THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

12306 – Financial Reporting Framework

CA Professional (Strategic Level I) Examination
December 2014

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

(a) Bond premium = Purchase price - face value
= Rs. 10,811,100 – Rs. 10,000,000
= Rs. 811,100

(2 marks)

(b) Credit risk premium of the bond = Effective interest rate – risk free rate
= 8% - 6%
= 2%

(2 marks)

(c) Interest in 2013 = 1 Jan to 30 June 2013 + 1 July to 31 Dec 2013
= Rs. 420,969 (i.e. 10,524,226 x 4%) + Rs. 437,808 (i.e.10,945,195 x 4%)
= Rs. 858,777

(3 marks)

(d)

	Rs.
Amortised cost at 31 December 2012	10,524,226
Interest to 30 June 2013 @ 4%	420,969
	10,945,195
Interest to 31 December 2013 @4%	437,808
Amortised cost of the bond at 31 December 2013	11,383,003

(3 marks)

(e) As the bond is classified as an available-for-sale financial asset, it is necessary to determine the bond's fair value at the year end.

(2 marks)

(f) As there is no observable market value for the bond, the bond's fair value can only be obtained by discounting the expected cash flows at the current market rate. As a market rate for a comparable bond may not exist, it would be necessary to derive a current market rate for the bond. The easiest way to estimate the current rate for the bond is by reference to a benchmark rate or the risk free rate, which is part of the bond's effective rate of interest at 8%.

(3 marks)

(g) **Fair value of bond as at 31 December 2013**

Risk free rate on 31 December 2011	=	6%
Credit risk premium	=	2% (200 basis points)
Risk free rate on 31 December 2013	=	8%
Ignore change in the bond's credit spread since acquisition		
Current interest rate to discount future expected cash flows	=	10%
(i.e. 8% plus 200 basis points)		

Receivable on 31 December 2015	=	Rs 7,000,000
Receivable on 31 December 2014	=	Rs 2,000,000

PV of expected cash flows discounted @ 10%	=	Rs. 5,785,124	(i.e. 7 mn /1.1^2)
		Rs. 1,818,181	(i.e. 2 mn/1.1^1)
		Rs. 7,603,305	

FV of bond value as at 31 December 2013 = Rs. 7,603,305

(3 marks)

(h) **Value of the bond to be stated in the balance sheet as at 31 December 2013**

Basis is it should be stated at fair value = Rs. 7,603,305

(2 marks)

(i) **Impairment to be recognised in the income statement in 2013**

Amortised cost of the bond at 31 Dec 2013 before impairment	11,383,003
FV of bond as at 31 December 2013	(7,603,305)
Impairment arising during 2013	3,779,698
Recycling of loss recognized in equity	266,322
Total impairment recognised in profit or loss	4,046,020

(3 marks)

(j) **Amortised cost of the bond as at 31 December 2014**

31/12/2013 risk free rate	8%
Credit risk premium of the bond	2%
Effective interest rate	10%

Assumption: semi-annual effective interest rate of 5%

	Rs.
FV of bond / amortised cost at 31 December 2013	7,603,305
Interest to 30 June 2014 @ 5% (i.e. 7,603,305 @ 5%)	380,165
	7,983,470
Interest to 31 Dec 2014 @ 5% (i.e. 7,983,470 @ 5%)	399,173
	8,382,643
Cash received on 31 December 2014	(2,000,000)
Amortised cost of the bond at 31 December 2014	6,382,643

(3 marks)

(k) **Accounting for impairment loss** - No

When a decline in the fair value of an AFS financial asset has been recognised directly in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative loss that had been recognised directly in other comprehensive income should be reclassified from equity and recognised in profit or loss, even though the financial asset has not been derecognised.

(4 marks)

Examiners' comments

Most of the candidates attempted this question, but a very few could earn more than the 50% of the allocated marks.

Part (a) - A reasonable number of candidates had written correct answers. Others had incorrectly calculated the bond premium by subtracting the face value from the purchase price.

