THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC 1 - Corporate Financial Reporting

December 2017

Answer 01

Relevant Learning Outcomes/s;1.1(Level A)
Study text reference:102-133,702-707,476-485

(a)

(i) Investment property transfer to PPE

The company is going to construct the head office which is to be used for administrative purposes. It is the commencement of owner occupation.

Samanala PLC will transfer the land to PPE at its original cost which is incorrect. According to LKAS 40 paragraph 60 the transfer of land to owner occupied property should be at Fair value, and this will be considered as the deemed cost. Therefore, the transfer of the difference in the fair value and original cost to the SOCI is incorrect. The gain/loss arising due to changes in FV on the date of transfer and the previous FV should be charged to the P & L.

Interest accrual on debentures

Borrowing cost of a qualifying asset can be capitalised. Since the project goes on till 2019 it is a qualifying asset and therefore the borrowing cost incurred on the same could be capitalised.

Samanala PLC can capitalise borrowing costs that are directly applicable to the construction. Debentures were issued specifically for the project. According to LKAS 23 paragraph 12, the eligible borrowing cost will be calculated by deducting any investment income on the temporary investment of the borrowings from the cost incurred from those borrowings.

The capitalisation of interest can be only be made during the construction period. The period from 01st April to 01st May, may not form part of the borrowing cost.

The capitalisation of interest on the bank loan would be commenced as and when the loan funds are utilised.

Unutilised fund investment income

Total interest income from securities should not be part of the investment income. One month from 01 April to 1st May will be recognised as investment income and the balance period interest (i.e. for 7 months) needs to be deducted from the borrowing cost, prior to capitalising it.

WIP

Cost of launching the project

Project launching expenses are preliminary expenses. Therefore, the cost of launching the project [2Mn] may not be capitalised under LKAS 16 as it is not directly attributable and it is not resulting in any economic benefits.

The capitalisation of the site preparation cost, legal and other professional fees and other directly attributable costs under work in progress is correct.

(ii) 45,000,000*9% *7/12 = 2,362,500
Deduct Interest income = 800,000 * 7/8 = 700,000
Capitalise = 1,662, 500

(b) As per section 1 of the SME standard states the companies which cannot use SLFRS for SMEs. Sama Finance Ltd is a company registered under the Finance Companies Act No 78 of 1988 hence not allowed to use SLFRS for SMEs. The company should prepare financial statements using the full SLFRSs.

S & S (Pvt) Ltd is a company that does not have public accountability, and does not fall under 1.1 of Section 1 of SLFRS for SME. Therefore S & S may adopt SLFRS for SME for its own financial statements. However, for consolidation purposes with Samanala PLC, the parent company will need to do the adjustments required by the full SLFRS.

(c) Option 01

	2016	**2017**
Profit (Rs.million)	800	920
Shares (Nos)	2,000,000	2,000,000
EPS (Rs.)	400	460

(Total 25 marks)

Answer 02

Relevant Learning Outcomes/s; 1.1(Level A)
Study text reference: Page 334-339,358-366,141-147

(a)

(i)

- The convertible debentures have a liability and equity component. BFL has to separate these components and account for it separately.
- For this purpose, the interest rate of similar debentures without the conversion option will be used.
- Hence, the computation of debt and equity components are as follows:

Year	**01 (Rs. million)**	**02 (Rs. million)**	**03 (Rs. million)**	
Interest	12	12	12	
Capital	-	-	200	
Total	12	12	212	
DCF @ 9%	0.917	0.842	0.772	
	11	10.1	163.67	184.77

	Capital (Rs. million)	**Issue Cost (Rs. million)**	**Total (Rs. million)**
Debt	184.77	(1.85)	182.92
Equity	15.23	(0.15)	15.08
Total	200.00	2.00	198.00

- 2Mn issue cost should be reversed from the profit or loss statement.
- The financial liability will be re-measured by using the effective interest rate covering the issue cost. Hence, the value of the liability is as follows:
  182.92 x 1.0938 – 12 = 188.08 Million
- Equity will not be re-measured

(ii) BFL should satisfy all of the following conditions as per LKAS 39 in order to designate it as a cash flow hedge. (para 88)

