

KE1 – Financial Accounting & Reporting Fundamentals

September 2016

Examiner's comments

Question-wise comments

Question 01

The candidates were required to answer 10 multiple choice questions carrying 20 marks in total. The average score obtained for this question was between 14 – 16 marks.

Majority of the candidates made mistakes in choosing the correct answer for the following questions.

- a) In Q 1.6, answers (A) and (B) are somewhat similar. But in the question it is asked about the qualitative characteristics of financial information. The students who did not read the question carefully made mistakes in answering this question.
- b) In Q 1.7 students were tested on the basic knowledge of Control. Majority of the candidate indicated that A Ltd has non-controlling interest in B Ltd and chose an incorrect answer (B).
- c) In Q 1.9 The candidates were required to compute ROCE using given information. Majority made mistakes in this computation. PBIT should have been taken as the numerator by adding the interest cost to the given figure of profit before taxation. But most of the students deducted the interest cost from the PBT and arrived at an incorrect answer of 6.8% (answer B) whereas the correct answer was 11.4% (answer A).

Question 02

This question had 10 different parts testing the candidate's knowledge on various topics. Short answers were expected from the students giving due consideration to the action verb used in the question.

Performance on this question overall was not satisfactory. Some of the common mistakes made by the candidates were as follows.

- Students have not properly read the question/ scenario.
- Question numbers were not mentioned in the answer scripts

- Misallocation of time among the questions
- Very poor handwriting by some candidates
- Incomplete sentences in the formulation of answers.
- A few cases of lengthy paragraphs instead of short answers were noted.

Comments on the individual questions are as follows.

- 2.1 The candidates were required to write journal entries to correct some errors in recording transactions. Performance was good on this part. Almost all the candidates had answered well and scored full marks.

Some candidates made a few fundamental errors and did not score full marks.

Eg: Some candidates passed JEs to the day book. Instead of passing entries to the sales account, some passed the entry to the sales day book. It appears that these students do not understand the basic concepts of bookkeeping (prime entry books and double entry books)

- 2.2 This question was based on control accounts. Majority answered this question also very well. However, some candidates did not know that the correct total of the individual trade receivable account balances should equal the control account balance.

- 2.3 This question tested the knowledge of the revenue recognition criteria. It was seen that most students did not have sufficient knowledge of the revenue recognition criteria.

Eg: i) Some students wrote that it should be definite that future economic benefits will flow to the entity. And revenue should not be recognized if it cannot be measured definitely without doubt.

ii) Some wrote that revenue should be recognized on accrual basis and not on cash basis.

iii) Some others spent time unnecessarily writing lengthy answers explaining separately how each component of revenue should be recognized, i.e., revenue from sale of goods, sale of services, interest, royalty etc.

- 2.4 This question was about initial and subsequent measurement of a fixed asset (machinery). Answers for part (a) in computing the initial measurement was fairly satisfactory. However, there were a few students who had added general overheads also in capitalizing the asset.

But the performance on part (b), subsequent measurement of the asset was very poor. Very few students scored the 1 mark allocated to this part. It was noted that majority of the candidates had not understood the question and as a result could not provide satisfactory answers.

The answer expected was to mention that subsequently an entity can use either the cost model or revaluation model. But majority of answers did not contain these points.

Eg: i) Most candidates said the asset should be depreciated on straight line or reducing balance basis, over its useful lifetime.

- ii) Some others wrote that subsequent measurement is necessary for revaluation purposes and/or disposal purposes or for providing correct depreciation
- iii) Some others mentioned the type of subsequent expenses that can be capitalised, after initial recognition

2.5 This question was about prior period errors.

Majority students thought that there is one answer for both scenarios. Therefore majority answered that (i) and (ii) both cannot be prior period errors. Some other candidates correctly identified that scenario (i) relates to accounting policy and (ii) relates to a change in accounting estimate, but did not explain whether they result in prior period errors or not. Therefore the answer given was not for the question asked and these students did not score any marks as a result.

