

## Examiner's Report

### AA3 EXAMINATION - JANUARY 2019

#### **(AA31) FINANCIAL ACCOUNTING AND REPORTING**

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Most of the common mistakes made by candidates have been identified and given below. The unsuccessful candidates should take steps to avoid making these types of mistakes in order to be successful at the future examinations:

#### PART A

##### **Question No. 01**

**Part (a)** required the candidates to differentiate financial capital maintenance concept from physical capital maintenance concept in arriving at profits.

**Part (b)** required the candidates to calculate the earned profit of a given business based on the financial capital maintenance concept.

Only a very few candidates answered **part (a)** correctly and obtained full marks. Some were able to define only financial capital maintenance concept. Majority did not know the difference between financial capital maintenance and physical capital maintenance. Lack of knowledge about conceptual framework on financial reporting was seen.

Many candidates calculated the earned profit correctly, but there were candidates who added the capital introduced and deducted the drawings from the difference of closing and opening net assets balances. There were a few candidates who totaled the opening and closing net assets balances from that total, added capital introduced and deducted the drawings. They did not know that closing net assets are arrived from adding additional capital and the profit for the year and deducting drawing to the opening net assets.

**Areas to be improved:** Conceptual framework on Financial Reporting.

##### **Question No. 02**

**Part (a)** required to explain what is meant by "Sustainability Reporting".

**Part (b)** required to state two benefits of Sustainability Reporting

Only a few of the candidates was able to state that sustainability report is a report published by the Organization which gives information about the economic, environmental, social and governance performance. Some have given as it is a financial report.

Some answered **part (b)** correctly. They stated that it gives a holistic view of risks and Opportunities and it helps in streamlining processes for reducing costs and improving efficiency.

**Areas to be improved:** Knowledge on Sustainability Reporting.

### Question No. 03

This question required to determine whether revenue should be recognized as per LKAS 18 in each of the 3 incidents given in **parts (a), (b) and (c)**.

#### Part (a)

Some candidates stated that even though the goods have not been delivered to the customer, there was a sales contract in existence because they have already issued an invoice. Therefore the company has transferred the risks and rewards to the customer and sales should be recognized. There were others who stated that even though items have been invoiced, the risks and rewards have not been passed to the customer and sale cannot be recognized. Students should understand that risks and rewards should be transferred to buyer to recognize the revenue.

#### Part (b)

Most candidates correctly stated that the dividend had been approved on 30<sup>th</sup> March 2018 and Dividend could be recognized as revenue for the year ended 31<sup>st</sup> March 2018. However some have mentioned that dividends could not be recognized as revenue. They did not know at what point dividend is recognized as revenue.

#### Part (c)

Only a very few candidates stated that revenue should be recognized by reference to the stage of completion as at 31<sup>st</sup> March 2018.

They correctly calculated the stage of completion =  $\text{Rs.150,000} / \text{Rs.600,000} \times 100\% = 25\%$  and revenue to be recognized as 25% of Rs.1,000,000 = Rs.250,000/-.

Some stated Revenue for 4 years = Rs.1,000,000/- and for one year revenue is  $\text{Rs.1,000,000} / 4 = \text{Rs.250,000/-}$ . They have calculated without knowing the concept how to recognize.

There were some others who stated revenue to be recognized as Rs.100,000/- by deducting Rs.150,000/- from  $\frac{1}{4}$  of Rs.1,000,000/-.

Of the 3 parts, performance of **part (c)** was poor.

**Areas to be improved:** Knowledge on Application of Accounting standards.

### Question No. 04

Required to prepare the cash flows from operating activities using the direct method. Some candidates used the indirect method. They started with the profit before tax amount. They did not know the difference between direct method and indirect method. Those who knew the direct method showed the cash received from customers, cash paid to suppliers, income tax paid and expenses paid and arrived at the correct net cash generated from operating activities as Rs.74,000/-. Some candidates arrived at Rs.67,500/- as net cash generated from operating activities by deducting debenture interest of Rs.6,500/- from Rs.74,000/-. Some have not deducted depreciation of Rs.12,500/- on expenses. Most of the candidates who used direct method were able to score full marks.

