CA THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

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KB1 – Business Financial Reporting

June 2019

SECTION 1

Answer 01

Relevant learning outcome/s: 1.1.1 and 1.3.3 1.1.1 Demonstrate knowledge of the conceptual framework of Sri Lanka Accounting Standards, with emphasis on: - Objectives of general purpose financial statements - Underlying assumptions - Qualitative characteristics of financial statements - Elements of financial statements - Recognition and measurement of elements of financial statements - Concepts of capital and capital maintenance 1.3.3 Discuss the regulations applicable to the accounting profession and financial service industry.
Study text reference: Pages 7, 36 and 37

(a)

- **Existing investors (shareholders)**
  Existing investors of the hotel want to assess how well the management is performing, how profitable the hotel's operations are and the potential for dividend payments, as well as whether their investment is sound.

- **Potential investors**
  Potential investors' decisions mainly involve whether to buy equity or debt instruments of the company, and they would like to know the expected return on their investments.

- **Lenders**
  They want to ensure that the hotel is able to keep up interest payments and eventually repay the amounts advanced.

- **Creditors (suppliers)**
  They would like to know whether the company will be able to continue operations and have the ability to settle its dues.

- **Tax authorities**
  They want to know about business profits in order to assess the tax payable by the hotel.

- **Employees of the company**
  They would want to make a decision about their future career. The amount of their wages and salaries depend on how well the company is performing.

- **Customers**
  They would like to know whether the company will be able to continue production and supply goods and services.

- **Public**
  Any possible justification.

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(b) Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995 identifies business entities as Specified Business Enterprises (SBEs) based on revenue, number of employees and liabilities to banks and other financial institutions in addition to the Other SBE categories given below.

Other companies:

1. Which have a turnover in excess of Rs. 500 million
2. Which at the end of the previous year had liabilities to banks and other financial institutions in excess of Rs. 100 million
3. Which have a staff in excess of 1,000 employees.

Even though M&M's revenue and number of employees are below the prescribed limits, its liabilities to banks and other financial institutions in the previous year are above the prescribed limit.

Therefore M&M has to submit its audited finical statements for the year ended 31 March 2019 to SLAASMB. Accordingly the MD's opinion is not accurate.

(Total: 10 marks)

Answer 02

Relevant learning outcome/s: 2.1 Level A Thorough knowledge and comprehension of the standard to identify significant complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the evaluation and application of standards in resolving a complicated matter related to financial reporting. Where: - A "complicated matter" includes transactions and/or events which require thorough analysis of the matter and evaluation of standards. - It may require the analysis, application and evaluation of relevant standard/s.
Study text reference: Pages 219 – 224

(a) The inventory of Syntex PLC should be valued as follows.

Finished goods

	Rs.
Cost per unit	
Material → 10kg * 550	5,500
Conversion	4,500
Total	10,000
Net realisable value	
Expected selling price	16,000
Less: Selling costs estimate	(1,500)
Net realisable value	14,500

Value of finished goods inventory at closing → 200 * 10,000 = Rs. 2,000,000
Value of raw material inventory at closing → 550 * 1,000 = Rs. 550,000

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The net realiasable value (NRV) of the raw material (Rs. 300) if sold as raw material is lower than the cost. However, the NRV of processed finished goods is higher than the cost. Therefore the raw material inventory should not be written down, and be recorded in the books at cost.

	Rs.
Expected sale proceeds if sold as raw material	*200*
NRV per kg of raw material	*1,000*

(b)

- In an inflationary situation, the FIFO method shows a more favourable performance due to ending inventory being higher than the costs assigned to the units sold.
- However, profit-based payments such as bonuses and taxes may also go up. As a result, the increased profits will get diluted to reach a net result.
- The cash flow position will not improve since the increased profit impact is offset by the increased working capital on inventories.
- Rather the cash flow position may deteriorate due to the cost of extra profit-based payments such as bonuses and tax payments.
- WAC assigns average costs to the units that are sold, as well as to the units in ending inventory.
- In an inflationary situation, the WAC method of valuation neither produces favourable profits nor an adverse cash flow position as in the case of FIFO.

