ADVANCED CORPORATE REPORTING

PROFESSIONAL 2 EXAMINATIONS – JULY 2019

NOTES:
Answer All Questions

TIME ALLOWED:

3 hours plus **20 minutes** to read the paper

INSTRUCTIONS:

During the reading time you may write on the examination paper, but you may not commence writing in your answer book. **Please read each Question carefully**.

Marks for each question are shown. The pass mark required is 50% in total over the whole paper.

Start your answer to each question on a new page.

You are reminded to pay particular attention to your communication skills, and care must be taken regarding the format and literacy of your solutions. The marking system will take into account the content of your answers and the extent to which answers are supported with relevant legislation, case law or examples, where appropriate.

List of the cover of each answer booklet, in the space provided, the number of each question attempted.

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF SRI LANKA

ADVANCED CORPORATE REPORTNG

PROFESSIONAL 2 EXAMINATIONS - JULY 2019

You are required to answer **ALL** questions.

Time Allowed: 3.0 hours, plus **20 minutes** to read the paper.

If you make an assumption in any question, please state your assumption clearly.

Case Study

You have recently been appointed as financial accountant at Kothmale Ltd. (Kothmale) which began as a Indian business. However, nine years ago the company moved its operations and established in Sri Lanka. The company manufactures external hard drives and operates in a sector where the rate of technological change rapidly renders products obsolete. To ensure its products remain competitive, the company undertakes significant research and development activities. In addition, in the recent past, it has acquired young companies with promising research and development projects.

The managing director of Kothmale is Thilak Silva. Today is your first day in your new position and you've been asked to attend a welcome meeting in Thilak's office. Thilak begins the meeting "Welcome. As I'm sure you've noticed, we're a fast growing company. We have to be: we operate in a sector where only the strongest survive. We might double in size next year or we might be out of business.

The previous accountant had quit without notice and it has left us in a difficult situation. Your predecessor left on bad terms and you won't be able to contact her to assist with your transition. The company's financial statements for the financial year ended 31 December 2018 are in draft form and there are a number of outstanding accounting issues which need to be resolved. I will send you an email later this afternoon outlining these issues. We prepare our financial statements using International Financial Reporting Standards (IFRS). The company is taxed at a corporate tax rate of 14%.

"I would prefer if you would avoid recommending any accounting treatment regarding the outstanding issues that decreases the financial position of the company. The previous accountant was unable to see the bigger picture and refused to play a part in keeping the company in business. I hope you're different."

The meeting concludes and you make your way to your new office. You log in to your work email account and see an email, copied below, from Thilak:

To: Financial Accountant (accounts@Kothmale.com)

From: (thilaksilva@kothmale.com)

Subject: Outstanding accounting issues

Good day,

As discussed this morning, below are the outstanding accounting issues:

1. Acquisition of Perera Ltd.

Kothmale has acquired several subsidiaries over the last number of years. Typically the company acquires full ownership of the subsidiaries and has written off all Goodwill associated with the acquisitions in prior years. The financial statements of the subsidiaries for the financial year ended 31 December 2018 have been correctly consolidated in the financial statements for Kothmale Group (outlined in Attachment 1) except for a subsidiary called Perera Ltd.

Kothmale acquired a company called Perera Ltd. two years ago (on 1 January 2017). The accountants at Perera experienced a problem with their accounting system and were able to provide only the financial statements for the 2018 financial year in the last couple of days. As a result, Perera's financial statements have not yet been consolidated into the group accounts. Kothmale Group's draft financial statements (excluding Perera) and Perera's financial statements are included in Attachment 1.

Background information on Perera:

- Kothmale acquired 70% of the share capital of Perera on 1 January 2017 when the retained profit of Perera Ltd had

a balance of Rs.70,000. Perera has not undertaken any share issues or buybacks since the acquisition. All of the tangible assets and liabilities of Perera were considered to be fairly valued at the date of acquisition.

- On 3 January 2017, sold an item of equipment to Kothmale for Rs. 150,000. The equipment had originally cost to Perera Rs.140,000, and accumulated depreciation of Rs.30,000 had been provided by Perera to the date of sale. Kothmale considered the equipment to have a remaining useful life of 10 years at the date of purchase and depreciation is being provided on the straight-line basis.

- During the 2018 financial year, Kothmale started supplying certain inventory to Perera, which keeps a mark up of 30%. Included in Perera's inventory at 31 December 2018 is Rs.130,000 of such inventory.

- The consolidated retained profit at 1 January 2018 was Rs.900,000 for Kothmale Group (excluding Perera) and the retained profit for Perera was Rs.90,000 at the same date.

- No dividends were proposed or declared by either Kothmale or Perera during the periods under review.

2. Impairment

The auditors are in the process of completing the audit of the 2018 financial year. They have raised a query about a potential impairment to one of our machines. During 2018, this machine was damaged during a power surge. The machine still works but its production capacity has been reduced. The auditors have queried whether the machine should be impaired because it has lost some of its resale value as a result of the damage.

The machine originally cost Kothmale Rs.1,000,000. Accumulated depreciation associated with the machine is Rs 250,000 to 31 December 2018. A mechanical engineer assessed the machine in early January 2018. The engineer's report states that similar damaged machines have sold for Rs 300,000 in the recent past. In addition, due to the unique nature of the machine, significant advertising costs of Rs. 20,000 will be incurred to find a buyer. The machine is not covered by insurance.

The power surge reduced the production capacity and also shortened the expected life of the machine. Kothmale's management accountants have estimated that the damaged machine will generate cash flows of Rs.200,000 per annum over an expected remaining useful life of 3 years. Kothmale's cost of capital is 10%.

