CA THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

KC1 – Corporate Financial Reporting

June 2019

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Answer 01

Relevant Learning Outcomes/s: 1.1
Study text reference: 367-370, 450-462, 298-312

(a) At the date of initial application of SLFRS 9 the company can designate an investment in equity instrument as at fair value through OCI and it is an irrevocable election. Therefore, this principle can be applied to this investment on 1 January 2018 with the initial application of SLFRS 9.

Since the investment has been measured at cost, the company shall measure the fair value at the date of initial application (i.e.1.1.2018). Any difference between the previous carrying amount and the fair value shall be recognised in the opening retained earnings of the reporting period that includes the date of initial application (para7.2.12).

Therefore, the investment should be measured at the date of initial application at Rs. 15 million. Rs. 1 million should be recognized in the opening retained earnings for the year ended 31 December 2018.

Thereafter at each year end the investment's fair value should be estimated and changes should be recognized in OCI and never reclassified to profit and loss, even if the asset is impaired, (sold or otherwise derecognized).

Under LKAS 39, impairment losses were recognized in profit or loss, if there had been a significant and prolong fair value reduction below the cost. Under SLFRS 9, impairment should be assessed using expected loss model and the resulting loss allowance should be recognized in OCI.

In this instance, the investment if fair valued there is no impairment to be recognized.

(b) Related Party Transactions/outstanding balances with the Government and Government-related entities

1. P is controlled by the Government of Sri Lanka

2. Nature and amount of each individually significant transactions.

   (i) Government granted P a loan equivalent to 50% of Entity P's stated capital at a market interest rate. This loan is repayable in quarterly installments within the next five years. Outstanding balance as at 31 March 2019..

   (ii) Printing work with a value of Rs. 12 million was done by Entity B which is controlled by the government. This amount was fully settled during the year. Arm's length price of a similar work is Rs. 15 million.

3. Nature and amount of collectively significant transactions
   (i) 35% of sales of P are made to government related entities.
   (ii) The company benefits from guarantees provided by the government for the company's bank borrowings.

4. Transactions with Key management personnel
   Mr. Jin is key management personnel of P appointed by the government. P has a transaction amounting to Rs. 0.5 million and this is receivable by Entity P as at 31 March 2019.

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(c)

(i) Because the investment property is measured at fair value, there is a rebuttable presumption that the company will recover the carrying amount of investment property entirely through a sale. If that presumption is not rebutted, the deferred tax reflects the tax consequences of recovering the carrying amount entirely through sale. This presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all the economic benefits over time, rather than through sale.

Since Ram does not expect to use the property for more than 5 years, it will not consume substantially all the economic benefits derived from the asset and therefore the presumption is not rebutted.

Therefore, if the property is sold, the carrying value as at the year-end is Rs. 16 million and the tax base is (Rs. 13mn/15*13) Rs. 11.3 mn. This results in a taxable temporary difference of Rs. 4.7 mn.

Ram needs to recognize deferred tax using the enacted rate applicable for a future period of 10%.
The Deferred tax impact would be as follows.
Rs. 3 mn (Rs. 16 mn – Rs. 13mn) * 20% = Rs. 0.6mn
Rs.1.7mn (Rs. 13mn – Rs. 11.3mn) *10%= Rs. 0.17mn

(i) A temporary difference may arise on initial recognition of an asset or liability, for example, a part or all of the cost of an asset will not be deductible for tax purposes. Since there is no tax impact at the initial recognition of these motor vehicles, deferred tax is not recognized.

(ii) The entire carrying amount will be deductible for tax purposes in the future periods. The warranty provision has a tax base of nil (carrying amount less the amount deductible for tax purposes in the future). The deference between the carrying amount and its tax base is Rs. 3 million. This is a deductible temporary difference. This will result in a deferred tax asset of Rs. 0.3 mn.

Impact from change in the tax rate from 12% to 10% should be recorded in profit or loss. In this case there are no amounts affecting OCI.

