SUGGESTED SOLUTIONS

20404 – Advanced Financial Reporting

CA Professional (Strategic Level II) Examination

December 2014

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

(a)

	SMP	MTL	LRP	Adjustments	Consolidated SFP
Assets					
Non-current assets					
Goodwill				50,000	50,000
Brand				135,000	135,000
Property, plant and equipment	750,000	455,000	200,000	37,800	1,242,800
Investment in LRP	150,000			(150,000)	
Investment in associates				114,000	114,000
Investment in MTL	620,000	-	-	(620,000)	-
	1,520,000	455,000	200,000		1,541,800
Current Assets					-
Inventory	500,000	40,000	100,000	(5,000)	535,000
Amount due from SMP		60,000		(60,000)	-
Trade receivables	220,000	50,000	80,000		270,000
Cash and cash equivalents	60,000	10,000	50,000		70,000
	780,000	160,000	230,000		875,000
Total assets	**2,300,000**	**615,000**	**430,000**	(498,200)	**2,416,800**
Equity and Liabilities					
Equity					
Stated capital	800,000	100,000	200,000	(100,000)	800,000
Revaluation reserve	30,000	170,000	100,000	(120,000)	80,000
AFS Reserve	40,000	-		(40,000)	-
Retained earnings	580,000	75,000	120,000	(175,700)	479,300
Other components of equity	-	30,000	-	(30,000)	-
	1,450,000	375,000	420,000	(465,700)	1,359,300
Non-current liabilities					-
Borrowings	600,000	230,000	-		830,000
	600,000	230,000	-		830,000
Current liabilities					
Trade and other payables	190,000	10,000	10,000	27,500	227,500
Amounts payable to MTL	60,000			(60,000)	-
	250,000	10,000	10,000	(32,500)	227,500
Total equity and liabilities	**2,300,000**	**615,000**	**430,000**	(498,200)	**2,416,800**

1	Acquisition of MTL		
	FV of consideration paid		500,000
	NCI at FV	250,000	12,500
			512,500
	FV of net assets acquired		(462,500)
	Goodwill		**50,000**

1.1	FV of net assets	300,000
	Brand	150,000
	FV of land	18,000
	FV of building	22,000
	Unrecorded tax liability	(27,500)
		462,500

2 Acquisition of balance 25% at 31 March 2014

Additional consideration paid	120,000
NCI acquired	12,500

3 **Investment in associate**

3.1 Investment in LRP is an associate. 25% investment with the ability to secure a board position.

3.2	Total investment as at 31 March 2014	150,000
	AFS reserve	(40,000)

Profit for the period

	1/4/2013	31/3/2014		
RR	100,000	100,000	-	
RE	80,000	120,000	40,000	10,000

	Dividend		(6,000)
	Equity accounted balance		114,000
4	**Profit reconciliation**		
4.1	Depreciation of building	22,000	2,200
4.2	Amortisation of Brand	150,000	15,000
4.3	Unrealised profits		
	Number of stock in hand	5	
	Gross profit	(0.2*5mn*5)	5,000
5	**Inter-company current accounts elimination**		
	Amount due from SMP		60,000
	Amounts payable to MTL		60,000
5	**Equity reconciliation**		
	Retained earnings - SMP		580,000
	Profit for the year - MTL	75,000	
		50,000	25,000
	Additional investment	(120,000)	
	NCI on step acquisition	12,500	(107,500)
	Amortisation + Dep^{n}.		(17,200)
	Unrealised gain on inventory		(5,000)
	Profit on equity accounted investee		4,000
			479,300

(b) (i) This is a joint venture arrangement. Unanimous agreement of all parties is required.

Equity accounting shall be followed.

(ii) This is a subsidiary. Majority of voting rights is with the company.

Examiners Comments

The question number 01 was comprised of 02 parts and was aimed at testing the candidate's knowledge on the followings.

- ✓ Correct identification of the relationship (subsidiary, associate, join venture)
- ✓ Computation of goodwill by considering the fair value of assets and liabilities and unrecorded assets and liabilities
- ✓ Recognition of non-controlling nearest fair values
- ✓ Accounting for investment in associate and subsidiary
- ✓ Adjustment required on intercompany on preparation of consolidated financial statements

The overall average mark of the candidates for the question was around 20

Comment

In part (a) of the question, the students were asked to prepare the consolidated statement of financial position after making necessary adjustments.