1. The hedging relationship must be designated at its inception as a hedge based on the entity's risk management objectives and strategies. Formal documentation should made by BFL on:
   - Identification of hedge item
   - Hedge instrument
   - Nature of risk that is hedged
   - How BFL will assess the effectiveness of hedging instrument
2. The hedge must be expected to be highly effective, usually an effective rate of 80% to 125%. BFL's Hedge is highly effective.
   Effectiveness = 30/29 * 100 = 103.45% or 29/30*100=97%
3. For the cash flow hedges, the forecasted transaction which is subject to hedge must be highly probable. In this instance BFL purchasing the steel is highly probable as it is in the construction industry and would require steel for its projects.
4. Effectiveness of the hedge could be measured reliably
5. Hedge is being assessed on an ongoing basis and effective at the reporting date

Hence, all the above conditions were satisfied by BFL and could classify the above transaction as a cash flow hedge.

<u>Recognition:</u>
Financial Assets (derivative) Dr – Rs. 30 million
Other comprehensive income Cr – Rs. 29 million
Profit or loss Cr - 1 Million

When the steel purchase transaction is completed the gain recognized in OCI could be reclassified against the carrying value of Inventory.

Alternate answer (based on SLFRS 09)

(a) (ii) Alternative answer in the light of SLFRS 09 (students may also consider that)

BPL should satisfy the following criteria in order to designate it as a cash flow hedge in terms of SLFRS 09.

1. The hedging relationship should contain only the eligible hedging instruments and eligible hedging items. BFL uses future contracts in order hedge the risk of steel prices rising. In the light of SLFRS 09, the future contracts can be considered as eligible since it is normally/usually identified as a derivative measured at fair value through profit or loss.

   Further, the hedging item i.e. the steel price, can be considered as an eligible hedging item as;

   - BFL has a forecasted transaction which is highly likely to take place as it requires steel for its operations.
   - The hedged item (steel prices) could be measured reliably

2. At the inception of the hedge BFL has to formally designate the hedging and should document the relationship.

3. (a) BFL needs the economic relationship criteria as the future contract and the steel prices are oppositely related for the same risk of the rising price of steel.

   (b) The effect of credit risk associated will not dominate the value change of the above economic relationship. As in BFL's transactions the credit risk effect does not impact the hedging instrument or hedged item.

   (c) The hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item and hedging instruments. In this case BFL should look into the hedging ratio by looking into the amount of steel purchases forecasted with amount of utilisation in future contracts.

If the above conditions were satisfied by BFL then the hedge could be recognised.

Recognition

Financial assets (derivative) - Dr. Rs. 30 million
Other comprehensive income - Dr. Rs. 29 million
Profit and loss - Cr. Rs. 1 million

When the steel purchase transaction is completed the gain recognized in OCI could be realized against the carrying value of inventory

(b) 1. The above patent right is an internally generated intangible asset. As per LKAS 38 *Intangible assets* in recognising of expenses related to research and development the following must be considered.

- During the research phase the cost incurred will be <u>expensed to Profit or loss</u> as it <u>is not far enough to establish that the entity will generate economic benefits</u>.

- Cost incurred by Sena PLC during the development phase could be capitalized subject to the conditions laid down in LKAS 38 as follows:

  - Project is technically feasible
  - Entity has intention to complete the project or sell it
  - Entity has the ability to complete the project or sell it
  - Generation of probable economic benefit
  - Availability of adequate technical, financial and other resources to complete the project.
  - Ability to reliably measure the cost incurred.

(i) The market research cost cannot be considered as development activities as it cannot currently generate economic benefit to Sena PLC

(ii) The cost for design simulation and design variance analysis could also be considered as a research phase cost as it does not give a marketable outcome and does not establish the generation of economic benefit to the entity.

(iii) Development work to finalise the prototype design, materials and methods are considered as costs incurred during the development phase as it satisfies all of the above criteria and establishes the fact of probable economic benefit flowing to Sena PLC

(iv) Further staff costs will be allocated to the cost of the intangible assets based on the time spent.

(v) Cost of upgrading the machinery will be capitalised to tangible assets and market testing and staff training cost are expensed to profit or loss.

