CA THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

12306 – Financial Reporting Framework

CA Professional (Strategic Level I) Examination
June 2014

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

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Answer No. 01

(a) The arrangement is classified as equity under LKAS 32.16 because the contingent consideration arrangement will result in the issuance of a fixed number of Zebra PLC's equity shares if the target is met.

(b) SLFRS 2 requires the expense to be calculated separately for each tranche over the vesting period for that tranche. That will result in the expense being front-loaded. The answer is 500 x Rs. 10 for the first tranche plus 250 x Rs. 10 for the second tranche that should be accounted in the financial statements of the year ended 31.12.2013

(c) As per the LKAS 20 the benefit of a government loan at a below market rate of interest should be treated as a government grant. The loan should be recognized and measured at fair value at the transaction date and subsequently it should be measured at amortised cost in accordance with LKAS 39. Accordingly the loan should be initially measured at a market rate of 8%, which is 68 million (100 mn *0.6805 calculated present value of the future cash flow) the difference between the initial carrying value of the loan and loan proceeds that is 32mn (100 – 68) should be treated as Government Grant.

Initial Recognition and Measurement
Loan - 68 Mn
Government Grant – 32 Mn

Since the loan should be subsequently measured at amortized cost, loan Carrying Value should be stated in the financial statements at the end of the reporting period is 73.6Mn (Initial fair Value of Rs. 68Mn should be measured at 8% i.e. 68Mn *1.08). Interest of 5.4 Mn should be charged as interest expenses in the income statement and Government grant also should be amortized to compensate the expenses. Therefore amortization of government grants of Rs.8.4Mn should be charged to income statement.

(d) Impairment testing is time intensive and judgmental due to:

- the identification of impairment indicators;
- assessing or reassessing the cashflows;
- determining the discount rates;
- testing the reasonableness of the assumptions; and
- benchmarking the assumptions with the market.
- Calculation of recoverable amounts is difficult and may not have required data
- If the market capitalisation is lower than a value-in-use calculation, then the VIU assumptions may need challenging, as the cashflow projections might not be as expected by the market

(e) The initial carrying amount of debt security is Rs. 8,000,000 and the transaction costs of Rs 600,000 are spent. This treatment applies because the debt security is classified as held for trading and, therefore, measured at fair value with changes in fair value recognised in profit or loss.

The initial carrying amount of the bond is Rs 11,000,000 i.e. the amount paid for the bond and the transaction costs. This treatment applies because the bond is not measured at fair value with changes in fair value recognised in profit or loss. Any changes in fair value of the bond are taken to reserves until the bond is sold.

	Carrying value Rs million	Re- measured Rs million	Impairment Rs million	Fair value less costs to sell Rs million
Goodwill	160	160	(160)	–
Plant and equipment	280	260		260
Stocks	200	180		180
Financial assets	170	170		170
Financial liabilities	(140)	(140)		(140)
	670	**630**	**(160)**	**470**

SLFRS 5 requires that immediately before the initial classification of the disposal group as held-for-sale, the carrying amounts of the disposal group be measured in accordance with applicable SLFRS, and any profit or loss dealt with under that SLFRS. The reduction in the carrying amount of property, plant and equipment will be dealt with in accordance with LKAS 16, and that of the inventory in accordance with LKAS 2.

Income statement

After the re-measurement, the entity will recognise an impairment loss of Rs 160 m on re-measurement to the lower of carrying amount and fair value less cost to sell. This loss is allocated to goodwill in accordance with LKAS 36. Thus, goodwill will be reduced to zero. The loss will be charged against profit or loss.

Balance sheet

In the balance sheet, the major classes of assets and liabilities classified as held-for-sale should be separately disclosed on the face of the balance sheet or in the notes. Thus, in this case, there would be separate disclosure of the disposal group as follows.

Assets	**Rs.million**
Non-current assets	
Current assets	
Non-current assets and current assets classified as held-for-sale	610
Liabilities	
Current liabilities	
Liabilities directory associated with non-current assets classified as held-for-sale	140
Total liabilities	

Answer No. 02

(a) LKAS 28 (definition)
Significant influence

(1) Is the power to participate in financial an operating policy decision of investee but not control or joint control over those policies.

The standard mentions board representation as an indication of significance influence but does not provide guidance on how to evaluate the representation in the context of the size of the board, voting patterns and the like.

(2) Cobra PLC has the right to appoint 2 directors on the Board of Alpha Ltd. which consists of 11 directors. Hence has power to participate in policy decisions.

(3) Board decisions are passed by 70% majority of directors as per information given. Since there are 11 members, majority is 8 (11 x 70%).

(4) The other 2 major investors together has only 7 members and hence do not have clear majority, and therefore no ability to influence on their own.