No impairment of the machine has been recorded yet in our accounts.

3. Legal Claim

On the 10 October 2018, Kothmale organised a Christmas party at the company's head office in Sri Lanka. Unfortunately, there was an outbreak of food poisoning and the company has received 200 legal claims from employees in respect of the incident, seeking compensation at an average of Rs.5,000 each. A letter from Kothmale's legal advisors, dated 10 December 2018, suggest 40% of these claims are likely to be successful. Thilak does not want to make any provision for these claims on the grounds that less than 50% of the claims are likely to be successful. The legal advisors have suggested that an average of two years from the end of the current reporting period will elapse before the claims are settled. The risk related discount rate is estimated to be 10%.

4. Share options to directors

Kothmale issued share options to its directors on 1 January 2018. The options have a vesting period of 10 years and had a fair value of Rs. 2,000,000 on the date of issue. To be eligible to exercise the share options, employees are required to remain continuously employed by Kothmale over the entire vesting period. Actuaries have estimated that 30% of the directors who have received share options will leave the employment of Kothmale over the vesting period.

The options have no financial implications for the next 10 years, so no amounts have been recognised in relation to the share options in the financial statements for the 2018 financial year.

5. Deferred Payment

As an incentive to persuade a potential customer to buy, Kothmale offered a deferred payment arrangement. The hard drives, with a selling price of Rs.2 million, was delivered to the customer on 1 January 2018. The customer paid 25% of the selling price on that date. The balance will become payable in 1 January 2020. The applicable finance charge is 10% per annum. A sum of Rs.2 million was recognised as revenue in the draft financial statements in respect of this transaction.

6. Capitalised research expenditure

When Kothmale moved its operations and established in Sri Lanka, we decided to prepare our financial statements

using International Financial Reporting Standards (IFRS) for the first time. Last week, I received a query from our auditors about an intangible asset that has remained capitalised on our balance sheet for a number of years.

The accounting standards we applied previously allowed us to capitalise early-stage research expenditure on our statement of financial position. The capitalised research expenditure totals Rs.500,000. The expenditure has remained on the balance sheet since we transitioned to IFRS and has not been amortised since. I'm not sure how the research expenditure should have been accounted for and what the accounting implications are for our group financial statements."

7. Board appointment with supplier

In February 2018, I was appointed as the non-executive Chairman of Beta Ltd. Beta supplies Kothmale with raw materials that are used in the production of our hard drives. During the 2018 financial year, sales by Beta to Kothmale totalled Rs.324,000. At the end of the year, the amount outstanding to Beta in relation to these sales was Rs.54,000. In addition, I was paid a salary for my role as Chairman of Rs.100,000 by Beta. Each of these transactions has been correctly accounted for in the financial statements of Kothmale and Beta. However, I'm not sure if we need to consider any adjustments or additional disclosures due to the relationship between myself, Kothmale and Beta.

Regards,

Thilak

Attachment 1:

The following are the summarised financial statements of Kothmale Group (excluding Perera) and its subsidiary, Perera Ltd, at the 31 December 2018:

Statement of Financial Position as at 31 December 2018

	Kothmale Group (exc Perera Ltd)	Perera Ltd
ASSETS	**Rs.**	**Rs.**
Non-Current Assets		
Plant	2,400,000	384,000
- Cost	4,800,000	480,000
- Accumulated depreciation	(2,400,000)	(96,000)
Intangible assets (research & development)	2,500,000	
Investment in Perera Ltd (200,000 shares)	175,000	
	5,075,000	384,000
Current Assets		
Inventory	900,000	350,000
Trade receivables	750,000	60,000
Cash & cash equivalents	1,300,000	18,000
	2,950,000	428,000
TOTAL ASSETS	**8,025,000**	**812,000**
EQUITY & LIABILITIES		
Equity		
Share capital (Rs.1 shares)	2,500,000	200,000
Consolidated retained profit / Retained profit	2,450,000	160,000
Non-controlling interest	320,000	-
	5,270,000	360,000
Non-Current Liabilities		
Long-term loan	1,543,000	420,000
Bond instruments	932,000	
Deferred tax	50,000	8,800
	2,525,000	428,800
Current Liabilities		
Trade payables	230,000	23,200
TOTAL EQUITY & LIABILITIES	**8,025,000**	**812,000**

Statement of Profit or Loss and Other Comprehensive Income for year ended 31 December 2018

	Rs.	Rs.
Profit before tax	1,510,000	57,500
Taxation	(215,000)	(6,300)
Profit for the year	1,295,000	51,200
Profit attributable to:		
Equity holders of parent	1,295,000	

REQUIREMENT:

1. Using Kothmale Group and Perera' financial statements in Attachment 1, prepare a draft Consolidated Statement of Profit or Loss and Other Comprehensive Income, Statement of Changes in Equity and Statement of Financial Position for Kothmale Group for the financial year ended 31 December 2018.

NOTE: In answering Question 1 you may ignore any adjustments for notes 2 to 7 as provided in the above case.

(45 marks)

2. Write a memo to Thilak Silva addressing the following:

Discuss and justify the necessary accounting treatment for each of the outstanding accounting issues (2) – (7) relating to Kothmale Limited. You should provide journal entries, where appropriate.

(40 marks)

3. Assess the main ethical issues arising in the case study and suggest appropriate safeguards or courses of action to resolve such issues.

(15 marks)

[Total: 100 Marks]

END OF QUESTION PAPER