Hence,

Intangible asset	**Rs. million**
Development work to finalize the prototype design, materials and methods	12.0
Staff cost development part (2*0.6)	1.2
	13.2

Amount Capitalized to PPE
Cost of upgrading the production facility Rs. 5 million

Expenses/P&L	**Rs. million**
Market research	5.0
Design generation, simulation and design variance analysis	4.0
Production and branding expenses (8-5)	3.0
Balance staff cost (2-1.2)	0.8
	12.8

(Total: 25 marks)

Answer 03

Relevant Learning Outcomes/s:2.1,2.3,3.1,4.1,5.1
Study text references:497-554,728-752,41-49,13-20

(a)

Strategy 1

Shareholding before and after the share issue

	Before		**New Share Issue**		**After**	
	No. Of Shares	**Holding %**	**No. Of Shares**	**Holding %**	**No. Of Shares**	**Holding %**
Malik	765,000	51%	7,500,000	30%	8,265,000	31%
Lasantha	300,000	20%	5,000,000	20%	5,300,000	20%
THP	435,000	29%	12,500,000	50%	12,935,000	49%
	1,500,000	100%	25,000,000	100%	26,500,000	100%

An investor has power over an investee when the investor's current existing rights gives it the ability to direct the relevant activities

Assessing power is straightforward when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment will be more complex and require more than one factor to be considered, for example when power results from one or more contractual arrangements.

In this case, the size of THP's voting interest and its size of the shareholding will be 49% and will be the major shareholder of the company with the new share issue**.** However, only Malik and Lasantha would need to co-operate to be able to prevent THP from directing the relevant activities of the company. Therefore, it is clear that THP does not have power over relevant activities of QPL**.**

However, all the other facts and circumstances should be considered including the following, when assessing the power.

- Potential voting rights held by vote holders (i.e. impact of issuing convertible debentures in the future)
- Contractual arrangements between THP and other two vote-holders
- Rights arising from other contractual arrangements (e.g. Ability to direct operating and financing activities have impact on ability to direct relevant activities)

Financial reporting treatment

In THP's financial statements, the existing investment in QPL is an investment in an associate (29% voting rights plus one director will give the ability to influence significantly). With the new investment, it continues to be an investment in an associate which should be measured using the equity method

Equity method	(Rs.'000)
Net asset as at 31.03.2017	55,259
Carrying value as at 31.03.2017 (55,259*29%)	16,025
Share of profit for 9 months (3,000*29%)	870
New investment by THP (250,000*50%)	125,000
Carrying value as at 1.1.2018	141,895

Strategy 2

Shareholding of THP in QPL after the share issue

	Before		New Share Issue		After	
	No. Of Shares	Holding %	No. Of Shares	Holding %	No. Of Shares	Holding %
THP	435,000	29%	25,000,000	100%	25,435,000	96%
Total	1,500,000		25,000,000		26,500,000	

With the new share issue, THP gets the majority of voting rights and therefore the control of QPL

However, it is required to consider whether there are any contractual arrangements that prohibit THP from directing relevant activities QPL. Further, the impact on potential voting rights held by vote holders (i.e. impact of issuing convertible debentures in the future) should be considered if issued.

Financial reporting treatment

The existing investment in QPL is an investment in an associate. As THP becomes the parent of QPL with the new investment, as of the acquisition date (i.e. 1 January 2018), THP needs to recognise goodwill/gain from the bargain purchase.

Goodwill computation will be as follows.

		(Rs.'000)
Consideration transferred		
Cash		125,000
Deferred consideration		
Cash (75,000/1.15^3)		49,314
Shares (2,000*Rs.60)		120,000
		294,314
FV of existing investment		22,000
FV of NCI		43,000
		359,314

Less		
FV of net assets acquired		
As at 31.3.2017	55,259	
Profit for the 9 months	3,000	
New Share issue	250,000	
FV increase of the building	4,000	
DT on FV increase (4,000*.28)	(1,120)	(311,139)
Goodwill		48,175

Note

1. Customer List – Since the contracts prohibit QPL selling, leasing or otherwise exchanging information about these customers with another party, it does not meet the separability criteria and therefore will not be recognised as an intangible asset acquired in a business combination.

2. Operating lease in which QPL (acquiree) is the lessor (para B 42)
   Acquirer does not recognise a separate asset or a liability if the terms of the operating lease are either favourable or unfavourable when compared with market terms. Therefore, THP cannot recognise an asset for the favourable lease terms.