(5) Hence it appears that Cobra PLC, although having only 20% shareholding, has significant influence over Alpha.

(b)

(1) they may not have the industry knowledge required to effectively function as a INED

(2) they may have very different views to that of the directors representing shareholders and there could be clashes on board decisions

(3) they may not have the same commitment and enthusiasm to that of directors representing shareholders

Answer No. 03

(a) The reporting entity shall consider the closeness of the related party relationship and the following other factors such as whether it is;

- Significance of the transaction in terms of size
- Carried out on non- market terms
- Outside normal day to day business operations, such as the purchase and sale of businesses
- Disclosed to regulatory or supervisory authorities
- Reported to senior management
- Subject to shareholder approval

(b) **This question tests the candidate's ability to exercise professional judgment. Marks will be awarded for valid arguments with supporting facts from relevant accounting standards.**

Given the nature of the agreement, the company accounts these agreements under operating lease. Accordingly, neither asset is capitalized nor liability is recognized.

The company's current accounting policy is to expense refurbishment/renovation cost incurred. Now, the company is considering to capitalize one of such expenditure because the amount incurred is substantial. This accounting treatment is not in line with the company's current accounting policy.

And also as the company has not been transferred all the risk and rewards incidental to this asset, company cannot capitalize this amount incurred for cladding.

(c) As the company is still using the asset, the estimated 10 year useful life time cannot be considered as accurate and the asset cannot be fully written off from the books of accounts as the company is still generating economic benefits from the asset.

<u>LKAS 16</u>
<u>Useful life of PPE</u> should be reviewed at least year end and depreciation charge for current and future years should be adjusted accordingly for any significant changes in expectations.

<u>Depreciation method</u> also should be reviewed at least each year end, and if there is any significant change in expected patterns of economic benefits the method should be changed. Such changes should be accounted as changes in accounting estimate as per LKAS 8 and requires prospective adjustment in financial statements.

The company has not reviewed the estimated useful life or the depreciation method and made adjustments and hence although the asset is still being used, it is written off in the books.

In order to correct the position, the company needs to re-assess the useful lifetime of the asset and account for it as a change in estimate as per LKAS 8. However restating the asset value results in a revaluation and as per the standard all the assets in that class need to be revalued and not only this machinery.

Answer No. 04

(a) IFRIC 15 was issued in June 2008 in response to concerns raised about the inconsistency in accounting for real estate sales. Divergence in practice has arisen whereby some entities recognise revenue when the real estate is transferred to the customer in accordance with LKAS 18 (revenue) whilst others recognise revenue over the period of construction in accordance with LKAS 11 (construction contracts).

To address this divergence practice, IFRIC 15 clarifies the determination of whether an agreement is within the scope of LKAS 11 or LKAS 18. The current accounting policy of the company should be reviewed according to the criteria given by IFRIC 15.

According to IFRIC 15, a contract shall be identified as to whether it is a construction contract or a sale of goods (service). This determination shall be made with reference to the terms and conditions of the contracts signed with the customers.

The main factor is that whether the construction is made for customers specifications or whether the construction is done for pre-set models or specifications determined by the constructor. In other words, whether the customer could make major structural changes to the construction or not would determine the relevant standard to use.

If no structural changes can be done by the customer then it is a sale of good transaction LKAS18 applicable where revenue shall be recognized when the risk and rewards are passes. That is at the completion of the units.

Otherwise the contract would fall under LKAS 11 – Revenue should be recognized on the basis of stage of completion.

(b) Subscriptions to publications and similar items.

When the items involved are of similar value in each time period, revenue is recognised on a straight-line basis over the period in which the items are dispatched. When the items vary in value from period to period, revenue is recognised on the basis of the sales value of the item dispatched in relation to the total estimated sales value of all items covered by the subscription. Advances received shall be deferred until the performance obligations are satisfied.

Answer No. 05

(a) Present value of debt component
Principal – Rs. 10, 000, 000 payable at the end of 5 years
10,000, 000* 1/ $(1.08)^5$
Rs. 6,805, 832

Interest – Rs. 500, 000 payable annually in arrears for 5 years
500, 000* PVAF(8%,5)
500, 000* 3.9927 = Rs. 1,996, 350

Total liability component = Rs. 8,802, 182 (6,805, 832 + 1,996, 350)

(b) Equity Component = Rs. 10, 000, 000 – Rs. 8,802,182
= Rs. 1,197,818

(c)

Cash Dr	Rs.	10, 000, 000
Convertible notes payable	Rs.	8, 802, 182
Equity	Rs.	1, 197, 818

Answer No. 06

Machinery
Tax base = carrying amount + future deductible amount – future taxable amount
= 200 + 125 - 200
=125

Advances
Tax base of revenue received in advance = carrying amount – amount of revenue not taxable in the future
= 800 -800
= 0 (nil)

