CA THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

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20404 – Advanced Financial Reporting

CA Professional (Strategic Level II) Examination

December 2012

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

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Answer No. 01

DRW Group
Consolidated Statement of comprehensive income for the year ended 31 December 2011

	DRW A	SW B	6 Months results of SW C = B / 2	Adjustment D	DRW Group A + C + D
	Rs.000	**Rs.000**	**Rs.000**	**Rs.000**	**Rs.000**
Revenue	92,500	45,000	22,500		115,000
Cost of Sales	(70,500)	(36,000)	18,000	(120) + (50)	(88,670)
Gross Profit	22,000	9,000	4,500	(120) + (50)	26,330
Distribution cost	(2,500)	(1,200)	(600)		(3,100)
Administrative expenses	(5,500)	(2,400)	(1,200)	(1,500)	(8,200)
Finance Cost	(100)	-	-		(100)
Profit before tax	13,900	5,400	2,700	(1670)	14,930
Income tax	(3,400)	(1,500)	(750)		(4,150)
Profit after tax	10,500	3,900	(1,950)	(1670)	10,780
Other Comprehensive Income					
FV of Property				500-150	350
AFS FV gain				300	300
Total other comprehensive income					650
Total Comprehensive Income					11,430
Profits attributable to NCI (1,780 x 23%)					409
Profits attributable to group shareholders					10,371
					10,780 ======
Profits attributable to NCI				409	409
Profits attributable to shareholders					11,021
Total Comprehensive Income					11,430

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DRW Group
Consolidated Statement of Financial Position as at 31 December 2011

	DRW Rs.000	SW Rs.000	At Acquisition Rs.000	Post Acquisition Rs.000	DRW Group Rs.000
Assets					
Non-Current Assets					
Property Plant and Equipment	25,500	13,900	1000	500-50	40,850
Goodwill			12,000+800+1950 2550-5,000-1000-1200		5,000
Brand Name			1,200	-120	1,080
Investment	1,800	-	- 800	300	1,300
Current Assets	12,500	2,400		600	15,500
					-
Total Assets	**39,800**	**16,300**	**6,400**	**1230**	**63,730**
Equity and Liability					
Equity					
Equity share of Rs.1 each	12,000	5,000	12,000-5000		24,000
Revaluation reserve				500-150	350
Other equity reserves	2,500	-		300	2,800
Retained earnings	12,300	4,500	-2550	-120-50 +169- 1,500-409	12,340
NCI			1950	+600-169+409	2,790
Non-current Liabilities					
Loan notes	3,000	4,000			7,000
Differed Tax				150	150
Current Liabilities	10,000	2,800		1500	14,300
Total equity & liabilities	**39,800**	**16,300**	**6,400**	**1230**	**63,730**

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Workings

1. Goodwill

		Rs. '000	Rs. '000
Consideration			
Shares	= 5,000*80%*3/5*5		1,2000
6% Loan (Notes)	= 5,000*80%*100/500		800
NCI			1,950
			14,750
FV of net assets acquired			
Reported NA		9,500	
Post Acquisition profits		-1,950	
PPE		1,000	
Brand		1,200	
		9,750	
			(9,750)
			5,000

NCI Rs. 9,750 x20% Rs. 1,950

2. Right Issue

		Rs. '000	Rs. '000
Shares held by NCI Before right issue			1,000
Shares subscribed			200
Total Shares held by NCI			1,200
Total Shares in issue			5,200
NCI after right			23%
Fair value before rights issue excluding post acquisition profit		9,750	
Cash Received		600	
Share Capital 31/12/2011			10,350
NCI before right issue	Rs. 9 150x20%		1,950
NCI after right issue	Rs. 10,350x23%		2 380.50
Increase due to right issue Rs. 2,380.50 – Rs. 1,950			430.50
Shareholders of DRW (77%) (Rs. 600 - Rs. 430.50)			169.50
			600.00
			=====

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3. NCI at 31/12/2011

	Rs. '000
NCI at Acquisition	1,950
Rights issue	600
Post-acquisition Profits	409.40
Share of rights DRW	(169.50)
Net Assets	2789.90

4. SW Reserve reconciliation

			Rs. '000	Rs. '000
Reserves at 31/12/2010	Rs. 4,500- Rs. 3,900			600
1st 6 months	3,900 x 50%			1,950
Pre-Acquisition reserves				2550
Profit for 2011			3,900	
Post-Acquisition (6 M)			1,950	
Depreciation			(50)	
Amortization			(120)	1,780
NCI		23%		409.40
Shareholders		77%		1,370.60
				1,780.00