Therefore, in an inflationary situation the FIFO method of inventory valuation produces a more favourable performance compared to the WAC method of valuation. However, WAC will not adversely affect the cash flow position as in the case of FIFO.

(Total: 10 marks)

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Answer 03

Relevant learning outcome/s: 2.2 Level B Good knowledge and comprehension of the standard to identify moderately complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the analysis and application of standards in resolving a moderately complicated matter related to financial reporting. Where: A "moderately complicated matter" includes transactions and/or events which require an analysis of a matter and evaluation of such matter with the related.
Study text reference: Pages 315 – 319 and 342 – 352

(a)

Under SLFRS 9

Classification	**Measurement basis**
Investments at amortised cost	Amortised cost
Investments at fair value through profit or loss (FVTPL)	Fair value
Investments at fair value through other comprehensive income	Fair value

Under LKAS 39

Classification	**Measurement basis**
Loans and receivables	Amortised cost
Investments at fair value through profit or loss (FVTPL)	Fair value
Available-for-sale investments	Fair value
Held-to-maturity investments	Amortised cost

SLFRS 9 bases the classification of financial assets on the contractual cash flow characteristic and the entity's business model for managing the financial asset; whereas LKAS 39 bases the classification on specific definitions for each category. Overall, the SLFRS 9 financial asset classification requirements are considered to be more principle-based than those under LKAS 39.

(b)

Initially, the financial liability is measured at fair value, which was Rs. 200 million. Also the coupon payment of Rs. 24 million (200 * 12%) is reduced from the liability. Hence, the carrying amount of the financial liability as at the year-end is Rs. 176 million. The difference between the carrying amount of Rs. 176 million and the fair value using the original credit risk represents a change in the fair value due to market fluctuations, and should be recorded in the income statement, which is Rs. 27.07 million (203.07 – 176).

The difference between the fair values, using the original credit risk and actual value of Animax's bond, is a result of the deterioration in the credit quality of the bond and should therefore be recognised through OCI. It is a gain of Rs. 1.54 million (201.53 – 203.07).

(Total: 10 marks)

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Answer 04

Relevant learning outcome/s: 2.2 Level B Good knowledge and comprehension of the standard to identify moderately complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the analysis and application of standards in resolving a moderately complicated matter related to financial reporting. Where: A "moderately complicated matter" includes transactions and/or events which require an analysis of a matter and evaluation of such matter with the related.
Study text reference: Pages 115, 116, and 617 – 625

(a)

			Rs.
Specific borrowings			
Finance cost	5,000,000 * 12%		600,000
Finance income			(370,000)
Net finance cost			230,000
General borrowings			
Capitalisation rate			
Outstanding during the year	*Interest rate*	*Finance cost*	
Rs. 1 million	14%	140,000	
Rs. 3 million	13%	390,000	
		530,000	
Capitalisation rate (530,000/4,000,000)		13.25%	
Finance cost relating to the amount used for the plants (1,500,000 * 13.25% * 6/12)			99,375
Total borrowing cost to be capitalised to the plant for the year ended 31 December 2018			329,375

(b) Per Section 9 of SLFRS for SMEs, a parent need not present consolidated financial statements if:
(i) the parent itself is a subsidiary, and
(ii) its ultimate/intermediate parent produces consolidated general purpose financial statements that comply with full SLFRS or SLFRS for SMEs.

Further, a subsidiary is not consolidated if it is acquired and held with the intention of selling/disposing it within one year from the acquisition. Otherwise, a parent shall present consolidated financial statements.

Since G does not satisfy the criteria above it should present consolidated financial statements consolidating M, and M's two subsidiaries other than the one acquired and held for disposal. When G prepares consolidated financial statements that comply with SLFRS for SMEs, M is exempted as both the above criteria are met.

