Examiner's report

F3/FFA Financial Accounting
December 2012

General Comments

Candidates continue to perform well in those syllabus areas which are brought forward from FA1 and FA2 and built upon at this level. The questions with the highest pass rates on this paper included:

- Books of prime entry
- Processing of ledger accounts
- Correction journals
- Inventory valuation
- Statements of cash flows

However, review of candidates' performance in December 2012 continues to show that there is little improvement from the last two sittings on questions testing preparation of simple consolidated financial statements.

Questions with the lowest pass rates included:

- Calculation of consolidated income statement extracts
- Identification of associates and describing the principle of equity accounting
- Accounting effects of a revaluation of a non-current asset

The following examples were three of the questions with the lowest pass rates on the paper. The aim of reviewing these questions is to give future candidates an indication of the types of questions asked and guidance on dealing with exam questions, as well as a technical debrief on the topics covered by the specific questions selected.

Sample Questions for Discussion

Example 1

The following information is available for the year ended 31 October 2012:

Property	$
Cost as at 1 November 2011	102,000
Accumulated depreciation as at 1 November 2011	(20,400)
	81,600

On 1 November 2011, the company revalued the property to $150,000.

The company's policy is to charge depreciation on a straight-line basis over 50 years. On revaluation there was no change to the overall useful economic life. It has also chosen not to make an annual transfer of the excess depreciation on revaluation between the revaluation reserve and retained earnings.

What should be the balance on the revaluation reserve and the depreciation charge as shown in the financial statements for the year ended 31 October 2012?

	Depreciation charge	Revaluation reserve
	$	$
A	3,750	68,400
B	3,750	48,000
C	3,000	68,400
D	3,000	48,000

The correct answer is A. The most popular incorrect answer was C.

The volume of data given in this question can appear overwhelming, but with the good exam technique of reading the question stem first, one part of this question can be answered quickly and efficiently.

From the question stem, the revaluation reserve balance as at 31 October 2012 is being asked for. When revaluing an asset, it is the carrying value of the asset which is revalued, rather than the cost, and as the question states there is no annual transfer of the excess depreciation, the balance on the revaluation reserve can be found as:

$150,000 - $81,600 = $68,400

It is good to see that candidates had spotted this, as the most popular incorrect answer option of C also uses $68,400.

The tricky bit of this question, which is commonly tested at this level, is what the new depreciation charge will be. As the revaluation takes place on 1 November 2011, a whole year's depreciation is calculated on the revalued amount. The new charge will take the revalued amount of $150,000 and depreciate the asset over its **remaining** useful economic life.
The question does not tell us how long we have had the asset for, but by looking at the accumulated depreciation brought forward we can tell how old the original asset is:

Original depreciation charge:

$102,000/50 years = $2,040 per annum and as $20,400 is accumulated depreciation brought forward, then the asset must have already been held for 10 years.

Therefore, the remaining useful economic life is 50 years – 10 years= 40 years

The new depreciation charge should be calculated as: $150,000/40 years = $3,750

The incorrect answer option of C, calculates the new depreciation charge as $150,000/50 years= $3,000.

Example 2

According to IAS 28, *Investments in associates*, which, if any, of the following statements are correct?

(1) Equity accounting will always be used when an investing company holds between 20%- 50% of the equity shares in another company

(2) Dividends received from an investment in associate will be presented as investment income in the consolidated accounts.

	Statement 1	Statement 2
A	Correct	Correct
B	Correct	Incorrect
C	Incorrect	Correct
D	Incorrect	Incorrect

The correct answer is D. The most popular incorrect answer was C.

Taking each of the statements in turn:

(1) The key word to pick out of the first sentence is always. This is incorrect. Firstly, if an investing company holds 30% in another company and has no other investments, consolidated accounts would not be produced and therefore equity accounting would not be used. Secondly, despite an investing company having a 20% holding in another company, significant influence may not exist. i.e. another company may hold the remaining 80% of the shares and hence equity accounting would not be used in the investing company books. Statement 1 is incorrect

(2) In the consolidated accounts, the basic principle of equity accounting is that the group's share of the associate's profit after tax is included, not the dividend income which would be shown in the investing company's own income statement. Statement 2 is incorrect

Example 3

Tulip Co acquired 70% of the voting share capital of Daffodil Co on 1 March 2012.
The following extracts are from the individual income statements of the two companies for the year ended 31 August 2012:

	Tulip Co	Daffodil Co
	$	$
Revenue	61,000	23,000
Cost of sales	(42,700)	(13,800)
Gross Profit	18,300	9,200

What should be the consolidated gross profit for the year ended 31 August 2012?

A $21,520
B $22,900
C $27,500
D $24,740

The correct answer is B. A significant number of candidates selected the incorrect answers of C and D. These include common errors which are discussed below.

When answering questions on the preparation of consolidated financial statements, there are two important facts to establish quickly:

1) What is the size of the holding acquired?
2) What is the date of acquisition?

Firstly, it is identified from the first sentence in the scenario, that control has been established. I.e. Tulip Co had acquired a 70% holding. This means that Daffodil Co will be consolidated as a subsidiary, on a 100% line by line basis to reflect control. Answer option D is incorrect as it consolidates Tulip Co's gross profit with only 70% of Daffodil Co's gross profit. Answer option C, which adds all of Tulip Co's consolidated gross profit and 100% of Daffodils Co's gross profit would also be incorrect, as you must consider the second issue.

In this question, as important as the size of the holding acquired, is the date on which it is acquired. The 70% holding was acquired on 1 March 2012, which means that during the year ended 31 August 2012, Daffodil Co had only been a subsidiary for 6 months of the year. Only post acquisition results of the subsidiary should be consolidated.
This means the consolidated gross profit would be reported as:

Tulip Co	$18,300
Daffodil Co ($9,200 x 6/12)	$ 4,600
Consolidated gross profit	$22,900 – correct answer B.

It is interesting to note that the two most popular incorrect answer options of C and D, did NOT take into account the date of acquisition and shows that candidates had therefore missed the 6 months mid-year acquisition of Daffodil Co.

Conclusion

In this exam, some of the worst answered questions continue to involve core syllabus areas, including consolidation MCQs. This suggests that more work is still needed. Careful reading of the question stem, all the answer options and applying a methodical approach should help candidates improve their attempts.

In preparation for this exam, it is essential that students do not try and rote learn syllabus/subject areas and that they practise questions which will help them understand the topics and enable them to apply their knowledge to any questions presented to them.