THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

EXAMINERS' COMMENTS

SUBJECT	**SESSION**
Financial Accounting	Intermediate - Autumn 2007

General:

The candidates' performance in this paper was very disappointing. Most of the questions were relatively easy but very few students were able to perform well. It is apparent that although lack of knowledge is an issue but inability to apply the knowledge in practical situations, is an even greater problem, for most students.

Question-wise comments are given hereunder:

Q.1 This question related to the conversion of a partnership into a limited company after retirement of one of the partners. The examinees were required to prepare Partners' Capital accounts with appropriate adjustments necessitated by the revision in the valuation of assets and liabilities based on their fair value. They were also required to prepare realization accounts and the opening balance sheet of the new Company. Although it was a simple question the students made various types of mistakes. The most common among them were the following:

- Most of the students got mixed up and made adjustments required in the partners' capital account in the realization account and vice versa.

- Most of the students were not able to make adjustments related to salary correctly. They credited the entire amount of reversal to F's Account. In fact, the total reversal of 180 thousand (90+90) should have been credited in the partners profit sharing ratio of 5:3:2.

- Very few students could make correct adjustment for reversal of goodwill. Goodwill was correctly credited to the partners in the ratio 5:3:2. But, while reversing the same, many students debited it equally to D and E instead of debiting their accounts in the ratio 5:3.

- Most of the students ignored the expenses incurred on incorporation of Paradise Limited and the preference shares issued in lieu thereof, while preparing the opening balance sheet.

Q.2 This was the worst attempted question. Almost 31% of the candidates did not attempt it at all. Those who did attempt made various mistakes, some of which are described hereunder:

- Very few of the students could calculate the amortization correctly. They missed the basic point that as a first step they should have determined the year of purchase or calculated the used life of the intangible assets S,T & U. The relevant information as regards cost, accumulated amortization under the existing policy and the existing rates of amortization was available in the question. Thereafter, they could easily have calculated the amortization under the revised policy.

- The change in accounting estimate, due to management's decision regarding change in useful life and rate of amortization, was treated retrospectively, instead of considering it prospectively.

- Most of the students used the accounting profit to arrive at the provision for taxation and did not care to add back inadmissible expenses or deduct admissible expenses to reach taxable profit.

- Several students included other income (gain on sale of property) in gross profit.

- Few candidates deducted wastage sale from normal sale while few others added it in admin & selling expenses!

- Prior year's corresponding figures were often omitted.

- Profit and loss account was captioned as "as at 30-06-2007" instead of "for the year ended June 30, 2007".

Q.3 The examinees performed better in this question which required the preparation of Balance Sheet and Profit and Loss Account in accordance with the International Accounting Standards and the Companies Ordinance 1984. However, almost every student made a number of mistakes as discussed below:

- Most of the students failed to calculate the opening balance of the cost and accumulated depreciation of furniture and fixture. Consequently they could not calculate the correct depreciation, for the year.

- A large number of candidates allocated depreciation on plant and machinery to admin and selling expenses also.

- Very few of the students could disclose all the required information in the note related to fixed assets. The disclosure of disposal of fixed assets was completely ignored by most of them.

- Only the notes related to fixed assets and cost of goods sold were required. Many students ignored the instructions and wrote the accounting policies and other notes to the accounts also. As a result, they lost precious time which affected their performance in the other questions. Many such students went on to miss one or more of the other questions altogether.

- Heading of the balance sheet showed "for the year ended June 30, 2007" instead of "as at June 30, 2007" while the heading of Profit & Loss Account showed "as at June 30, 2007" instead of "for the year ended June 30, 2007".

- Sub-heads such as Non-current Assets, Equity and Non-current Liabilities were missing or erroneously stated as Long-term Assets, Share Capital and Reserves, Long-term/Deferred Liabilities, respectively.

- "Property, Plant and Equipment" was termed as "Fixed Assets" or was inter-changed with "Non-Current Assets".

- Loss on sale of fixed assets, was shown as a part of Administrative Expenses.

- Advertising and selling expenses were also apportioned to manufacturing costs.