(Total: 10 marks)

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Answer 05

Relevant learning outcome/s: 4.1.1 and 4.1.2
4.1.1 Demonstrate a thorough understanding of the different techniques available to analyse financial statements, including ratio analysis and common size financial statements. 4.1.2 Interpret relevant financial ratios, including profitability ratios, liquidity ratios, efficiency ratios, and gearing and solvency ratios.
Study text reference: Pages 632 – 667

(a)

	Win Lanka PLC	**Sun Lanka PLC**
Operating profit margin = (EBIT/Sales * 100)	4.63%	4.82%
After tax net profit margin = (PAT/Sales * 100)	2.72%	1.99%
EBIT	258	274
Interest	(48)	(117)
PBT	210	157
Tax	(59)	(44)
PAT	151	113
Return on equity = (Profit available for equity holders/Total equity) * 100	10.86%	14.15%
Debt ratio		
(Total debt/Total assets) * 100)	25.00%	54.99%
Interest cover		
(EBIT/Interest)	5.38	2.34

(b) Even though Win Lanka has the higher net profit margin of 2.72%, its operating profit margin is lower than that of Sun Lanka. However, since the debt ratio of Win Lanka is 25% and it is lower than that of Sun Lanka (54.99%), it shows clear evidence of a low financial gearing position at Win Lanka.

The interest cover of Win Lanka is also stronger (5.38) than that of Sun Lanka (2.34). Stronger interest cover gives additional confidence for borrowing institutions to provide debt finance at a lower interest rate. This may be the reason for the lower effective interest rate of 10% [(Interest/Total debt) * 100] for Win Lanka compared to the higher effective interest rate (12%) of Sun Lanka.

Hence it can be concluded that even though Win Lanka is not more efficient in managing business operations compared to Sun Lanka, it is more efficient in managing the financial gearing of the company, and this could result in it having a comparatively higher net profit margin.

(Total: 10 marks)

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SECTION 2

Answer 06

Relevant learning outcome/s: 3.1 Consolidated financial statements
Study text reference: Pages 511 – 585

Red PLC

Consolidated statement of financial position as at 31 March 2019

	Red PLC	**BPL**	**W1**	**W2**	**W3**	**W4**	**W5**	**W6**	**W7**	**W8**	**Inter co. set-off**	**Group**
	Rs. '000											
Non-current assets												
Property, plant and equipment	534,500	208,200	11,600	105								754,405
Investment	440,000	-	(260,000)						7,399			187,399
Brand name			4,000					(150)				3,850
Goodwill			2,015									2,015
	974,500	**208,200**										**947,669**
Current assets												
Inventory	456,100	95,600	2,000				(2,000)					551,700
Trade receivables	235,700	54,200										289,900
Receivable from BPL	5,300	-									(5,300)	-
Cash and cash equivalents	23,500	14,200										37,700

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	720,600	**164,000**										**879,300**
Total assets	**1,695,100**	**372,200**	**(240,385)**	**105**			**(2,000)**	**(150)**	**7,399**			**1,826,969**
Equity and liabilites												
Equity												
Stated capital	1,000,000	250,000	(250,000)									1,000,000
Retained earnings	419,900	21,400	(15,750)	84	23	(62)	(1,600)	(120)	7,399	(1,130)		430,144
	1,419,900	**271,400**										**1,430,144**
Non-controlling interest			18,000	21	6		(400)	(30)		1,130		18,727
												1,448,871
Non-current liabilities												
Deferred tax liability	5,200		3,248		(29)							8,419
Contingent liability			3,200									3,200
	5,200											**11,619**
Current liabilities												
Trade payables	245,700	82,300										328,000
Amount due to Red PLC	-	5,300									(5,300)	-
Deferred consideration			917			62						979
Accrued expenses	24,300	13,200										37,500
	270,000	**100,800**										**366,479**
Total equity and liabilities	**1,695,100**	**372,200**	**(240,385)**	**105**	**-**	**-**	**(2,000)**	**(150)**	**7,399**			**1,826,969**