**Areas to be improved:** Preparation of cash flow under the direct method.

## PART B

### **Question No. 05**

Required to compare the performance of a company with the industry based on ratio calculation.

Some candidates compared the ratios of year ended 31<sup>st</sup> march 2017 with 31<sup>st</sup> march 2018 instead of comparing company performance with the industry performance. Question clearly mentioned that how to compare. It shows that students do not read question properly.

When calculating ROCE, some candidates divided the profit before interest and tax by shareholders equity without adding the bank loans. Some candidates took PBIT as numerator and stated capital was taken as the denominator.

Most of the candidates stated that ratios of the company have increased / decreased compared to the industry but failed to comment on the possible reasons for such changes in ratios.

Some candidates wrote lengthy answers without giving the possible reasons for variation of ratios. Such candidates did not score marks but only wasted their time.

**Areas to be improved:** Computation of ratios and how to interpret those.

### **Question No. 06**

This question required preparation of Cash Flow using Indirect method. The performance was good.

But some candidates made the following mistakes:

- (1) Failed to take the net profit before tax of Rs.2,650,000/-. They took the profit before interest and income tax of Rs.2,900,000/-.
- (2) Failed to recognize changes in working capital, financing and investing activities separately.
- (3) Considered decrease in trade payables and increase in inventories and trade debtors as cash inflows.
- (4) Failed to arrive at the correct tax paid amount of Rs.30,000/-.
- (5) Failed to arrive at the profit on disposal of asset Rs.200,000/-.
- (6) Failed to take the depreciation amount as Rs.1,000,000/- instead taking Rs.650,000/- by omitting depreciation of disposed asset amounting to Rs.350,000/-.
- (7) Some do not know about the format used under the indirect method.

**Areas to be improved:** Application of accounting standards.

## Question No. 07

### Part A

Required to prepare **(a)** the lease debtors account and **(b)** Un earned finance Income Account.

More than 50 % of the candidates answered these two parts well.

Common mistakes that were made by some candidates are as follows:

- (1) Leased debtors Account was credited with Rs.2,500,000/- and capital repayment of Rs.356,409.75 was debited to Leased debtor's Account.
- (2) Though the question required the candidate to show the leased debtor's account as at 31.12 2018, entries were shown only as at 31.12 17 without showing the entries relating to year ended 31.12.18. They have not understood that question was given with reference to the 2<sup>nd</sup> year of lease term.
- (3) Some prepared statement in columnar form showing the selling price, annual interest, installment, capital repaid and balance carried forward but failed to show the leased debtors account and un earned finance income account.
- (4) Leased debtors account was debited with Rs.3,907,048.75 on 01.01.17 instead of debiting with Rs.2,500,000/-.
- (5) Leased account was debited with Rs.2,500,000/- and credited with Rs.781,409.75. as at 31.12.17.
- (6) Some have still prepared interest in suspense account.

### Part B

Required to determine how the given two instances will be recognized as per LKAS 10 - Events after the reporting period.

- B (1)** Though candidates answered this as an adjusting event, they have not stated that the loss of Rs.35.5 million should be adjusted in the financial statements.
- B (2)** None of the candidates identified this as a constructive obligation. If there is a practice to pay incentive it has to be adjusted in the financial statements. Otherwise it is not an adjusting event.

**Areas to be improved:** Application of Accounting Standards.

## PART C

### **Question No. 08**

Tested the knowledge on preparing Company Accounts for publication purpose.