The second part of this question referred to how a prior period error should be corrected. A fair number of candidates knew that the correction should be made retrospectively. They knew the term “retrospectively” but did not know the meaning of it. Majority went on to explain that retrospective effect means going back to the respective period in which the error occurred and adjust it in that year’s financial statements by reissuing new audited FS.

Some other irrelevant and incorrect answers were also seen Eg: A few said prior period errors should be corrected through a general journal and channeled through revaluation surplus account.

In this question the action verb used was “state” and therefore the expectation was a direct short answer. However, students spent time unnecessarily explaining at length.

2.6. This question was about events after the reporting period. The action verb was “discuss”. However, majority of candidates chose to write whether the scenarios gave rise to adjusting event or non-adjusting event only. Reason why adjusting event or not was not explained and therefore did not score the full marks.

The loss of marks was due to not paying proper attention to the action verb used in the question. The performance on this question was below the satisfactory level.

Eg:

- i) Some students mixed up adjusting and non-adjusting events
- ii) Reason, justification given was incorrect- Eg: an event should be adjusted depending on its materiality. A destruction of asset by fire subsequent to reporting date should be adjusted as the asset existed at end of F/Y.
- iii) Some answers were incomplete. Without saying whether it is a adjusting event or not candidates wrote that “it should be reported”. Therefore did not score any marks.

2.7 The question was on deferred tax- recognising taxable temporary differences and deductible temporary differences.

About 20%- 25% of the candidates have mixed up taxable and deductible temporary differences. On average, candidate’s knowledge on this topic is not satisfactory. Very few students scored 3 out of 3 marks.

- 2.8 The question was on accounting for Finance lease transaction. It was noteworthy that most of the candidates failed to answer this part of the question or provided incorrect answers. Knowledge on this topic was also seems to be very poor.
- 2.9 The question was on the disclosure requirements of a contingent liability. A fair number of candidates have attempted to provide some answer. But most of them had either written the recognition criteria of a liability or defined what a contingent liability is. Therefore very few students scored on this part.
- 2.10 This question tested the candidate regarding the classification of two separate financial assets. Performance was very poor on this question as well. Very few candidates scored marks for this.

Majority (almost all of the candidates) answered that scenario (i) is a current asset and (ii) is a non-current asset. Therefore majority of answers were irrelevant.

Overall, the last four parts of the question (2.7 onwards) was performed very badly. The number of candidates who did not attempt these parts was also high. As a result the overall performance on question 2 fell short of expectation.

Question 03

This was one of the optional questions carrying 10 marks, but was well attempted by many. The question had two parts.

- Part (a) required the candidates to compute the profit earned by a business during a period where opening and closing net assets values and certain transactions during the year were given. This was a simple computation carrying 2 marks.
- a) A considerable number of candidate failed to understand that purchase of a PPE item would not have any impact on the net assets as the increase in PPE would counter balance the decrease in cash (if a cash purchase) or increase in creditors (if a credit purchase).
 - b) Without understanding this principle, students adjusted the purchase of PPE too and therefore lost some of the marks.
- Part (b) of the question was based on the principles of bank reconciliation. A fair number of students scored well on this section. However, following gaps in knowledge level were observed.
- In a proper bank reconciliation statement there will be adjustments for (i) unrealized deposits and (ii) unpresented cheques only. Any other entries missed out or errors made should be adjusted in the bank balance as per cash book in order to arrive at the correct balance as per cash book. It was noted that this concept is not understood by many. Candidates were aware of how to add or deduct the adjustments and arrive at a final answer, without understanding the proper way of doing it.

Question 04

The scenario tested here was on Partnership accounts. The students were required to prepare the adjusted Profit and Loss Account and the Appropriation account of a partnership business and further to prepare the SOFP of the partnership.

This question also carried 10 marks and was one of the optional questions.

The question was well attempted and a fair number of candidates have understood the question, and what is required of them. Following shortcomings in the candidates' answers were observed.