Part (b) - Most of the answers were incorrect as the candidates were not familier with the effective interest rate (8%) though it was stated in the question. Many used the annual interest rate (10%) and deducted the risk free rate seperately for each year.

Part (c) - A large number of candidates ignored the annual interest payable half yearly in computing the interest for the year ended 31 December 2013 and had incorrect answers. They had used 4% for the full year (Rs. 848,938). Some had incorrectly used the purchase price (Rs. 10,811,100) instead of the amortised cost of the bond for computing the interest.

Part (d) - The answer for this part was incorrect by almost all the candidates due to the incorrect answer of part (c). No candidate correctly calculated 4% by annual interest. There were no correct answers for amortised cost of the bond as at 31 December 2013.

Part (e) - Most of the candidates correctly answered the need to determine the fair value of the bond as it was classified as available for sale investments.

Part (f) - A large number of candidates had satisfactorily answered to this part. Candidates had explained the ways of determining the fair value of the bond if there is no a market price available.

Part (g) – Most answers were incorrect as the candidates had not added the credit risk premium (2%) in working out the current interest rate (10% = 8% + 2%). The PV of the future cash flows was dicounted using 8% by all candidates. Due to this, the FV of the bond as at 31 December 2013 was incorrect.

Part (h) – Answers to this part were incorrect due to incorrect answers in part (g).

Part (i) – This part had incorrect computations due to:

- The computation in part (d) was incorrect
- The deduction of FV was incorreect due to incorrect answer in part (g)
- The loss recognised in equity (Rs. 266,322) was not added for the total impairement charged .

Part (j) - The amortised cost of the bond as at 31 December 2014 was incorrectly computed by all candidates due to following errors:

- The use of semi annual interest rate as 4% instead of 5% (i.e. (8% + 2%) / 2)
- Incorrect amount used as the fair value of the bond for computing interest for both parts of the year
- Interest of the first part of the year was not added to FV in computing the interest for the second part of the year
- Expected cash flows (i.e. Rs. 2 million) was not deducted in working out the answer

Part (k) - A large number of candidates had correct answers and the explanations too were justified.

Answer No. 02

(a) A reclassification adjustment is an amount reclassified to profit or loss in the current period which was recognised in other comprehensive income in the current or previous periods.

(2 marks)

(b) LKAS 1 states that an entity should classify an asset as current if it meets one of the following criteria:

- the asset is expected to be realised, sold or consumed within the entity's normal operating cycle.
- the asset is held primarily for the purpose of trading
- the asset is expected to be realised within twelve months after the reporting period
- the asset is cash or cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

(3 marks)

(c)

Carrying amount	74,000
Specific impairment	(2,000)
Revised carrying amount	72,000

Recoverable amount is Rs. 70,000 (higher of value in use and FV less cost to sell)

Therefore, the impairment to be set off first from goodwill is;
Rs. 72,000 – Rs. 70,000 = Rs. 2, 000

Then, goodwill will be = Rs. 16,000 – Rs. 2,000
= Rs. 14,000

(5 marks)

(Total: 10 marks)

Examiners' comments

The avarage marks for this quesion was around 7 and the question was well answeerd by many candidates.

Part (a) and (b) - these were direct questions where majority of the candidates were able to get the full marks allocated for those parts.

Part (c) - a considerable number of candidates were unable to recognise the specific impairment relating to the stock. Accordingly they have arrived at an incorrect goodwill amount for the cash generating unit by charging the total impairment value against the exsisting value of the goodwill.

It indicates the candidates' lack of knowlegde of accouting treatment that is required in reviewing the imapriment of a cash generating unit in a senario where there is a specific impairment realting to a particular asset.

Answer No. 03

(a) (i)

* **Level 1** inputs are unadjusted quoted prices in active markets for items identical to the asset being measured
* **Level 2** inputs are inputs other than quoted price in active markets included within Level 1, that are directly or indirectly observable
* **Level 3** inputs are unobservable inputs that are usually determined based on management's assumption.

