FINANCIAL ACCOUNTING

Q.1 In this question on lease accounting, two situations were given and in each case the examinees were asked to decide whether it was a case of finance lease or operating lease. The response was quiet reasonable however very few students could achieve full marks. The common mistakes were as follows:

- Very few of the students could identify all the five conditions specified in the IAS.
- Extremely few students specified the fact that even if one of the condition is met, the lease should be classified as a finance lease.
- Many students decided that both transactions should be classified as operating leases, on the basis of one or two conditions only.
- Most of the students claimed that a Bargain Purchase Option was available to the lessee. They ignored the fact that since bargain price was to be determined through negotiations between the two parties, it was not necessary that the negotiated price will be attractive enough and the lessee may not exercise the option.

Q.2 In this question, four situations were given and in each case, the examinees were required to determine the date on which revenue will be recognized. The response of the students in each part of the question is discussed hereunder:

(i) Many students were of the view that price of the systems should be recognized as revenue on delivery whereas installation charges should be recognized when the installation was complete. However, according to IAS 18 “Revenue”, an entity retains significant risks of ownership if the installation which is a significant part of the contract, has not been completed.

(ii) About 50% of the students erroneously stated that revenue should be recognized since the annual fee was non-refundable. Actually in such cases, revenue recognition should be equally distributed over the period of the contract.

(iii) A large number of students stated that since 25% of the revenue had to be received even in case of cancellation of the deal, the same should be recognized immediately on signing of the contract. However they must understand that cancellation charges are meant to compensate the seller and could be recognized only if the cancellation takes place. Otherwise, it will be treated as an advance and shall be recognized as revenue when the significant risks and rewards of ownership are transferred i.e. when the systems are delivered in a condition acceptable to the buyer.

(iv) One of the conditions necessary for revenue recognition is that the seller should be in a position to measure the revenue reliably. Hence in this case the sale should have been recorded after the discount had been finalized. Many students could not answer this part correctly.

Q.3 Most of the students calculated the relevant ratios correctly, however very few of them could analyze the situation in a proper way.

A large number of students gave a very high weightage to current ratio and quick ratio and therefore agreed with the observation of Mr. Pink. The comments were mostly lacking as regards the following:

(i) The students failed to recognize that the current ratio of company A i.e. 1.54 was not bad either, although it was lower than that of company B.

(ii) Only about 1/3rd of the students commented on the other relevant ratios i.e. Stock Turnover Ratio and Debtors Turnover. Most such student only mentioned that Company B was better in this case. They could have secured relatively more marks by explaining the implications of a highly adverse Stock Turnover Ratio and Debtors Turnover.

Q.4 The performance of the students in this question was generally poor. The common mistakes were as follows:

- Many students were totally unprepared and produced Statement containing a single column only.

- The entry to record the proposed dividend of Rs. 42.0 million was required to be reversed. Instead, a large number of students reversed the paid dividend of Rs. 25.0 million also.

- The cost incurred on testing of a new plant had been debited to intangible assets. While making the correcting entry many students credited accounts such as “Cash”; “Cost of Testing” and “Capital Work in Progress” etc., instead of crediting “Intangible Assets”.

- Most students passed entry to correct the amortization that had been recorded in 2006 only. The amortization recorded in 2005 was mostly ignored. Moreover, only a few of them knew that while making correction for 2005, Retained Earnings will be credited and in the Journal Entry to correct amortization charged in 2006, Administrative Expenses will be credited.

- In the adjusting entry to record depreciation on plant, many students credited “Plant and Machinery” instead of crediting Accumulated Depreciation.

- While passing the entry to record bad debts most students could not understand that since the security against trade debts had been impaired in the year 2006; the full amount of Rs.11.0 million should be charged to the year 2006. Moreover, while recording the provision, many students credited “Trade Debts”, instead of crediting “Provision for Bad Debts”.

- Very few students were able to compute the opening balance of retained earnings for 2005 correctly. It should have been determined by adding the amount of dividend paid during 2005 i.e. 22 million to the balance of retained earnings, as shown in the trial balance.

- In the Statement of Changes in Equity, a large number of candidates showed the figures related to 2006 only.

Q.5 Most of the students could not attempt this question correctly and made many mistakes. Some of the common mistakes were as follows:

- Shareholders equity and down payments from buyers were included in the calculation of weighted average rate of financing.

- According to the given scenario, documentation cost of 2.5 million and a portion of the cost of land preparation i.e. 7.5 million was financed through shareholders equity and carried no financing costs. Most students incorrectly applied the weighted average rate of borrowing on the above costs also.

- Capitalization of financing cost should commence from the date the payment was made or the date on which finance was obtained, whichever was later. Most candidates computed the cost of borrowing from the dates the loans were obtained.

- The capitalization should have stopped, on November 30, 2006 i.e. the date of completion of the project. Most candidates computed the same, till the end of the year i.e. December 31, 2006.

Q.6 This question consisted of seven parts. The students were required to discuss each case as regards the disclosure of related party relationship and related party transactions, in the financial statements.

The mistakes which many students repeated were as follows:

- They gave their decisions without discussing the basis of their decision.

- In part (ii) many students were of the view that since Mr. Slim was formerly a senior executive of the bank, the bank is a related party of Yellow Limited. However, there is no such condition in IAS 24.

- A major supplier as was the case in part (iii) could be a related party only if it can influence the decision of its customer. Most students reached their conclusions, both in the affirmative and otherwise, without giving any reasons thereof.

- In part (iv) many examinees incorrectly stated that any benefit given to the CEO in accordance with the Company's policy for all employees, need not be disclosed in the financial statements.

- In part (v) it was clear that a related party relation shall be deemed to exist if Mr. Clear is in a position to influence his nephews. Most of the students were not able to answer correctly.

- In part (vi) and (vii), related party relationship existed but no transactions were carried out. Most of the students ignored this fact and declared that the relationship as well as the transaction was required to be disclosed in the financial statements.

Q.7 This question was attempted very poorly as the students didn't seem to have studied the topic thoroughly. Conceptual understanding was very poor. The question needed to be answered in four steps viz.

- Calculation of correct accounting income
- Calculation of taxable income
- Calculation of deferred tax
- Passing journal entries.

The most common mistakes were as follows:

- Many students ignored the first step altogether

- Most of the students tried to combine the first two steps and got confused.

- Most students were unable to ascertain that since no future tax benefit was available to the company in respect of Product Development Costs, the tax base should be considered as zero.

- Many students computed deferred tax on Research Costs also, inspite of the fact that such cost had been fully charged off, for accounting as well as tax purposes.

- Surprisingly, a large number of students passed separate journal entries for tax as well as accounting depreciation, research costs and amortization.

- The interest paid to directors should have been added in accounting income to arrive at taxable income. In many cases it was shown as an adjustment to arrive at accounting income.

- Many candidates computed deferred tax on interest to directors, which was totally incorrect.

- A large number of students were not able to pass the journal entry related to deferred tax correctly and made all sort of incorrect entries.

(THE END)