Inventory
Tax base = carrying amount + future deductible amount – future taxable amount
= 1200+ 1200-1200
=1200

Long term loans
Repayment of loans have no tax consequence. Hence tax base 2,200

Answer No. 07

(a) The interest rate implicit in the lease ('IIR') is the discount rate that, at the inception of the lease, causes the aggregate present value of

(a) the minimum lease payments; (Lease rentals + guaranteed residuals) and
(b) the unguaranteed residual value

to be equal to the sum of the fair value of the leased asset and any initial direct costs of the lessor

Method 3 correctly considered all these cash flows, therefore

Implicit Interest rate = 20%

(b)

	CF	Timing	@ 20% AF/DF	PV
Rental	30	1-5 years	3.00	89.91
Residual guaranteed	15	5	0.40	6.05
PV of MLP				95.96

Fair Value of the asset	100
PV of MLP as % of Fair Value	96%

This is a finance lesae as it cover substantial % of Fair value at the inception of the lease

(c) The lessor's gross investment in the lease is the aggregate of the minimum lease payments receivable by the lessor under a finance lease and any guaranteed and unguaranteed residual value to which the lessor is entitled

= (30 X 5) + 25 = Rs. 175 m

(d) The net investment in the lease is the gross investment discounted at the interest rate implicit in the lease

Method 1

	CF	Timing	@ 20% AF/DF	PV
Rental	30	1-5 years	3.00	89.91
Residual (guaranteed + Not guaranteed)	25	5	0.40	10.09
Net Investment in the lease				100.00

Or

Fair Value = Net Investment = Rs. 100m

Answer No. 08

(a) (i) Name, address and business experience of directors and details of other directorship held.

(ii) details of directors' shareholdings

(iii) Sale and purchases of shares by any director in the year immediately preceding the date of issue of prospectus with the prices of such sale and purchases

(iv) details of directors' aggregate emoluments including bonus/profit sharing payments made during last completed financial year.

(v) Directors' interest in any assets acquired, disposed or leased by the entity during past two years preceding the issue.

(vi) full particulars of any contract or arrangement in force at the date of the application in which a director of the entity is materially interested in relation to the business.

(b) (i) Companies licensed under the banking Act No. 30 of 1988
.
(ii) Companies carrying on leasing business

(iii) factoring companies

(iv) fund management companies

(v) Companies authorised under the Control of Insurance Act, No. 25 of 1962, to carry on insurance business.

(vi) Companies registered under the Finance Companies Act, No. 78 of 1988.

(vii) Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate unit trust.

(viii) Companies licensed under the Securities and Exchange Commission Act, No.36 of 1987, to carry on business as stockbrokers or stock dealers.

(ix) Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate a Stock Exchange.

(x) Companies listed in a Stock Exchange licensed under the Securities and Exchange Commission Act, No.36 of 1987.

(xi) Other Companies

(a) which have a turnover in excess of Rupees 500 Million;

(b) which at the end of the previous financial year, had shareholders equity in excess of Rupees 100 Million;

(c) which at the end of the previous financial year, had gross assets in excess of Rupees 300 Million.;

(d) which at the end of the previous year had liabilities to banks and other financial institutions in excess of Rupees 100 Million;

(e) which have a staff in excess of 1000 employees.

(xii) Public Corporations engaged in the sale of goods or the provision of services.

(xiii) A group of companies, any one of which fall within any of the above categories. For this purpose, "a group of companies" means a holding company and its subsidiaries, the accounts of which have to be consolidated under section 147 of the Companies Act, No.17 of 1982

(c)

<table>
<tr><th></th><th>Executive</th><th>Non-Executive</th><th>Independent</th><th>Non Independent</th><th>Reason</th></tr>
<tr><td>W K B De Silva</td><td>✓</td><td></td><td></td><td>✓</td><td>Is the CEO. Hence has executive responsibility for mgt. of co., & involved in the day to day operations: Generally, an executive director brings daily workplace biasness and they are also bias towards the decisions on their performance bonus. Hence an executive director cannot be an independent director.</td></tr>
<tr><td>Prof. R Narayan</td><td></td><td>✓</td><td>✓</td><td></td><td>Not involved in day today management of the Co. Hence non executive director. No other relationship or material interest in the Co. Hence independent.</td></tr>
<tr><td>S Dasanayake</td><td></td><td>✓</td><td colspan="2">Can be either independent or non-independent</td><td>Not involved in day today management of the Co. Hence a non-executive director. He has a close connection with the company through SIL (Pvt) Ltd. However if the contract value is equivalent to 10% of turnover of SIL then only the close connection is material in which case he is not independent. If the value of the contract to sell goods is less than 10% of the turnover of SIL, then not material and he will be treated as independent director</td></tr>
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