- Partners Salary Adjustment - One partner has been overpaid and another partner had been underpaid as per the information given in the question. Some candidates were confused as to the value to be shown in the appropriation account. Some of the candidates showed only the over payment and the underpayment. This shows that the principles are not properly understood.
- Vehicle taken over by one partner- this value should be treated as drawings and instead some of the candidates adjusted this to the relevant partner's Capital Account.
- In arriving at the profit on disposal of the vehicle taken over, a fair number of candidates failed to adjust for the accumulated depreciation and the overcharging of 3 months depreciation in the P&L account.
- Stock taken by S has been adjusted incorrectly- either by debiting P&L or deducting from closing inventory or both.
- Interest on capital was provided for the full year instead of for 9 months.
- Some of the students lost marks as they have not given proper workings. The question does not require the students to show the partners current account and the capital account entries separately. However, in order to arrive at the final value for the SOFP, this working is necessary. The marking examiners could not award marks without workings when the final answer was incorrect. However, such students may have done some of the adjustments correctly and some others incorrectly. In situations like this the candidate fails to score part of the marks for the correct adjustments he may have done in the absence of the workings.

Question 05

This was also one of the optional questions. Candidates knowledge on preparation of Financial statements of a nonprofit organization was tested in the first part (part a) of the question.

Part (a) of the question had 6 marks in all, and only the income and expenses account was required to be prepared. The students who attempted this part had scored well. However, the following common mistakes were noted.

- Income and Expense account was debited with the cost of purchase of chairs, Rs 95,800/=
- The donation expenses and donation income had been incorrectly netted off.

Part (b) was a theory question carrying 4 marks. The question required the candidates to explain the accounting treatment for specific donations received by a nonprofit making organization. Although this was direct from the study text, the performance on this part was very poor. Almost no candidate scored more than 2 marks out of the 4 marks allocated to the question.

Majority did not know that special donations are not revenue receipts, but capital receipts and it should be maintained in a special fund created for that purpose. Quite a number of candidates wrote that it should be credited to P&L as income and the expenditure also expensed.

Some others who identified correctly that special donations are capital receipts were not clear on the accounting treatment and disclosures.

There were no complete answers on the accounting treatment and therefore as a result of the unsatisfactory performance on this part, the overall marks for question 5 was below the expected level.

Question 06

In this question, the candidates' knowledge on preparation of financial statements from incomplete records was tested. The performance on this question was good.

Most of the candidates understood the information in the question and what was required of them. And therefore managed to score good marks for this question. However, careless mistakes made by some of the candidates resulted in them not being able to score some of the 'easy' marks. Following are the common errors and the mistakes made by some of the candidates.

- Not showing proper workings of the trade receivables and payable accounts. Some students lost easily obtainable 2 to 2 ½ marks due to this.
- Adjustment No 7 relating to the settlement of a debt by a customer, treated as cash sales was not correctly adjusted by many candidates. Some candidates deducted this value from cash sales which was correct, but did not adjust the debtors account.
- Some candidates made errors in identifying the pre-payments and the accruals correctly and making necessary adjustments in the P&L Account. As a result, the closing balances of electricity and telephone and rent were incorrect.
- A few candidates have shown Solomon's drawings as expenses in the P&L account.
- Although the question clearly mentioned that only the computer purchased during the year only has not been depreciated, some candidates provided depreciation at 20% for all assets.

Question 07

This is one of the compulsory questions carrying 20 marks. In this question the candidate's knowledge and ability to prepare financial statements for the management and for publication is tested.

As always, the question had three parts, namely: the preparation of Comprehensive Income Statement, Preparation of Statement of Changes in equity and Preparation of SOFP.

The performance of the candidates was below the expected levels. Most of the adjustments focused on accounting standards (Leasing, Valuation of AFS asset, disposal of a revalued asset etc.....) deviating from the routine standard adjustments seen in previous question papers. Candidates did not shown familiarly with these adjustments and therefore performance on this question was below expectation.