(3 marks)

(ii) Market approach
Income approach
Cost approach

(3 marks)

(b)

* The fair value hierarchy places highest priority to level 1 inputs (quoted prices) and the lowest priority to level 3 inputs, (unobservable inputs)
* In the given scenario level 1 inputs are not available (i.e. quoted price of identical assets)
* Hence the valuation basis will have to be using level 2 and level 3 inputs.
* Sales prices for a similar kind of investment property in a similar location and the market rent data for similar property can be considered as directly observable inputs, which falls under level 2 input category.
* The method used by ABC Ltd using estimated values that would be incurred to build similar property less any obsolesces can be considered as having based on level 3 inputs such as management estimates, cash flow forecast and assumptions about future developments.
* As level 2 inputs provide better confidence on the valuation basis when data are available it should be given priority over using level 3 inputs. Accordingly method used by the company does not reflect the requirements of SLFRS 13.

(4 marks)

(Total: 10 marks)

Examiners' comments

The avarage marks obtained by candidates were limited to 4 to 5 marks.

Part (a) - Many candidates were able to describe the different levels of inputs and the three approaches of determing fair values. Therefore at least 3 to 4 marks were scored by many candidates on this part. However a considerable number of candidates made mistakes in describing the level of inputs given in the standards; instead they have named them.

Part (b) - When it comes to the application part of the question the average marks earned by the candidates were around 1 to 2 marks. This cleary indicates their inadequate knowledege in the application of the standard to practical scenarios. Some candidates tried to answer the question referring to the Investment Property standard instead of using SLFRS 13.

Answer No. 04

(a) (i) Treasury bills
Repos
Marketable securities

(3 marks)

(ii) For a short term investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore an investment normally qualifies as a cash equivalent only when it has a short term maturity (e.g. 3 months or less from the date of acquisition). Other short term investments should be reflected under investment activities. Equity instruments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example, preferred shares acquired within a short period of their maturity and with a specified redemption date.

(2 marks)

(b) Being the first government grant, the company should select the appropriate policy for accounting for government grants according to LKAS 20 – *Accounting for Government Grant and Disclosure of Government Assistance*.

Then the company should decide whether to treat the grant received as a revenue grant or as a capital grant. Based on the nature of the government grant the following treatments could be applied.

If it is considered to be of revenue nature (i.e. it was provided to reimburse the expenses incurred by the company on renovation), then the company should recognise the grant as other income and the renovation cost as an expense.

In this scenario the revaluation reserve will be credited by Rs. 5 million and revaluation surplus of Rs. 5 million will be taken through OCI.

If the grant is considered to be of capital nature, (grants relating to assets), there are two alternative approaches.

Method 1 - Recognition of the grant as deferred income

- Under this method, the cost incurred on renovation amounting to Rs. 2.5 million is debited to the building account
- Accordingly, the revaluation surplus would be credited by Rs. 2.5 million by debiting building account by the same account

Method 2 - By setting off the grant in arriving at the carrying amount of the asset.

- Under this method, the cost incurred on renovation will be set off against the grant received (Rs. 2.5 million) within the building account.
- Accordingly, the revaluation surplus would be credited by Rs. 5 million with the debit entry in building account.

(5 marks)

(Total: 10 marks)

<u>Examiners' comments</u>

Part (a) (i) - Although only 3 marks were allocated, some candidates produced lengthy answers by reproducing paragraphs from LKAS 7 but failed to give the 3 examples. Therefore they could not score the allocated 3 marks.

Some gave examples for cash such as petty cash balances, savings account balances, current account balances and bank overdrafts, instead of giving examples of cash equivalents.