Most of the candidates have done well in this and were able to score average around 17 marks for the part (a). However considerable number of candidates were unable to arrive at the accurate Goodwill figure as they were not using the full consolidation method. Instead they have applied the % of ownership on the total adjusted NAV and then arrived of the incorrect goodwill amount. Similarly considerable number of students have made mistakes with the computation of NCI at fair value. Therefore, the above 02 points indicate the candidate's limited of knowledge on the accounting for NCI at fair value.

However candidates were able to demonstrate a satisfactory level of knowledge on the rest of the question such as elimination of intercompany transactions, elimination of unrealized profit, consolidation of result of the subsidiary etc. were addressed well by the candidates.

Part (b) of the question was perfectly designed to identify the candidate's ability to recognize the associate joint venture relationship correctly. The average mark for this part was around 03.

Many candidates identify first scenario mistakenly as an associate relationship instead of joint venture. A few candidates were recognized it as a subsidiary as well indicating confusions in identifying joint venture relationships.

A few students have made mistakes with 2nd scenario by identifying it as an associate where relationship was a subsidiary.

It was noted that a considerable number of students have wasted their valuable time on writing requirements of corporate governance for above 02 parts whereas the question was directly required them to indicate financial statement implication.

Answer No. 02

(a) Rationally cannot agree.

Before the LKAS 17 amendment in 2011, the rational provided by the Sector Financial controller was right.

However, as per LKAS 17,

When a lease includes land and building elements, an entity assesses the classification of each element as finance or an operating lease separately. In determining whether the land element is an operating or a finance lease, an important consideration is that land normally has an indefinite economic life.

As the land component is significant in Subsidiary A, it should assess the lease classification separately for land and building.

In performing its assessment, Subsidiary A should unbundle the lease rentals to land and building

(b) Entities are permitted to treat interests held under operating leases as investment property – provided that;

(i) they would otherwise meet the definition of investment property and

(ii) that the fair value model is applied.

This classification alternative is available on a property-by-property basis so that the entity need not classify all property interests held under operating leases as investment property.

However, LKAS 40 requires that once one operating leasehold interest is classified as an investment property, all property classified as investment property must be accounted for under the fair value method.

These leasehold interests are also considered as the same disclosure requirements as other investment properties.

LKAS 17 requires leases to be separated into land and building components, subject to this being possible or the land element being material. If the interest is to be an investment property carried at fair value, there is no requirement to separate the land and building elements of the lease.

(c) Impairment = Amortised cost – DCF (or PV of future cash flows)

DCF = 60 m x D.F. (3 years, 10%) = 60 x 0.751 = 45m

Impairment allowance = 80 – 45 = Rs. 35 million

(d) Interest income for the year ending 31 March 2015 = Rs. 45 m x 10%
= Rs. 4.5 m

(e) A hedging relationship qualifies for hedge accounting if, and only if, all of the following conditions are met:

- at the inception of the hedge there is **formal designation** and documentation both of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge;

- **the hedge is expected to be highly effective** in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship;
- **a forecast transaction** that is the subject of a cash flow hedge must be **highly probable** and must present an exposure to variations in cash flows that could ultimately affect net profit or loss;
- **the effectiveness of the hedge can be reliably measured**, i.e. the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured
- **the hedge is assessed on an ongoing basis** and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

General comment

This question contains 25 marks 71% of the candidates scored marks between 10/25 – 20/25. 99% of candidates attempted for this question and only 1% got zero marks. (Based on the scripts marked) Accordingly the performance of the students is good.

This is a question with five parts and was tested candidates' knowledge on SLFRS & its practical application in various scenarios.

In part (a) it is required to apply LKAS 17 Leases and state whether the sector finance controller's view is agreeable or not, regarding separating land & building lease components part (b) tests the knowledge of identifying land & building obtained under operating leases as investment properties part (c) tests the calculation of impairment allowance in a situation where there are objective evidence of incurred loss relating to loan receivables and part (d) is a basic calculation question of interest income of the loan in part (c). Last part (e) ask about qualifying conditions for a valid cash flow hedge it is a completely theory question.