Some of the common mistakes observed are as follows.

i) In the Comprehensive Income Statement and SOFP-

- Knowledge on the items that should be recorded under OCI is very poor. Only a handful of the candidates recorded the fair value gain on AFS investment (Rs 19,000/=) in the OCI

- Most of the candidates either had not understood or mis-interpreted the OCI statement as a part of double entry. Some candidates re-transferred the revaluation reserve to the OCI in working out the loss on disposal of machinery.
- A large number of candidates correctly computed the current year's income tax provision (i.e. $310,000 \times 28\% = 86,800$) but failed to adjust for overprovision of previous year Rs. 15,000) and thereby lost some of the marks.
- Almost all candidates were not conversant with accounting for operating leases. A few candidates incorrectly recorded it as a financial lease and recorded a non-current liability ($\text{Rs. } 100,000 \times 10 - \text{Rs. } 100,000 \times 4 = \text{Rs. } 600,000$) and its current portion as Rs.200,000. Correct computation of the lease rent charge to P&L was seen only in a handful of answer scripts.
- The provision for guarantee ($\text{Rs. } 500,000 \times 80\% = \text{Rs. } 400,000$) was overlooked by a large number of candidates and no entries was passed.
- The provision for bad and doubtful debts was correctly computed by many. Yet the transfer to P&L was incorrect due to not adjusting for the opening balance (Rs. 5,200)
- Quite a number of candidates took the Employee Benefits (provision for gratuity Rs. 45,230/-) incorrectly to the P&L account under other income.
- Out of those who recorded Employee Benefits in the SOFP, almost all the candidates showed it as current liability.

ii) Statement of Changes in Equity-

- large number of candidates were not aware of the transactions to be shown herein. Instead of the narration Profit/ (Loss) for the year, majority of the candidates took the OCI to the statement of Changes in Equity.
- Some others showed the fair value of shares (Rs. 525,000/=) incorrectly under stated capital column.
- There were 3 marks in all awarded for this part and very few candidates scored 50% of that. This part was not attempted by a large number of candidates due to either not studying or to lack of knowledge of the relevant entries.

KE2 – Management Accounting Information

September 2016

Examiner's comments

Question-wise comments

General points about candidates' handwriting

There were number of instances in scripts where marking examiners found it extremely difficult to read the candidates' handwriting. Therefore, no marks were allowed for the illegible parts of the answers.

The following may be helpful in enhancing the performance level of the candidates.

1. Read the question several times and answer only what is required by the question.
2. Candidates should carefully understand the theories/concepts applicable to the given scenario of the question. They should evaluate the given information and link them with the applicable theories /concepts carefully to derive the answer.
3. Be extra vigilant in extracting the correct details/figures to the answer script and avoid arithmetical errors.
4. Focus on the Action Verb given in the question to provide the exact and appropriate answer.
5. By studying the theory properly and answering past question papers and practice questions you can improve the subject knowledge as well as the ability to write answers well.
6. Plan your answer properly and manage the time efficiently at the examination.

Question 01

Consists of ten multiple-choice questions each carrying two marks. The performance of the candidates was satisfactory with 73% of candidates scoring half or more marks.

Performance of the candidates in individual question is given per the table below.

Percentage of the candidates selecting the answers A, B, C, D as correct.

| Question No. | A% | B% | C% | D% |
|--------------|----|----|----|----|
| 1.1 | 1 | 70 | 17 | 12 |
| 1.2 | 27 | 4 | 51 | 18 |
| 1.3 | 11 | 58 | 9 | 22 |
| 1.4 | 3 | 32 | 26 | 39 |
| 1.5 | 4 | 85 | 4 | 7 |
| 1.6 | 6 | 44 | 33 | 17 |
| 1.7 | 17 | 10 | 52 | 21 |
| 1.8 | 35 | 30 | 17 | 18 |
| 1.9 | 5 | 5 | 40 | 50 |
| 1.10 | 24 | 13 | 27 | 36 |

Note: Correct answers are circled.

Question 02

2.1

The overall performance of the candidates **was average**. The average marks scored by candidates range from 2 to 2 ½ marks. The question has been designed to test the candidates' ability to identify the **relevant cost** for financial evaluations. Many candidates (about 60%) had failed to understand the requirement of the question; thus, they provided examples of relevant cost **without referring to the question**. Some candidates (about 30%) had just listed the cost elements from the question. A few good candidates (about 2%) had demonstrated precisely taking examples from the question, the **relevance and irrelevance** of the cost given, arguing for on both sides. These candidates scored the full marks allocated to this part of the question.