The change in the tax rate is an estimate change which requires prospective adjustments in the financial statement.

(Total: 25 marks)

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Answer 02

Relevant Learning Outcomes/s; 1.1
Study text reference: 136-147, 287-293

(a) As per paragraph 54 of LKAS 38, an intangible asset cannot be recognized for expenses incurred on research activities. Therefore, such expenses should not be recognized as an intangible asset. Further, paragraph 57 of LKAS 38 states that, an entity shall demonstrate, it can satisfy all the conditions given in (a) to (f) to recognize an intangible asset arising from a development activity.

As per the given information the project was at the initial stage (knowledge gathering phase) over the last 2 years and Biotec was not able to assess the technical feasibility until recently. Accordingly, it can be concluded that the cost incurred for the project did not fall into the development phase and the probability to generate future economic benefits is remote. Therefore, the company had recognized an intangible asset without satisfying the intangible asset recognition criteria of LKAs 38.

Hence the recognition criteria were not met at the recognition point, the company should remove the cost of the intangible assets recorded in the financial statements as an error correction by retrospectively adjusting the financial statements as required by LKAS 8

Accordingly, the decisions taken by the management are not in accordance with LKASs.

(b) As per the agreement, control over the completed machine will transfer/pass to the customer in two years' time, which indicates NM's performance obligation will be satisfied at a point in time

Further, the contract includes a significant financing component. This is evident from the difference between the amount of the promised consideration in two years' time of Rs. 450 million and the amount of consideration at the inception of the contract of Rs. 350 million and the significant time between the proposed settlement days.

The implied interest rate included in the contact is 13.39% (the interest rate that discounts Rs.450 million to Rs.350 million over two years)

Year	Opening balance	Interest	Closing Balance
1	350	46.9	396.9
2	396.9	53.1	450

On inception - 1 April 2019

Cash	Dr.	350 million
Contract liability		350 million

(Recognition of contract liability for the payment received in advance)

During the 1st year ended 31 March 2020

Contract asset	Dr.	180 million
Cash		180 million

(Recognising the cost incurred on production)

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Interest expense	Dr.	46.9 million
Contract liability		46.9 million

(Recognising implied interest cost on the contact)

During the 2nd year ended 31 March 2021

Contract asset	Dr.	120 million
Cash		120 million

(Recognizing the cost incurred on production)

Interest expense	Dr.	53.1 million
Contract liability		53.1 million

(Recognising implied interest cost on the contact)

On the settlement - 31 March 2021

Contract liability	Dr.	450 million
Revenue		450 million

(Recognising the revenue on the contract)

Cost of sales		300 million
Contract asset		300 million

(Recognising the cost of the contract)

(c) According to the conditions given in the scenario, the contractor transfers control over time, therefore, recognition of revenue over time based on the performance completed is in accordance with SLFRS 15.

- B makes progress payments during the construction and installation period, to compensate GSK for performance completed, and payments made are non-refundable.
- B does not have the right to terminate the contract, unless GSK fails to perform as promised.
- GSK has an enforceable right, to all of the consideration promised under the contract, if it continued to perform as promised.
- GSK had a right to terminate the contract, due to any significant liquidity issue of B.
- The agreement prevents GSK from being able to direct the plant to another customer.

In addition to assess the probability of collecting the consideration which an entity will be entitled, at the inception of the contract, it is necessary to reassess the collectability when there is an indication of a significant change in facts and circumstances.

Therefore, even though this contract met the collectability criteria at the inception, subsequent significant deterioration of the customer's ability to pay the consideration, resulted in the collectability criteria not being met. Hence there might no longer be a valid contract for accounting purposes.

Although it is concluded that the contract is no longer valid, since GSK has the right to terminate the contract due to any significant liquidity issue of the customer and the payments received are non-refundable (due to over the time PO satisfying criteria of the contract), it is not required to reverse the revenue recognised to date.

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(**Alternative answer:** The updated assessment is prospective in nature and would not change the conclusions associated with performance already completed. That is, an entity would not reverse any receivables, revenue or contract assets already recognised under the contract).