Part (a) (ii) - majority of the candidates reproduced paragraphs from LKAS 7. The candidates should have stated the two alternative ways to reflect short term investments in the cash flow statement. According to LKAS 7, if the investments have a short term maturity (3 months or less from the date acquisition) and are readily convertible to a known amount of cash with an insignificant risk of change in value of cash, such short term investments will be reflected under cash equivalents. All other short term investments should be reflected under Investment Activities.

Only a few candidates answered this part correctly. Some candidates mentioned how short term investments should be reflected in the statement of financial position instead of the statement of cash flows.

Therefore it is very important to read the question well and understand what is expected by the examiner and also give thought to the number of marks allocated.

Part (b) - this question was based on LKAS 20. As this was the first grant received by the company, the candidates were supposed to firstly select the appropriate policy for accounting for government grants and disclosure of government assistance. Only a very few candidates mentioned the policy and its disclosure.

According to LKAS 20, the company has the option to treat the grant received as a revenue grant or a capital grant.

If the candidate considered this as a revenue grant, then the candidate was expected to advice the company on the accounting treatment in the manner given below.

If the candidate assumes that the grant has been provided to reimburse the company's renovation expenditure of Rs. 2.5 million, then the company should consider the grant as other income and the renovation cost as an expense. Under this method, the building value will be zero.

Then the building account has to be revalued by Rs. 5 million; credit the revaluation reserve with the Rs. 5 million and take the revaluation surplus through OCI.

Only a very few candidates considered Rs. 2.5 million as a revenue grant, but most of them did not mention the revaluation of the building with Rs. 5 million.

Some candidates even suggested to debit the revaluation reserve with Rs. 5 million instead of crediting it.

Majority of candidates considered Rs. 2.5 million as a capital grant. LKAS 20 recommends two alternative methods i.e. deferred income approach or setting off the grant in arriving at the carrying amount of the asset. The candidates were expected to explain both methods if they choose the capital approach. Only a very few candidates mentioned both approaches.

Most candidates recognised the grant as a deferred income. Under this method, they recommended debiting the building account with Rs 2.5 million and crediting deferred income.

They were also required to debit the building account with another Rs. 2.5 million and credit the revaluation reserve. But some of them debited the building account with Rs. 5 million and credited the revaluation reserve with Rs. 5 million, thereby making the building account balance Rs. 7.5 million instead of Rs. 5 million.

Under the setting off the grant method, the building account is debited with the renovation cost of Rs 2.5 million and thereafter the grant of Rs. 2.5 million is credited to the building, thereby making the building cost zero.

Therefore, the building account has to be debited with Rs. 5 million and the revaluation surplus credited. Many candidates mixed up the setting off method under capital grant approach with the revenue grant approach.

Many candidates also wrote lengthy answers explaining the revaluation model and accounting treatment under LKAS 16 instead of LKAS 20, as the question stated that the company uses revaluation model.

The examiner expects the candidates to apply the relevant accounting standards in answering the question, and not to reproduce paragraphs from the accounting standards book.

Candidates are advised to prepare well for the exam by learning to apply the standards before sitting for the examination, and in answering the questions to spend time in proportion to the number of marks allocated.

Answer No. 05

(a) **Problems associated with the LIFO method**

- The LIFO method treats the newest item of inventory as being sold first, and consequently the items remaining in inventory are recognised as if they were the oldest. This is generally not a reliable representation of actual inventory flow. Accordingly this method lacks representational faithfulness of inventory flows.
- The LIFO method imposes an unrealistic cost flow assumption i.e. the measurement of cost of goods sold by reference to latest prices for the inventories sold.
- Some companies prefer to follow LIFO to take tax advantages, because it results in the cost of goods sold expense being calculated using the most recent prices being deducted from revenue, in determination of the gross margin. The LIFO method reduces profits in a manner that tends to reflect the effect that increased prices would have on the cost of replacing inventories sold. However, this effect depends on the relationship between the prices of the most recent inventory acquisitions and the replacement cost at the end of the period. Thus, it is not a truly systematic method for determining the effect of changing prices on profits.