2.2

The question is very simple and requires the candidates to calculate **total variable cost and the total fixed cost**, using the **high-low method**. Majority of the candidates (about 80%) had scored 2 of the 3 marks allocated to the question. A few of the candidates (about 10% to 15%) had displayed **poor knowledge about high-low method of computing costs**. Some candidates (about 40%) had failed to identify the **highest level of activity and the lowest level of activity in calculating the total costs** at the expected level accurately. As such, these candidates had lost the marks allocated for the identifications of **activity levels and the corresponding costs**.

Some candidates (about 40%) had not taken the **expected level of output of 150,000 units** for the calculation of total variable cost and thereby lost the opportunity to score the full marks allocated to this part of the question.

Overall performance of the candidates for the part **was somewhat satisfactory**. On average, candidates had scored 2 – 2 ½ marks out of the 3 marks allocated to the part.

2.3

Overall performance of the candidates **was very satisfactory**. It was surprising to note that many candidates (75% on average) had scored full marks for the part. Average marks scored by the candidates ranged from 2 ½ to 3 marks. Majority of the candidates (about 70% - 80%) appeared to be familiar with product costing. However, some candidates (about 20%) **had taken profit mark-up on selling price instead of cost** although it is clearly stated in the question. These candidates had failed to secure full marks allocated to part 2.3.

2.4

The performance of the candidates **was not up to expectation**. The average marks scored by the candidates range from 1 ¾ marks – 2 ¼ marks. The question is very straightforward and simple to answer. A considerable number (about 70% - 80%) of candidates had failed to **calculate VAT correctly**. These candidates had **calculated VAT on cost without** regard to the **profit margin** or the mark up. It is obvious that the VAT is charged **on the selling price** of a product.

The candidates did not appear to have understood the requirement of the question and viewed it from the Company's point of view, for example, the cost of 5 free rackets for every 100 given **away is just Rs. 15,000 for 100 rackets** (only the **cost of a racket** should be considered). Many candidates (about 60%) **had taken MRP** to arrive at the cost of free rackets given away.

Many candidates (about 60%) had computed the **cost of discount incorrectly although the question clearly states that discount is offered on MRP**. These candidates had applied discount on cost.

2.5

Question has been designed to test the **candidates' knowledge about conditional probability**. Although the question seems simple and straightforward, the performance of the candidates **was not satisfactory**. The average marks range from 1 – 1 ½ marks out of 3 marks allocated for this part of the question.

This question could have been simply analysed and answered by a **probability tree diagram**. Although a few candidates (about 40%) had answered the sub part (i) of the question correctly, sub part two **was not answered correctly by many candidates**.

A handful of candidates (about 5%) had **repeated the probabilities given in the question and provided them as conditional probability** for the sub part (i). Sub part (ii) was not answered correctly by many candidates (about 70%).

2.6

Average performance of this part was **somewhat satisfactory**. Majority of the candidates (about 60%) had scored the full marks allocated to this part of the question. However, some candidates (about 40%) had not calculated the Z score correctly, in which the part **square root of number of observation by which the standard deviation is divided in the formula had been missed out by many**.

Some candidates (about 20%) **did not appear to be familiar** with Z-score formula and some candidates had not computed the **upper and lower limits accurately**.

Average marks scored by the candidates vary from 1 to 1 ½ marks.

2.7

Overall performance **was not satisfactory**. Majority of the candidates (about 60% - 70%) had scored less than 2 marks. The average marks scored by candidates range from 1 ½ - 2 marks out of 3 marks allocated to the part.

However, a few candidates about (5%) had scored full marks allocated to sub part (i) of question. Many candidates (about 40%) had not considered **quarterly interest rate** applicable to the computation although an **alternative method is available**. Some candidates (about 15%) had completely **disregarded time value of money** whereas some candidates (about 50%) had **failed to compute the cumulative discounting factor** for the purpose of arriving at the amount of quarterly installment.

Handful of candidates had taken the **time period as 20 years** displaying **very poor understanding of the requirement of the question**. These candidates had failed to answer the second part of the question as **number of quarters left were inaccurate in their answers** (i.e. the correct no. of quarters left is 12).