Answer No. 03

Income statements for the year ended 31 March 2014

		Gama	Mega
		Rs. '000	**Rs. '000**
Revenue		120,000	205,000
Cost of sales		(105,000)	(180,000)
Gross profit		15,000	25,000
Operating expenses		(2,400)	(5,000)
Finance cost	Loan	(2,100)	(3,000)
	OD	-	(100)
	lease	-	(2,900)
Profit before tax		10,500	14,000
Income tax		(1,500)	(4,000)
Profit for the year		9,000	10,000
Dividend paid		2,500	7,000

Statements of financial position as at 31 March 2014

	Gama	Mega
Assets	**Rs. '000**	**Rs. '000**
Non-current assets		
Freehold factory	44,000	-
Owned plant	50,000	22,000
Leased plant		53,000
	94,000	75,000
Current assets		
Inventory	20,000	36,000
Trade receivable	24,000	37,000
Bank	6,000	-
	50,000	73,000
Total assets	**144,000**	**148,000**
Equity and Liability		
Equity shares of RS.1 each	20,000	20,000
Property revaluation reserve	9,000	-
Retained earnings	26,000	8,000

	55,000	28,000
Non-current liabilities		
Finance lease	-	32,000
7% Loan	30,000	-
10% loan	-	30,000
Deferred tax	6,000	1,000
Government grant	12,000	-
	48,000	63,000
Current liabilities		
Bank OD	-	12,000
Trade payable	31,000	38,000
Government grant	4,000	-
Finance lease	-	5,000
Tax	6,000	2,000
	41,000	57,000
Total equity and liability	**144,000**	**148,000**

(a)

			Workings					
			Gama			**Mega**		
	Gama	**Mega**	**N**	**D**		**N**	**D**	
Return on year end capital employed (ROCE)	14·8%	21%	12600	85000	14.8%	20000	95000	21%
Pre-tax return on equity (ROE)	19·1%	36%	10500	55000	19.1%	10000	28000	36%
Net asset (total assets less current liabilities) turnover	1·2 times	2.3 times	120000	103000	1.2	205000	91000	2.3
Gross profit margin	12·5%	12.2%	15000	120000	12.5%	25000	205000	12.2%
Operating profit margin	10·5%	9.8%	12600	120000	10.5%	20000	205000	9.8%
Current ratio	1·2:1	1.3:1	50000	41000	1.2	73000	57000	1.3
Closing inventory holding period	70 days	73 days	20000	105000	70	36000	180000	73
Trade receivables' collection period	73 days	66 days	24000	120000	73	37000	205000	66

Trade payables' payment period (using cost of sales)	108 days	77 days	31000	105000	108	38000	180000	77
Gearing	35·3%	74%	30000	85000	35.3%	67000	90000	74%
Interest cover	6 times	3 times	12600	2100	6	20000	6000	3
Dividend cover	3.6 times	1.4 times	9000	2500	3.6	10000	7000	1.4

(b) Analysis

Liquidity

Mega's current ratio is marginally better than Gama's. Also it has better debtors collection period and creditors settlement period.

However, the inventory holding period of Mega is marginally higher than Gama.

Gearing

Even though return on equity of Mega is higher than Gama, Mega is highly geared.

It has a poor interest cover and dividend cover.

A large OD balance is also noted.

A heavily geared position could be risky. It increases the risk of failing to meet the loan covenant

Turnover

Asset turnover ratio of Mega is higher than Gama. This is mainly due to low assets position in Mega books.

Mega does not have free-hold assets.

Profitability

Profitability ratios of Gama are slightly higher than Mega. However this is only marginal

Mega's return on equity appears to be higher than Gama's. This is due to the fact that equity employed by Mega is lower than Gama

Gama has a higher dividend payout ratio. There are no reserves are retained for future investments.

Mega is not in its own property. It may be on a property that is on an operating lease.

This raise doubt about continuity

	Gama	**Mega**
Cost/FV	80000	175000
CV	41000	75000
Acc. Dep.	39000	100000
	51%	43%

Gama may have to invest in fixed assets in the near future, as 50% of the assets are already used.

However, it appears that there are adequate funds to invest in Gama.

With the above analysis it is advisable to invest in Gama.

(c)

(i) Financial accounting information is affected by estimates and assumptions. Accounting standards allow different accounting policies, which impair comparability and hence ratio analysis is less useful in such situations.

(ii) Ratio analysis explains relationships among past information while users are more concerned about current and future information.

General Comment

Question No 03

This question has been set to test the theoretical knowledge of the candidates on the topics of financial statement, Ratio Analysis and (chapters 10 and 11 of the study text) and how they apply it to the practical situation. This question consists of 3 parts **namely,**

(a) calculation of very basic 12 ratios of company MEGA
(b) Evaluation of relative performance and financial position of two given companies MEGA & GAMA
(c) To explain limitation of ratio analysis and to indicate other useful information for the intended purpose

Performance of the candidate

It appears that this question found one of the easiest questions tested during the past few examination under the topic of ratio analysis and interpretation by perusing nearly 320 scripts. It was observed that performance of the candidates (average marks gained by candidates in number) have been far ahead than the previous examination.

