in the Code of Best Practice in Corporate Governance. The questions at this exam had been set within the framework of the syllabus and candidates who had studied the study text, could have easily given answers that would have satisfied Examiners' expectations. The answers were given based on common sense or general knowledge, and not on adequate technical know-how required at this level. A key 'take-away' from this exam is the inability of candidates to apply theoretical knowledge to practical situations.