Examiner's report

F3/FFA Financial Accounting

For CBE and Paper exams covering January to June 2015

General Comments

Section A of the examination consists of 35 multiple choice questions of two marks each, covering a broad range of topics on the syllabus. Section B has two longer questions (15 marks) testing the candidates' understanding and application of financial accounting skills in more depth. Thus, all questions are compulsory.

The following paragraphs report on each section and focuses on some of the key learning points.

Section A

This section tests a wide range of the syllabus; some questions test knowledge, whilst others require the application of accounting techniques and detailed calculations. Candidates are advised to attempt all the questions; even if they are undecided on the correct answer (after doing their own calculations) they should always choose an answer.

Candidates preparing for the next examination of FFA/F3 are advised to work through the sample of questions illustrated below and those provided in previous examiner's reports. They have been chosen to help candidates understand some of the questions that past candidates have found more difficult. Carefully review how each of the correct answers are derived.

Sample questions for discussion

Example 1 *(based on question 13)*

S Co has the following share capital in issue at 31 March 2015:

30,000 2% $1 irredeemable preference shares
20,000 4% $1 redeemable preference shares
100,000 50c ordinary shares

What amount will be included as equity capital in the statement of financial position at 31 March 2015?

A $130,000
B $70,000
C $80,000
D $100,000

This question is testing whether the candidate understands the different forms of financial capital i.e. debt or equity, and how they are treated in the financial statements.

Debt requires the payment of interest (or the transfer of some other form of economic benefit) to the provider of the finance, whereas equity gives the provider of the finance a right to share in the residual assets of the business should it cease to trade. Some forms of finance have the characteristics of both debt and equity, for example preference shares. It is therefore important to understand the type of preference share when deciding upon its treatment in the statement of financial position.

In this example the 30,000 2% $1 irredeemable preference shares do not have to be repaid and are therefore treated as equity. The 20,000 4% $1 redeemable preferences will have to be repaid to the preference shareholders so are regarded as debt and shown as a liability on the statement of financial position. The 100,000 50c ordinary shares are equity and will be shown as $50,000 in the statement of financial position.

The correct answer to this question is therefore C, i.e $30,000+ $50,000 = $80,000.

Example 2 *(based on question 28)*

F Co's statement of profit or loss for the year ended 31 March 2015 shows a profit for the year of $575,000. During the year, an ordinary dividend of $130,000 was paid and land costing $600,000 was revalued to $640,000.

What was the total comprehensive income for the year?

A $40,000
B $485,000
C $575,000
D $615,000

This question is testing whether a candidate understands the difference between the statement of profit or loss and the statement of comprehensive income. The statement of profit or loss summarises the incomes earned and expenses incurred during the financial period. The statement of comprehensive income is an extension of the statement of profit or loss to include unrealised gains, for example on the revaluation of intangible assets.

In this example the ordinary dividends of $130,000 are not relevant to answering the question, as they do not affect the statement of profit or loss or the statement of comprehensive income. The total comprehensive income for the year is $615,000 i.e. $575,000 (profit from the statement of profit or loss) + $40,000 (the unrealised gain on the land revaluation). The correct answer is D.

Example 3 *(based on question 34)*

The following information relates to L Co and M Co.

L Co	M Co	
Equity	$1,500,000	$1,500,000
Profit before interest and tax	$100,000	$100,000
Gearing ratio	25%	35%

Both companies borrow money at an interest rate of 5% and no new loans have been taken out during the year.

Based on this information, which of the following statements is TRUE?

A M Co's interest cover is higher than L Co's
B L Co's interest cover is higher than M Co's
C L Co and M Co have the same interest cover
D It is not possible to draw any conclusions regarding interest cover from the information provided

To answer this question the candidate needs to understand two key ratios: the gearing ratio and the interest cover ratio. Gearing is the level of external debt a company has (e.g. outstanding loans) in comparison to equity. Using the gearing ratio it is possible to calculate the amount of external long term debt each company has:

	L Co	M Co
Long Term Debt / Equity	Long Term Debt / $1,500,000 = 25%	Long Term Debt / $1,500,000 = 35%
Long term Debt =	$375,000	$525,000

Both companies pay 5% interest on debt therefore:

	L Co	M Co
Interest =	$18,750	$26,250

The interest cover ratio indicates the ability of a company to pay its interest out of profits. As both companies have the same profit before interest and tax it is obvious that L Co cover is higher that M Co's. However, for completeness the calculations are shown below:

	L Co	M Co
Interest cover = PBIT / Interest payable	$100,000 / $18,750	$100,000 / $26,250
Interest cover =	5.3	3.8

The correct answer to this is question is therefore B.

Section B

In this section candidates are required to prepare more in depth answers which usually test a candidate's ability to draft financial statements.

Candidates are often unsure of the correct format in which to present their answer and how to apply various accounting techniques. Neat and logical workings should always be presented so that marks can be awarded for method, even if the final answer is wrong.

The following comments explain how candidates might be able to improve their performance in future, for two financial statements:

Consolidated Statements of Financial Position

- In the paper version of the exam, use the correct format for a consolidated statement of financial position.
- Give the statement it's correct title i.e. "Consolidated statement of financial position at *(year-end date)*"
- The assets and liabilities of the parent and the subsidiary are added together on a line-by-line basis.
- The investment in the subsidiary (shown in the parents SoFP) is replaced with a goodwill figure. Where necessary, show clearly your workings for the goodwill figure.
- The share capital and share premium balances are not added together; only the balances related to the parent are used in the consolidation.
- The group share of the subsidiary's profit is calculated and added to the groups retained earnings. Where necessary, clearly show workings for the calculation of retained earnings.
- If there is intra-group trading then adjust the receivables and payables that cancel each other out.
- Any dividends paid by the subsidiary to the parent should be adjusted, as the net effect to the group is zero.
- Adjust for any unrealised profits on sales of inventory between the parent and the subsidiary.

Preparing a Statement of profit or loss for a sole trader

- Carefully read through the information provided in the question and decide what should be included in the statement of profit and loss. Remember not everything in a trial balance may be needed.
- Consider any notes provided and decide what adjustments or calculations are required e.g. prepayments or accruals.
- Exam questions of this type typically require a depreciation figure to be calculated using a stated method.
- in the paper version of the exam, always show your workings and reference them to the figures in the statement.

Conclusion

Overall, many candidates might still be able to improve their marks by learning the format of the key financial statements, and focusing on their exam technique. Candidates should carefully manage their time to ensure that all questions are answered.