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W1: Goodwill

	Rs. '000
Consideration paid	260,000
Deferred consideration	917
FV of non-controlling interest	18,000
	278,917
FV of net assets as at 1 July 2018	
Stated capital	250,000
Retained earnings	15,750
FV increase of land	13,000
Deferred tax @28%	(3,640)
FV decrease of building	(1,400)
Deferred tax @28%	392
FV increase of inventory	2,000
Brand name	4,000
Contingent liability	(3,200)
	276,902
Goodwill	2,015

W2: Depreciation on FV decrease of building

	Rs. '000
Depreciation	105
Deferred tax reversal	(29)

W3: Deferred tax

	Rs. '000
Deferred tax reversal	29
Retained earnings	23
Minority interest	06
	29

W4: Interest cost from deferred consideration

917 * 0.09 * 9/12 = Rs. 62,000

W5: Realisation of fair value gain of inventory

	Rs. '000
Dr. Retained earnings	1,600
Dr. Non-controllling interest	400
Cr. Current assets	2,000

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W6: Amortisation of brand name

	Rs. '000
Amortisation	150

W7: Investment in GPL (JV)

	Rs. '000
Investment	180,000
Share of post acq. Profit (34,300 – 19,200) * 49%	7,399
	187,399

W8

	Rs. '000
31 March 2019: BPC retained earnings	21,400
1 July 2018: Acquisition profit	(15,750)
	5,650
Non-controlling interest (5,650 @ 20%)	1,130

(Total: 25 marks)

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Answer 07

Relevant learning outcome/s: 2.1 and 2.2 2.1 Level A Thorough knowledge and comprehension of the standard to identify significant complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the evaluation and application of standards in resolving a complicated matter related to financial reporting. Where: - A "complicated matter" includes transactions and/or events which require thorough analysis of the matter and evaluation of standards. - It may require the analysis, application and evaluation of relevant standard/s. 2.2 Level B Good knowledge and comprehension of the standard to identify moderately complicated issues and any potential implications to the financial statements, and to exercise professional judgment in the analysis and application of standards in resolving a moderately complicated matter related to financial reporting. Where: A "moderately complicated matter" includes transactions and/or events which require an analysis of a matter and evaluation of such matter with the related.
Study text reference: Pages 120 – 122, 136 – 143, and 433 – 443

(a) Cost of an item of PPE includes the purchase cost and also any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by the management.

Hence the transport cost incurred by Aaron should also be added to the purchase cost of the machine and its components. The cost of the machine and its components is Rs. 303 million [(300 + (300 * 1%)].

The standard requires to depreciate separately the major components of a PPE with varying useful lives in order to reflect the depreciation charge and carrying value of the asset accurately .

Therefore, the depreciation charge of each component and the rest of the machine for the year can be calculated as follows.

- Component 1: Depreciation is Rs. 10.1 million ((20 + 0.2)/2)
- Component 2: Depreciation is Rs. 12.12 million ((60 + 0.6)/5)
- Rest of PPE: Depreciation is Rs. 20 million (((303 – 20.2 – 60.6) – 22.2)/10)

The total depreciation charge of the machine for the year is Rs. 42.22 million, and this should be recognised as an expense in the income statement.

The net carrying value of the machine as at 31 March 2019 was Rs. 260.78 million (303 – 42.22) and it should be reflected in the statement of financial position as a non-current asset.

The bi-annual maintenance cost of the machine of Rs. 0.5 million, and any related cost that is maintenance in nature, represent day-to-day costs of servicing the item. Hence, these costs should be recognised in the income statement as they are incurred.