There were number of candidates who were able to get in the range of 20-24 marks out of 25 allocated to this question.

Part (a)

Majority of candidates were able to get all 10 marks allocated for this part. Some candidates lost a few marks due to errors made in calculating ROCE, Pre Tax ROCE and gearing Ratio.

After tax return of 10 million used to arrive at the pretax return on equity with regard to candidates of ROCE and include the current portion of Finance lease outstanding balance of Rs.5 M under capital employed. This basic error had been made even after it was clearly stated in the question.

For calculation of some of the ratios of the company Mega values amounts appearing under GAMA has been used by a fair number of candidates.

Apart from those errors all other ratios have been calculated correctly and it appears that time management have been done well in answering the question.

Part (b)

It is observed that a lot of answers are of good quality and more comprehensive. Some of them were more analytical relevant to decisions and informative.

It is also observed that even though some candidates correctly calculated the relevant ratios, they were unable to explain the possible causes for variations of ratios between GAMA and MEGA. Even after analyzing the ratios some of them were unable to explain the effect of those (ie. longer cash operating cycle of MEGA is better than the shorter cash operating cycle of GAMA and vice – versa) just stating that MEGA ROE is better than GAMA which is not sufficient.

Part (c)

Unlike the answers to part (a) a fair number of candidates were unable to gain satisfactory level of marks for this part. For the reasons mentioned in the 2nd phase of this repot, majority of candidates answered only for one sub sections of this part. As a result of this, a fair number of candidates lost an opportunities to gain easy 2 marks.

On the overall performance of the candidates (based on nearly 320 scripts marked) an average number of candidates were able to score 17 out of 25 marks allocated for this question (ie. 68%)

Answer No. 04

(a)

- Integrity - Straightforward and honest
- Objectivity - Not to be bias and should not be in conflicting of interest and influence
- Professional competence and due care – Maintain professional knowledge
- Confidentiality – Maintain confidentiality of information
- Professional behavior – Comply with relevant laws and regulations

(b) AFR study guide, Chapter 12. 5.1

Strategy and analysis	High level of stg. view of the entity's relationship to sustainability.
Organisational profile	Organisation's structure, brands, location, operations, etc.
Report parameters	Reporting period, materiality, report boundaries etc.
Governance, commitments and engagement	Governance structure, commitment to external environment
Mgt. approach and performance indicators	Organised by economic, environmental, and social categories.

General comment

Though the average marks scored for this question is fair, the candidates' performance was variable. This is a two parts question which tests the ability of the candidates to present principles and GRI published guidelines on sustainability reporting.

In part (a) candidates were required to answer the fundamental principles set out in the code of ethics – 2010. Part (b) required to state five sections that a sustainability report should contain and explain the content of each of the sections.

Specific comments

Part (a)
Many candidates had answered well as expected, however limited number of them did not know basic fundamental principles.

Part (b)
Number of candidates had failed to understand the question properly. Therefore the answer had been limited to one area in sustainability reporting and accordingly explained environment, economic and social aspects.

Answer No. 05

The following shall be discussed.

- Key fundamental principles
  - Integrity –Whether the financial statements are true and fair. Should you re-issue the financial statements
  - Objectivity – How do you stay objectively when the CFO is very forceful to insert some financial information which are not correct and not independently taken?
  - Professional behavior – How do you proceed in a professional manner?

- Identify facts of the issue
  - Violation of standards. Regulations and corporate governance
  - Identify key affected parties

- How do you get involved in resolution
  - Identification of the following parties for notification
    - ICASL for advice
    - Notify SEC, SLAASMB
    - Discuss the matter with auditors
  - Check the facts and collaborate
  - Notification of top management
  - Keep the meeting discussions and communications with regulators

General Comment

This is similar to a case study question of checking ethical requirement for a given scenario. Majority of the candidates failed to answer correctly but average marks could have been collected for this question. Few candidates answered on ethical requirements. However they were unable to address the issue in concern and possible courses of actions.

Specific Comments

Question is silent on whether the CFO is a professionally qualified one or a member of another professional accounting body. If it has been clearly mentioned, candidates could have answered correctly. i.e. CFO and the group accountant are members of CASL.

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