Q.4 This was an easy question requiring calculation of impairment loss by comparing the recoverable amount with the carrying value of assets. The recoverable amount is the "fair value less incremental costs to sell" or "value in use" whichever is higher. A large number of students were aware of the above rules and easily got full marks. Some of the students incorrectly considered the lesser of the two as the recoverable amount while many others, incorrectly included the proportionate cost of legal adviser in the incremental selling costs. Several candidates worked out the impairment loss on an overall basis instead of calculating it for individual assets separately.

Q.5 The question tested students' knowledge of IAS-37 on provisions, contingent liabilities, contingent assets and its application to practical scenarios. According to the IAS a provision is required to be made if three conditions are met i.e.

(i) A present obligation exists at the date of the balance sheet.
(ii) It is probable that the outflow of economics resources will take place.
(iii) The outflow can be estimated reliably.

Although it was an open book examination the students were still unable to use the above criteria in making various decisions. Most candidates betrayed their weaknesses and arrived at incorrect conclusions. Moreover, in a large number of cases, the suggested treatment was not supported with any logical reasoning. Besides the above, the following mistakes were generally witnessed in most of the answers:

Part (i):

- The donation from city council was considered a receipt and netted off against restoration costs, resulting in a net provision of Rs. 150,000.

- Several students gave journal entries which were not required.

Part (ii)

Two types of obligations were apparent from the question i.e. the obligation to subsidize the meal and the obligation to construct the canteen. With reference to the subsidized meal, some of the examinees claimed that a constructive obligation has been created on completion of six months after commencement of commercial production and hence a provision should be made. Many others claimed that no obligation has been created as the same was created after the end of the year when the company decided to pay full amount and meal expenses, hence provision should not be made. Both arguments carried weight and were acknowledged as correct. However, those who did not give any reason to support their decision lost valuable marks.

As regards the construction of canteen, several students stated that construction cost should be provided. In fact, construction cost being a capital cost did not require any provision. At the most, it needed to be disclosed as a capital commitment.

Another obligation was created due to the company's non-compliance with the requirement of the law i.e. the probable penalty/fine for legal non-compliance. Most students forgot to discuss this obligation in the light of IAS-37.

Part (iii)

This part was relatively better attempted as the students were generally able to analyze as under:

- Actual sales returns relating to sales in June 2007 cannot be ascertained at the time of authorization of the financial statement by the Board. Therefore the provision there-against shall continue to be the same i.e. based on management's estimate of 40% of 10% of 32 million.

- The provision against sale returns relating to May 2007 should be adjusted to a total of 0.84 million i.e. 40% of 2.1 million.

Some of the students however made the following mistakes:

- Ignored the fact that the returned goods can be sold for 60% of the selling price.

- Declared that since G.P. ratio was not available, the amount of loss on account of sales returns could not be ascertained.

Q.6 The question involved three steps as given below:

- Identifying whether a particular cost falls under "research phase" or "development phase" or did not fall in any of them.

- If classified as a development cost, testing whether it meets all the six conditions necessary for recognition as an intangible asset.

- Making a decision whether the particular cost as given in the question should be charged as expense or recognized as an intangible asset.

The result in this question was also poor mainly because the students did not analyze the situation correctly and therefore could not properly evaluate each cost in the light of the above criteria.

Some of the specific errors committed by the examinees are described below:

- Confusing or inaccurate answers were given such as "charge as expense for intangibles", "to be recognized", instead of clear answers like charge off as research expense or charge off as selling expense or capitalize as a tangible asset or capitalize as intangible asset etc.

- Extracts of IAS were reproduced without relating the criteria specifically to each case.

- A large number of students declared that Cost of furnishing new laboratory should be charged off as they pertained to research phase. They failed to realize that they were capital items and should have been capitalized in any case. However, the depreciation thereon, pertaining to the period relating to the development phase could have been included in the cost of intangible asset.

- Similar treatment was required in case the useful life of the tools purchased exceeded one year. However, very few students discussed the issue of useful life.

- Cost of conducting the test on the device and the cost of preparation of technical feasibility were declared as development costs. At the time the above expenses were incurred, the outcome was uncertain and therefore these should have been charged off.

- Many examinees declared that material imported for commercial production and product launching expenses were development stage expenditures. In fact these are post development phase expenditures and should be included in manufacturing expenditure and marketing & selling expenses respectively.

(THE END)