Accordingly, the first statement made by the Accounts Executive is incorrect.

Until the GSK could once again establish that the probability of receipt criteria is met, no further revenue shall be recognised. Accordingly, the second statement made by the Accounts Executive is correct.

(Total: 25 marks)

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Answer 03

Relevant Learning Outcomes/s; 1.1, 2.1, 3.1, 4.1, 5.1
Study text references: 502-546, 727-750, 13-20, 42-48

(a) (i) Impact on the financial statements for the year ended 31 March 2019 if CBC acquires the machineries of Juizie (Pvt) Ltd.

As per SLFRS 3, acquiring only the machineries do not meet the definition of a business. A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Inputs and processes can also form a business without the output. But in this case, CBC purchases only inputs i.e. machineries without any processes. Accordingly, this is an asset acquisition.

Since machineries are non-current assets that are expected to be used in the production of goods, such machineries meet the definition of property, plant and equipment under LKAS 16.

This will have the following impact on the financial statements for the year ended 31 March 2019.

Machineries should be recognised initially at cost. Cost includes cash price equivalent of Rs. 630 million plus directly attributable costs (professional fees in this case) of Rs. 1.2 million. The PV of the 150 million payable in 2020 $\left(\frac{150}{1.15}\right)$ = 130 mn needs to be recognized as a liability.

The difference between the total payment and the cash price equivalent is considered as interest over the period of credit. Accordingly, Rs. 20mn should be recognized as interest expense in the financial statements for the year ending 31 March 2020. This interest cannot be capitalized as per LKAS 23.

(ii) Impact on the financial statements for the year ended 31 March 2019 if CBC acquires 70% shares of Juizie (Pvt) Ltd (Juizie).

With the acquisition of 70% shares, CBC becomes the major shareholder of Juizie. In this case, it is straightforward that CBC controls Juizie due to its 70% shareholding. But it is required to make sure that Ravi does not control Juizie by any other contractual arrangement.

Accordingly, CBC becomes the parent and Juizie becomes the subsidiary. CBC has to prepare consolidated financial statements.

CBC needs to compute goodwill at the date of acquisition.

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Goodwill computation	**Rs. '000**	
Consideration transferred		
Immediate payment		500,000
Contingent consideration	(40/1.15)	34,782
NCI (634,894*30%)		190,468
		718,770
Net assets		
Stated capital	700,000	
Retained earnings	(209,290)	
	490,710	
FV increase of machineries	179,200	
DT on FV increase	(50,176)	
Brand name	28,000	
DT	(7,840)	
Payable to CEO	(5,000)	634,894
Goodwill		90,972

Acquisition related costs of Rs. 4.3 mn should be expensed.

Employment contract of CEO of Juizie (Pvt) Ltd
Juizie (Pvt) Ltd has entered into this contract before the negotiations of the business combination began and the purpose of the agreement was to obtain the service of the CEO. Thus, as per para 51 and 52 of SLFRS 3, there is no evidence that the contract was arranged primarily to provide benefits to CBC or the combined entity. Therefore, the liability to pay Rs. 5 million should be included in the application of the acquisition method.

(b) As per SLFRS 3, during the measurement period, which shall not exceed one year from the acquisition date, the acquirer shall retrospectively adjust the provisional amounts recognized at the acquisition date to reflect the new information obtained. Accordingly, goodwill should be recomputed using the new fair value of the brand name. Brand name should be recognized at the new fair value. Non-controlling interest should be computed using the fair value of net assets after considering the new fair value of brand name and deferred tax on that. These adjustments should be made to the comparative amounts in the financial statements for the year ending 31 March 2020.

(c) Ratios have been computed assuming the IPO would take place on the date of acquisition. Existing ratios have not been adjusted for the proceeds of the IPO assuming that the IPO would not take place if the acquisition does not occur.