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(b)

Person/entity	Relationship	Related party?	Reference to LKAS 24
Xian (Pvt) Ltd	The entity and the reporting entity are members of the same group (i.e. a subsidiary of Aaron PLC).	Yes	Section 9 (b)(i)
Mr. Sumanadasa	Key management personnel of the reporting entity or of a parent of the reporting entity (i.e. director of Aaron PLC)	Yes	Section 9 (a)(iii)
SS (Pvt) Ltd	30% stake held by Mr. Sumanadasa, a director of Aaron PLC. This is not sufficient to be a related party of Aaron PLC.	No	Not Applicable
Onex PLC	The entity and the reporting entity are members of the same group (i.e. parent of Aaron PLC).	Yes	Section 9 (b)(i)
Mr. Amarasekara	Key management personnel of the reporting entity or of a parent of the reporting entity (i.e. Onex PLC is chaired and controlled by Mr. Amarasekara).	Yes	Section 9 (a)(iii)/(i)
Pivithuru Finance PLC	An associate or joint venture of a member of a group, of which the other entity is a member (i.e. an associate of Onex PLC).	Yes	Section 9 (b)(ii)
Flora (Pvt) Ltd	The entity is controlled or jointly controlled by a key management personnel of Aaron PLC (i.e. Flora (Pvt) Ltd is controlled by Mr. Amarasekara).	Yes	Section 9 (b)(vi)
Amarasa Restaurant (Pvt) Ltd	Not controlled by Mr. Amarasekara.	No	Not applicable

(c) Paragraph 33 of SLFRS 15 states that control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, the asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways

Paragraph 38 of SLFRS 15 requires an entity to consider indicators of the transfer of control, which include, but are not limited to, the following:

- the customer has a present right to payment
- the customer has legal title to the asset
- the customer has obtained physical possession of the asset
- the customer has the significant risks and rewards of ownership
- the customer has accepted the asset

Contract with X Ltd
X has physical possession, legal tittle, and an obligation to pay at the time of receipt. These indicate control is transferred when the goods are delivered to X.

Contract with Y Ltd
Y has physical possession of goods and an obligation to pay Aaron PLC within 75 days from the date of receipt of the goods. Y is responsible for bad debts, and also for any damage to the goods at its premises (as Y has to obtain an insurance cover). These indicate control is transferred when goods are delivered to Y.

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(d) Basic EPS for the year ended 31 March 2019

$$= \frac{\text{Net profit attributable to ordinary shareholders}}{\text{Weighted average no. of ordinary shares outstanding during the period}}$$

$$= \frac{\text{Rs. 120 million}}{\text{75 million}}$$

= Rs. 1.60

Diluted EPS

Convertible bond

Additional shares on convertible bond = $\frac{30{,}000{,}000}{100}$ * 50 shares = 15,000,000

Adjusted earnings

Net profit	= Rs. 120,000,000
Less: Interest saving for the year	= (Rs. 2,592,000)
(30 million * 12% * (100% – 28%)	Rs. 122,592,000

Share options

Number of shares that would have been issued at fair value = $\frac{18{,}000{,}000 * 2.5}{4}$

= 11,250,000

= (18,000,000)

= 6,750,000

Diluted earnings per share

$$= \frac{\text{Profit on basic EPS + Effect on profit of diluted potential ordinary shares}}{\text{No. of shares in basic EPS + Diluted potential ordinary shares}}$$

$$= \frac{122{,}592{,}000}{75{,}000{,}000 + 15{,}000{,}000 + 6{,}750{,}000}$$

= Rs. 1.27

(e) The convertible bond needs to be split into its liability and equity components. The liability component is the present value of future cash outflows discounted at 15%, and the equity component is the remainder. Both components are calculated below.

Non-current liabilities

Financial liability component of convertible bond (W1) = Rs. 27.44 million

Equity

Equity component of convertible bond = Rs. 2.56 million
(Rs. 30 million – Rs. 27.44 million)

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W1
Fair value of equivalent non-convertible debt = Rs. 27.44 million
(Rs. 17.16 million + Rs. 10.28 million)

Present value of principal payable at the end of 4 years = Rs. 17.16 million
(Rs. 30 million * 0.572)

Present value of interest annuity payable annually in arrears for 4 years = Rs. 10.28 million
(Rs. 30 million * 12% * 2.856)

(Total: 25 marks)

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