2.8

Overall performance **was very poor**. Large number of candidates **had not computed the outstanding balance** as at the end of 3rd year correctly which could have been simply computed by a **loan repayment schedule** up to 3rd year if the **mathematical manipulation is difficult** for students. Many candidates (about 60%) **had failed to compute the cumulative discounting factor** and read the table correctly to obtain the **applicable interest rate**. This part could have also been answered simply by **IRR** method, which **was not attempted to by any candidate**.

Overall, average marks obtained for the part range from 1 ½ - 2 marks.

2.9

The overall performance of the candidates **was somewhat satisfactory**. The average mark scored by candidates is **2 marks**. The question tests the candidates' knowledge about **ARR method and its limitations**.

Considerable number of candidates (about 30%-40%) had failed to **compute the ARR correctly** as the **elements needed to compute ARR had been inaccurate** in the answers. These include **elimination of residual value of Rs. 50mn** from the initial investment, non-consideration of average of both investment as well as the profits over the 5 year period.

It is regretted to comment that some candidates (about 20%) did not appear to have known the **major disadvantage of ARR** (i.e. time value of money is disregarded). These candidates had identified minor disadvantages such as **profits may be subject to manipulation, accounting profits are subject to different provisions for expenses** and had scored some marks.

2.10

Average marks obtained for the part range from 2 to 2 ½ marks out of 3 marks allocated to the question. This question is **simple**. The question has been designed to test the **knowledge about time series**. Overall performance was **somewhat satisfactory**. However, many candidates (40%) **had not explained what a time series means**, while some candidates (about 30%) **had related the answer to examples such as manufacturing and trading**. These candidates defined time series **only in relation to such settings where important elements of a time series were missing in their answers**.

Only about **two or three candidates** had given a **precise answer straight to the point i.e. very simply a series of values of a quantity obtained at successive times (i.e. record of observation of a time varying variable), often with equal intervals between them**.

The components of time series were had been listed by many candidates (about 60%)

Question 03

General Comments

This was a three parts question that tested the knowledge of inventory control and the application of it in a typical situation. In part (a) monthly demands and the lead times were provided for the calculation of Economic Order Quantity (EOQ) and ordering and carrying cost of EOQ. Part (b) requires calculation of 3 critical inventory control levels for tyres using the data provided together with answers obtained in part (a). Part (c) expected the students to demonstrate their understanding about the importance and how these levels (i.e. re-order level, maximum stock level and minimum stock level) assist the management to carry the production at SBM efficiently, economically & expeditiously.

Part (a) Practically all students answered this part, but the success of the answers is not satisfactory due to frequently made errors such as;

Failure to appreciate that the demand is per month, two tyres for a bicycle, incorrect calculation of average demand. Ch in EOQ formula is applicable for 1 unit per annum and not cost of holding average stock for one year. Co represents cost per order as opposed to cost of ordering expenses for the whole year (total marks allocated 3).

Part (b) Common errors observed in part (b).
ROL – failure to convert monthly demand in bicycles to weekly demand in no. of tyres so that maximum lead time in weeks and the timeframe is reduced to a common basis, e.g. either months to weeks or weeks to months so that uniformity in time is established .

Maximum Stock Level- Noticed incorrect using of Minimum Stock Level formula with EOQ, mixing up of minimum lead-time with that of maximum.

Minimum stock level- observed using other demand figures such as maximum or minimum instead of average demand and also average lead time confused with maximum and minimum lead times.

Failure either to convert demand in bicycles to number of tyres and weeks to months was widely witnessed in this calculation as well. (total marks allocated 3)

Part (c) ROL – many students appreciated the need to replenish stocks at this level to avoid stock out situation but only less than 5% answers stressed the benefit of ROL to prevent excess stocks.

Maximum level-generally satisfactory, but some candidates stressed on this level as an aid to reduce funds locked-up in stocks rather than avoiding obsolescence and wasteful expenditure.