(3 marks)

(b) **Cost per toy (Rs.)**

Cost of direct materials		80
Cost of conversion:		
Cost of labour	20	
Cost of packaging material	10	
Actual variable production overhead	12	
Allocated storage cost during the production process	5	47
Cost per toy		127

NRV (Rs.)

Selling price	150
Cost to sell (promotion discount)	(25)
Net realisable value	125

Inventory should be measured at lower of cost and net realisable value (NRV). Accordingly the toy should be measured at its NRV of Rs. 125.

Amount to be present as inventory in the company's financial statements (125 * 8,000) = Rs. 1,000,000

(4 marks)

(c)

Cost of material X	600,000
Trade discounts	(6, 000)
Bulk purchase rebates	(30,000)
Cost of shipping and delivery to warehouse	10,000
Unloading charges	2,000
Amount to be recorded as inventory	576,000

(3 marks)

(Total: 10 marks)

Examiners' comments

Part (a) - Candidates were required to explain the problems associated with the LIFO method. As the marks allocated were 3 marks, it would have been sufficient to write 3 problems associated with LIFO. But most of the candidates gave lengthy irrelevant answers.

Most of the candidates stated that by using the LIFO method the inventory items purchased earlier will remain in inventory over a long period and there will be a possibility of inventory items getting damaged and/or become obsolete. These candidates had totally misunderstood the LIFO method. They were not aware that LIFO basis is a method of inventory valuation. It only assumes that the latest stocks are issued first when valuing the inventory items and not that latest stocks are issued and items purchased earlier will remain in inventory.

Most candidates explained the FIFO and weighted average valuations. Even they went on to the extent of giving the advantages of FIFO, which was totally not required. They spent a lot of time in explaining these instead of answering the given question.

Part (b) - Some candidates explained the valuation but full marks were given for correct calculation of the cost of toy. Most of the candidates answered this part correctly.

This question required the candidate to compare the net realisable value of toy with the cost, and most candidates did this part well.

But there were a few who used the information given regarding the purchase of direct material in calculating the cost per toy. Instead of using the direct material cost per toy given in the question, they again worked out the raw material cost when calculating the cost per toy and could not get the correct answer.

There were some candidates who used the estimated production overhead instead of actual production overhead.

Part (c) - this part was fairly easy and about 90% of the candidates got it right.

But there were a few who added the trade discounts and bulk purchase rebates to the cost of material, and there were some who deducted trade discounts and bulk purchase rebates from the cost of material but added the warehouse rent to the cost of material X which was incorrect.

Question No. 5 was fairly easy, especially parts (b) and (c) for which most of the candidates obtained full marks. However, part (a) was done poorly as explained earlier.

It is important that the candidates read the questions well and pay attention to what is required by the examiner before starting to answer.

Answer No. 06

(a)

Plant		Dr. 120, 000
Decommissioning liability		Cr. 120, 000
P/L	Dr.	96,897
Decommissioning liability	Cr.	96,897

(4 marks)

(b) **Statement of financial position**

Cost of the plant	15,000,000
Net present value of the decommissioning liability as at 31/03/2010	728,000
	15,728,000
Changes in decommission liability	120,000
	15,848,000
(-) Accumulated depreciation	
(15,728,000/30*3) + (15,728,000 + 120,000 - 1,572,800)/27	2,101,511
Net book value	13,746,489

Decommissioning liability as at 31 March 2013	968,968
Increase in NPV	120,000
Unwinding impact	96,897
Decommissioning liability as at 31 March 2014	1,185,865

Income statement

Depreciation expense	Rs. 528,711 (i.e. 15,728,000 + 120,000 - 1,572,800)/27
Finance cost	Rs. 96,897

(6 marks)

(Total: 10 marks)

Examiners' comments

The focus of the question was to evaluate the candidates' knowledge on the IFRIC 1 - *Changes in Exsisting Decommissionning, Restoration and Similar liabilities.*

The average marks for the question was around 3 marks and it indicates that the candidates knowledge on the IFRIC 1 was not upto standard. A considreable number of candidates were only able to correctly mentioned the journal entry on recording the increse in decommissioning liability. Many were unable to correctly identify the amount that needed to be charged to the income statement for the period ended 31 March 2014. Accordingly candidates were unable to correctly state the balances that should appear as the decommissioning liability and the net book value of the plant.