THP should prepare consolidated financial statements by consolidating the results of QPL

(b)

Revenue

In 2016/17, the 81% revenue growth appears to be unusual when the previous years' growth rate is considered. Since the 2016/17 figures are not audited, it is required to check whether the 81% growth in revenue compared to the previous year is due to the opening of 5 new shops or due to an error in recognising revenue which has resulted in an overstatement. Further, it raises a doubt why the revenue growth in 2016/17 was not considered in forecasting future revenue if it resulted from new outlets opened in 2016/2017.

Revenue growth in 2017/18 is reasonable when the revenue growth in 2015/16 is considered. However, it seems that increasing the number of shops has not been considered in forecasting revenue in 2017/2018. In addition to that, despite the number of shops is further increased in subsequent years, revenue is not expected to grow year on year. Further, QPL does not expect revenue per outlet to increase towards the latter part of the forecasted period. This could be due to increased competition, due to problems with the pricing mechanism announced in 2017 (this may not have an impact on the 2016/2017 figures but would impact on subsequent years) or due to errors in preparing the forecast. Accordingly the revenue forecasted from year to year does not show a consistent trend in line with historical data and therefore the basis of forecasting revenue is questionable. This will require careful analysis of assumptions used in forecasting revenue.

Gross profit margin

Gross profit margin of 44% in 2016/2017 is significantly higher than the GP% of the previous two years. Such an increase in the GP% margin appears to be unusual because 70% of products sold by QPL are imported and the costs vary with every shipment due to exchange rate variability. LKR was depreciating significantly especially against USD over this period. Therefore the cost of drugs should have gone up rather than down. It is also clear that the QPL is not in a position to increase prices significantly due to the pharmaceutical industry being controlled by price regulations by the government, increased competition and availability of low substitutes. Accordingly, it is required to ensure that the cost of sales are not understated in the 2016/2017 draft financial statements.

However, GP margins in the forecast for the subsequent two years (i.e.2017/18 and 2018/19) show reasonable GP margins which are in line with the GP margins in 2014/15 and 2015/2016. Nevertheless, QPL has forecasted a decreasing margin from 28% to 24 % in the latter periods. This may be due to the impact of the new price mechanism where the prices are fixed but import costs are variable due to variability in exchange rates. However, it is required to check assumptions used in preparing the forecast to ensure that the GP% is accurate.

(c)

Currently QPL is highly geared as its debts are more than half of its equity and interest cover is very low. This represents a greater risk, because even a brief period of reduced profits could mean bankruptcy and loan defaults.

However, this position is going to be very healthy with the implementation of either strategy. This means QPL will have greater financial stability in the future as its profits will be sufficient to pay interest.

(d)

- Appointing Outside Directors

  According to the Code of Best Practice on Corporate Governance, every public company should be headed by an effective board which should direct and lead the company and the <u>Board should ensure that a sound internal control system is in place to safeguard shareholders investments and the company's assets</u>

  In establishing an effective Board, <u>having a balance of executive and non-executive directors</u> is very important to prevent one individual or a small group of individuals dominating the board's decision making. The Code also requires the Board to include <u>independent non-executive</u> directors
  Presently, majority of the directors are family members and there are no independent non-executive directors in the Board. Therefore, appointing outside directors with sufficient calibre would help QPL to have an effective board and thereby to establish a strong internal control system

  Further, having outside directors who are independent is very important in establishing the audit committee which in turn helps to achieve a sound internal control system.

- Appointing an Audit Committee

  The Code requires the Board to <u>appoint an audit committee</u> as per the principles stated therein. Further, the Board should require the <u>audit committee to carry out reviews of the process and effectiveness of the risk management and internal controls,</u> and to document to the Board and the Board takes the responsibility for the disclosures on internal controls.

  Audit committee's <u>purposes must include to assist the Board oversight of the processes to ensure that the company's internal controls and risk management procedures are adequate to meet the requirements of Sri Lanka Auditing Standards</u>. In addition to that, the audit committee's <u>duties and responsibilities include ensuring an effective internal control system and internal audit function are in place</u>

Therefore appointing an audit committee helps th QPL to have an effective internal control system.

(e)

This situation will create a conflict of interest as Lasantha is responsible in selecting the supplier and the decision will result in financial benefits to his immediate family member. He needs to evaluate whether this is going to be significant (e.g. whether such supplies would amount to a material part of the purchases of QPL).

Safe guards;

- Withdrawing from the decision-making process related to the selection of suppliers.
- Consulting with Institute of Chartered Accountants of Sri Lanka, legal counsel or another professional accountant.

(Total 50 marks)

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