Existing gearing ratio
Gearing ratio = Interest bearing borrowings ÷ (Shareholders' equity +Interest bearing borrowings)

(750mn+400mn+825mn)/(10,096)mn +(750mn+400mn+825mn) 16.3%

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After the acquisition

Borrowings

Existing loans of CBC	Rs. 1,975mn
Borrowings of Juizie	Rs. 642mn
For share buy-back (David)	Rs. 2,700mn
Total Borrowings	Rs. 5,317mn

Equity

Existing equity	Rs. 10,096mn
New share issue	Rs. 500mn
NCI	Rs 190, mn
Reduction due to share buy-back	Rs. (3,700)mn
Error in revaluation reserve and inventory	Rs. (800)mn
Total equity	Rs. 6,286mn

New gearing ratio for the group will be 46%.

Existing interest cover is 15.6 times.

Acquisition of Juizie and share buy-back has resulted in an increase in the gearing ratio from 18% to 46%. This has resulted in increased financial risk to the group than before. Further, due to the realization of short term investments, CBC will loose future interest income as well. However, with the acquisition of Juizie, the CBC would be able to automate the factory and increase the capacity by using the machineries of Juizie. This would increase future profits and cash flows to service the loans.

Existing interest cover is very healthy and there would not be an issue in the future as future profits would be increased and the new bank loans would be granted at the existing interest rate.

Liquidity

Existing current ratio = 9,610/7043 = 1.36:1
New current ratio = (9,610-1000-700+22.7)/ (7043+165+35+5)= 1.09:1

Existing quick ratio = (9,610-3892)/7043 = 0.8:1
New quick ratio = (9,610-3892-1000+11.2)/(7043+165+35+5)=0.65:1

The existing current and quick ratios show that CBC does not have adequate assets to meet future commitments to pay off current liabilities. Since these ratios have further reduced, it is alarming that the management may not be able to meet short term debts by its short term assets. The reduction is mainly due to using short term investments to buy back shares. CBC has to manage its short term assets in the future to overcome liquidity issues.

(d) The Board of CBC should establish an audit committee exclusively consisting of non-executive directors with a minimum of three non- executive directors of whom at least two should be independent.

If there are more non-executive directors, the majority should be independent. The committee should be chaired by an independent non-executive director.

The Board of CBC should, at least annually, monitor the company's risk management and internal control systems to ensure such systems are operating effectively. The company should have an internal audit function.

A related party transactions review committee should be established consisting exclusively of non-executive directors with a minimum of three non-executive directors of whom the majority should be independent.

It must adopt a Code of Business Conduct & Ethics for Directors, Key management personnel and all other employees

(e) The Finance Manager is a chartered accountant and:
   i. Should be aware of the requirements of SLFRS and should apply those requirements in order to achieve fairly presented financial statements.
   ii. Is bound by the CA Sri Lanka Code of Ethics.

If the Finance Manager makes the adjustments as instructed by the Chairman it is a violation of LKAS 38 and will not result in a fair presentation of financial statements. It will also lead to a breach of ethical principles set out in the Code.

As the first measure, the Finance Manager should explain to the Chairman the requirements of the accounting standards and principles in respect of the suggested adjustment. He should attempt to persuade the directors to refrain from amending the financial statements.

If the Chairman insists on the suggested adjustment, the Finance Manager should consider his position and identify the misstated amounts to the company's internal and external auditors.

There may be an intimidation threat to the Finance Manager from the Chairman because of actual or perceived pressures, including attempts to exercise undue influence over the Finance Manager.

Safeguards that may eliminate or reduce threats to an acceptable level fall into two broad categories: (a) Safeguards created by the profession, legislation or regulation; and (b) Safeguards in the work environment (for example having a proper internal control system). Communicate with member body (CA Sri Lanka).

In circumstances where unethical behavior or actions by the Chairman will continue to occur within the employing organization, the Finance Manager may consider obtaining legal advice.

In those extreme situations where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, he may conclude that it is appropriate to resign from the company.

(Total: 50 marks)

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