Mistakes that were made by the candidates are as follows:

#### **Income Statement:**

- (1) Disposal proceeds of Rs.200,000/- and insurance claim of Rs.300,000/- were not deducted from revenue.
- (2) Failed to add back the adjustment on net realizable value of closing stock amounting to Rs.400,000/- to cost of sales.
- (3) Failed to arrive at the Accumulated depreciation of the disposed lorry amounting to Rs.740,000/-.
- (4) Failed to include the development cost of software as an intangible asset instead charged to income statement as an expense.
- (5) Failed to take in to account the insurance claim of Rs.300,000/- when calculating profit on disposal.
- (6) Failed to deduct insurance over payment of Rs.100,000/- from administration expenses.
- (7) Failed to take in to account the 7 month's depreciation of 140,000 relating to disposed lorry making the total depreciation of Rs.1,900,000/-.
- (8) Failed to calculate depreciation on software for the year.
- (9) Failed to show Rs.260,000/- as damages payable for a law suit under other operating expenses.
- (10) Failed to remove the interest amount of Rs.180,000/- to be capitalized from finance expenses
- (11) Income tax Payable of Rs.1,700,000/- was taken as tax expense for the year.

#### **Statement of Financial position:**

- (1) Interest capitalized has not been taken to Capital work in progress account.
- (2) Rs.500,000/- has been deducted from the inventories without considering the net realizable value.
- (3) Prepaid insurance of Rs.110,000/- has not been identified as a current asset.
- (4) Damages payable amounting to Rs.260,000/- has not been shown as a current liability.

**Statement of Changes in Equity:**

- (1) Failed to take the profit after tax amount to Retained earning column.
- (2) Interim dividend paid has been shown as a deduction from the share capital column.
- (3) Final dividend on ordinary shares was deducted from retained earnings even it is a disclosure only.

**Areas to be improved:**

- (1) Application of Accounting Standards.
- (2) Adjustments relating to Accounting Entries.

**Question No. 09**

**Part A (a)** of the question tested the ability to compute goodwill and preparation of Consolidated Statement of Financial Position

99% of the students attempted this question. In general overall performance of this question was satisfactory

But the following mistakes were made by a few candidates:

- (1) When calculating Goodwill proportionate net assets were taken.
- (2) Fair value of non-controlling interest was not taken when calculating the goodwill.
- (3) Unrealized profits were calculated incorrectly.
- (4) Unrealized profits were debited proportionately to consolidated retained earnings and non-Controlling interest.
- (5) When eliminating intercompany transactions, cash in transit was not considered.
- (6) Goodwill was not taken in the statement of financial position.
- (7) Considering the amount shown as share capital in the Statement of Financial Position, some have added share capital of subsidiary of Rs.20,000/-.

**Part (B)** tested understanding of current ratio, gearing ratio, creditors turnover ratio and possible causes for their variation.

Even though the question required possible reasons for variation, some candidates compared the ratios of the two companies

**Areas to be improved:** Computation of goodwill, adjustments relating to unrealized profits and intercompany transactions. Understanding possible reasons for changes in ratios.

**General points to be considered in developing the level of Understanding of candidates**

- (1) Studying well the full contents of the syllabus completely and develop a thorough understanding about the level of knowledge expected from each unit or area.
- (2) Candidates should read the question carefully and provide answers to the question asked. They should show all the relevant workings related to the computations with clarity.
- (3) State the assumptions clearly if there are any assumptions involved in answering the questions.
- (4) Handwriting should be legible and the numbers of questions should be correctly written. Re-checking of question numbers, etc. before handing over answer script is a must.
- (5) Following correctly the instructions given in the question paper.
- (6) Perusal of past question papers and suggested answers would help sharpening of knowledge, skills and experience. It is always advantageous because the similar patterns and the structures may repeat in the real examination papers.
- (7) Refer Accounting Standards, Articles and Magazines in relation to this subject and other reading materials related to the relevant subject areas.
- (8) Time Management is crucial in the examination. By looking at the marks allocated to each question candidates can make an estimation of the time they require to spend in answering.
- (9) Appearing for the examination with a firm determination of passing the examination with due preparation.