5. Loan should not be reclassified as a non-current liability. It is a current liability as at 31/12/2011.

6. Legal charges incurred of Rs.1.5Mn on acquisition of SW should be charged to P/L.

7. Group Retained Earnings

	Rs. '000
Opening profit of DRW (Rs. 12,300 – Rs. 10,500)	1,800.00
Profit for the year	10,370.60
Rights issue – transfer from NCI	169.50
	12,340.10
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Answer No. 02

(a) (i) LKAS 17, requires a lease to be classified as a finance lease, if it transfers substantially all the risks and rewards of ownership. If title of both elements are passed to the lessee at the end of the lease term, both elements may fall to be classified as a finance lease. If title to land never passes to the lessee, the land element is classified as an operating lease and building element is looked at separately and accounted for as either an operating lease or a finance lease depending on the terms of the lease.

To classify the two elements of property separately the standard requires that the minimum lease payment be allocated to each element in proportion to their relative fair values at the inception of the lease.

Nethu PLC should classify the land element of the transaction as an operating lease given the 30 year lease term. Annual rental of Rs. 1 million (2.5 million/100 million x 40 million) should be charged as an expenditure to statement of comprehensive income. Further 40% of the first lease rentals paid is attributable to land. Therefore out of the Rs. 20 million attributable to the land, Rs. 666,667 should be charged as an expenditure to statement of comprehensive income. Balance amount of Rs. 19,333,333 should be shown as a prepayment under non current asset.

The lease term and useful life time of the building is 30 years. The present value of the minimum lease payment using the rate of interest implicit in the lease is closer to Rs. 60 million. At 1 April 2011, the building should be classified as a finance lease, recognize under property, plant and equipment at a value of Rs. 60 million. Nethu PLC should recognize at this date a corresponding finance lease obligation of Rs. 75 million. The difference between the asset value of Rs. 60 million and the lease obligation of Rs. 75 million amounting to Rs. 15 million should be recognized as an interest in suspense. This interest in suspense should be recognized as an expenditure over the lease period as given in LKAS.

The amount of Rs. 30 million attributable to building element out of the first instalment paid, should be deducted from the lease liability.

(ii) The estimated useful life of the investment property is much longer than the lease term of four years. Therefore Tharu PLC is a lessor of an operating lease.

LKAS 17 requires that lease income from operating leases shall be recognized in income on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the leased investment property is diminished.

The six month rent free period is a lease incentive, which shall be recognsied as an integral part of the net consideration agreed for the use of the leased investment property. Tharu PLC should recognize the aggregate cost of incentives as a reduction of rental income over the lease term. Therefore the rental income of Rs. 10,500,000 should be recognized in 2011/2012 financial statements of the company.

Total revenue Rs. 1,000,000 x 42 Month = Rs. 42,000,000

Per annum Rs. $\frac{42,000,000}{4}$ = Rs. 10,500,000

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(b) (i) The revenue should be recognized at the point;

i. Risk and rewards are passed
ii. When no continuing managerial involvements are retained.

Accordingly in both cash and credit sales; the above two conditions are satisfied at the point of signing sales /purchase agreement.

- The customer is able to sell the land after signing of the SPA (risk and reward on ownership interest)
- Customer can build on the land (use for intended purpose)

(ii) Total revenue

		#	Price(Rs)	Value(Rs)
Cash sales		2	4,000,000	8,000,000
Credit	Down payment	3	1,600,000	4,800,000
	Deferred payment at PV	3	2,400,000	7,200,000
Total Revenue				20,000,000

Interest income 720,000

End of the year	Annual Installment (Rs.)	Interest Income (Rs.)	Capital Repaid (Rs.)	Trade receivable (Rs.)	3 units	
					Interest income (Rs.)	Trade receivable (Rs.)
2011	(757,130)	240,000.00	(517,129.93)	1,882,870.07	720,000.00	5,648,610.21
2012	(757,130)	188,287.01	(568,842.92)	1,314,027.15	564,861.02	3,942,081.45
2013	(757,130)	131,402.71	(625,727.21)	688,299.94	394.208.14	2,064,899.81
2014	(757,130)	68,829..99	(688,299.94)	-	206,489.98	-

(iii) - 2011 - Interest income on deferred payment arrangement at 10%

- Balance outstanding after payment of first installment at the end of the year

Assume all the transactions have taken place at the beginning of the year.

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Answer No. 03

(a) (i) ROCE = $\frac{301.30}{1,230.25} \times 100$

= 24.5%

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(ii) Interest cover = $\frac{301.30}{40.5}$

= 7.4 times

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(iii) Price Earnings Ratio = $\frac{160}{48.12}$

= 3.32

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(iv) Dividend cover = $\frac{48.12}{10}$

= 4.812

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(v) Inventory turnover = $\frac{760.5}{290.10}$

= 2.62 times

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(5 marks)

(b) To : Chairman
From : CEO
Subject : Financial Performance

Profitability

Company's gross profit margin and net profit margin have increased during 3 years. As a result the company's profitability has improved. Return on capital employed has shown a declining trend as the result of decrease in asset turnover.