Some candiates have made mistakes in understanding the question as well. For exaple, some candidates have computed the present value of the increased decommisioning liability whereas the question has provided them with the PV of the decommissioning liability.

Many candidates have lost marks from part (b) due to the above mentioned points.

Answer No. 07

Party A

Gross consideration (450,000*10)	4,500,000
(-) relocation cost	(500,000)
Net rental consideration	4,000,000
Annual rent expense	400,000

Party B

Consideration (450, 000*8)	3,600,000
Annual rent expense from year 1 to year 10	360,000

Party B's agreement has the lowest impact to the income statement

According to SIC 15 para (5), the lessee shall recognise the aggregate benefit of incentives as a reduction of rental expense over the lease term, on a straight line basis unless another systematic basis is represent.

(Total: 10 marks)

Examiners' comments

The question was designed to assess the candidates' knowledge on the SIC 15 - *Operating Leases-Incentives.*

Only around 30% of the candidates were able to score more than half of the total marks of the question. This clearly indicates the lack of knowledge of the candidates on identification and application of SIC 15.

A few candidates attempted to compute discounted cash flows and tried to arrive at the answer. Some candidates correctly made the computation of the two options half way and failed to arrive at the correct answer.

Even though this is an open book examination, many candidates failed to at least identify the requirement provided in SIC 15 relevent to incentives.

Answer No. 08

(a) (i) **Risk management committee**
Ensure that corporation risk is properly identified, assessed and properly managed, and also that strategic planning and management decisions are made appropriately in the context of the risk appetite of the corporation.

(ii) **Nomination Committee**
Recommending a charter for the appointment and re-appointment of directors, consider making appointment and re-appointment of directors etc.

(iii) **Remuneration Committee**
Set remuneration policy and deal with remuneration of senior executives.

(iv) **Audit Committee**
Ensure the work of the external auditor maintains integrity and independence.
Assisting boards to discharge their responsibility in relation to the entity's financial information, application of accounting policies, internal control system, risk management system, business policies and practices, protection of assets and compliance with applicable laws and regulations.

(4 marks)

(b) (i) **Director Board**
Companies Act, No. 7 of 2007 – Section 166

The board of every company shall within six months after the balance sheet date of the company, prepare an annual report on the affairs of the company during the accounting period ending on that.

(1 mark)

(ii) Companies Act, No. 7 of 2007 – Section 168

- The nature of the business
- Financial statement for the accounting period completed and signed in accordance with SEC 151
- Auditor's report
- Changes in accounting policies
- Particulars of entries in interest register
- Remuneration and other benefits of directors during accounting period
- Total amount of donations made by the company
- Names of the persons holding offices as directors
- Auditor's fee etc.

(5 marks)

(Total: 10 marks)

Examiners' comments

The avarage marks earned by the candidates for this question was around 6 marks.

Part (a) - The majority of candidates were able to correctly mentioned the main responsibilities of the committees and accrodingly they were able to get full marks allocated for this part. However, some candidates showed poor knowledge on the role of the risk management committee.

Part (b) (i) - Many candidates were able to recognise the resposibility of the board of the company in preperation of the annual report.

Part (b) (ii) - A considerable number of candidates made a common mistake in answering this part. They seemed to write the content of the annual report of listed companies instead of writing the required items specified as per the Companies Act. Therefore candidates lost marks for this part. This also indicates that the candidates did not attempt to understand the question clearly; instead they have given a general answer to the question.

In general, it was noted that candidates have inadequete planning practice in writing the answer, resulting in a waste of their valuable time.

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