Liquidity

Current ratio has increased while quick ratio has decreased resulting liquidity being deteriorated. This indicates, stock in trade has increased. Debtors' collection period has increased over the period and creditors' payment period has also increased which indicates that the liquidity position has decreased.

Gearing

Gearing ratio has increased. The reason for such increase may be new loans taken during 2011 and 2012. Decrease in interest cover also shows increase in loans.

Efficiency

Return on capital employed has decreased and stock holding period has increased which show that efficiency of operations has reduced. Credit management has also deteriorated over the years.

Conclusion

Profit reported on the face of the Income Statement do not always indicate the true financial position of the company. Profits have improved but other indicators such as liquidity, gearing and efficiency ratios show an adverse position. Therefore management should pay their attention to these aspects too.

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Answer No. 04

(a) It is a long term multi stakeholder, international undertaking whose mission is to develop and disseminate globally applicable sustainability reporting guidelines for voluntary use by organisaitons reporting on the economic, environmental and social dimensions of their activities products and services.

(b) Triple Bottom Line.

It consists of three P's profit, people and planet. The concept demands that a company's responsibility lies with stakeholders rather than shareholders and the concept is made up of social, economical & environmental factors.

The phrase triple bottom line was first coined in 1994 by John Elkington, the founder of a British consultancy called sustainability. His argument was that companies should be preparing three different (and quite separate) bottom lines. One is the traditional measure of corporate profit (economical) – the "bottom line" of the profit and Loss account. The second is the bottom line of a company's people account (social) – a measure in some shape or form of how socially responsible an organization has been throughout operations. The third is the bottom line of company's "planet" account – a measure of how environmentally responsible (environmental) it has been. The triple bottom line (TBL) so consisting of the three Ps – profit, people and planet brings to measure the financial, social and environmental performance of the corporation over a period of time taking account of the full cost involved in daily business.

(b) Large listed company has a greater variety of stakeholders than a small private limited liability company. Therefore issues of corporate governance are more acute for listed companies. However there is a duty to be professionally ethical irrespective of whether the accountant is working for a public or private company.

A professional accountant must at all times adhere to the fundamental principles of professional ethics, whether working for a listed company or not.

The fundamental principles of professional ethics are drawn from the duties owed by members of the accounting profession. Professional accountants owe duties of care to the public, to those who employ them, to the profession itself and to other members of the profession. The overriding requirement is that a professional accountant must at all times perform work objectively and impartially and free from influence of any consideration that might appear to be in conflict with that requirement.

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Answer No. 05

To : Mr. Asanka Tennakoon - Marketing Director
From : Mr. X - Accountant
Subject: **Directors responsibilities and corporate governance**

Many business organisations have failed during the recent past due to not managing the business as per the corporate governance. To meet these challenges faced by the business organisations the directors of the business organization must ensure that they conduct the business in transparent manner in line with the best practices practiced by the other reputed organisations. The directors should continuously improve the way they conduct the business so that they can identify the risks the business organisations are exposed to and manage them effectively.

This report deals with the nature of corporate governance and the importance of good corporate governance, and responsibilities of a director.

Corporate governance is the system within an organization that protects the interests of its diverse stakeholders. Good corporate governance is evolving from command and control dictums to a more proactive and continuous process that assesses, sources, measures and manages risks across the enterprise.

Effective governance instills a culture of sound business practices and ethics, an understanding of company risks and how to manage them and efficient, appropriately executed processes to manage and monitor risk on an ongoing basis.

The seven components of good corporate governance include,

1. Board of Directors and Committees.
   Good corporate governance depends on the attitudes, competencies and independent voices of individual directors. The two-tier board has a role to pay, as does the audit committee.

2. Legal and regulatory
   Good governance requires an awareness of and responsiveness to legal boundaries.

3. Business practices and Ethics.
   Business ethics are moral boundaries or values that a company believes it should work within.

4. Disclosure and transparency.

5. Enterprise risk management.

6. Monitoring
   This comprises activities that ensure that all other parts of the corporate governance framework are working as expected

7. Communication.

Directors of business orgnisations are responsible to identify the risks the business organisaitons are exposed to, develop the internal controls and implement them to mitigate the risks identified etc. Further the directors are responsible to prevent and detect frauds and errors, and to prepare and present the financial statements as well.

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1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

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