Minimum level.- Many candidates appreciated the alarming level in stocks and possibility of stock outs but hardly any, except in one or two instances, they failed to understand that there is a possibility of changing consumption patterns and lead times as it was envisaged in the planning phase. (total marks allocated 4)

Question 04

Question tested the knowledge on concepts related to probability, standard deviation and comparison of dispersion (spread) for two distributions using the given data.

Being an optional question, the candidates' preference level for this question was low compared to other questions and from those who opted for this question it was observed that a considerable number of candidates have answered only the part (a).

Part (a)

Candidates were required to **recognize** the chemical to be produced taking into account the expected contribution per annum of each chemical.

The expected contribution per annum for Chemical CB had provided in the question as Rs.26 million. Candidates were required only to compute the expected contribution per annum for chemical BS applying the relevant probabilities at each demand level and compare the answer with the provided expected contribution per annum of chemical CB. Many candidates had successfully answered this part and earned full marks allocated for this part.

Although this part was very simple and required only basic knowledge of contribution and probability, the following shortcomings / errors were observed in the answers.

- Some candidates failed to compute the contribution per unit for chemical BS by deducting the variable cost per unit from the selling price per unit.
- Some candidates have computed the contribution per annum based on the total of given demand levels (530,000 units) ignoring the probability of occurrence.

- Certain candidates have just calculated the demand at one of the given demand levels ignoring all other occurrences and compared the answer with the given expected demand per annum of chemical CB. Eg : Taking the demand of Chemical CB as 100,000 units.
- Several candidates have made arithmetical errors in multiplication and errors in copying the data from the question. Eg. Copying 160,000 as 180,000.
- Some Candidates have just calculated the demand at each probability of occurrences without totaling it to arrive at the expected contribution of Chemical BS.
- Although question has clearly required to “**recognise**” the chemical to be produced based on the expected contribution per annum, a considerable number of candidates have just ended up the answer only with the computations, without arriving at a conclusion by comparing the expected contribution per annum of each chemical.

Part (b)

It was expected to **explain** the chemical that CPL would favour if the management prefers to accept the chemical with lower dispersion (spread) of contribution for 07 marks. The performance for this part was unsatisfactory.

The following errors were observed during the evaluation;

- Some candidates have taken “Number of Units” instead of “Contribution” at each demand level of Chemical BS in calculating the standard deviation.
- Certain candidates have erroneously divided the total expected contribution of Chemical BS by 04 considering the 04 occurrences in calculating the mean for computing the standard deviation.
- Further several candidates have made mistakes in computing standard deviations such as arithmetical errors, not taking the square root of the answer properly and not applying the square root at all in arriving at standard deviation.
- Majority of the candidates didn’t possess the understanding that to compare the dispersion (spread) of contribution between the given two chemicals, Coefficient of Variation had to be calculated. Many have tried to explain the answer based on the Standard deviation and expected contribution instead of coefficient of variation.
- Some candidates have applied irrelevant concepts such as regression line analysis and scatter diagrams using hypothetical figures for this part without computing standard deviation and Coefficient of Variation to arrive at the correct answer.
- Some Candidates have just written the answer as Chemical BS or Chemical CB arbitrarily without providing any valid explanations or computations.

Question 05

General comments

Question was not very well answered. Only a few candidates scored full marks. Those who answered this question answered only part (a) and scored 2 ½ - 03 marks only.

This question had only 10% of total marks of the paper and it was an optional question. This was a three-part question that tested the candidates understanding of maximisation of profitability under different costs and prices of products in the different market segments. Company is considering improving or maximising the profitability of the product in different market segments by changing prices and quantities.

1st part carries three marks. Candidates were required to calculate current total profit from both markets using the information given for two markets namely M1 & M2.

2nd part carries four marks. Candidates were required to calculate the new prices to be charged and quantities to be sold in each market in order to maximise the profitability of the company.

Final part carries three marks, candidates were required to prepare monthly profitability statements using the figures calculated in part (b) of the question to show the maximisation of profit after revision of prices and quantities in both markets. And further candidates were required to comment on the changes in profitability in comparison with the previous profit figures.

Answers to part (a) were generally excellent. Most of candidates got 3 marks where as others got 2 ½ marks (due to making the common mistake of deducting fixed cost twice in the profit calculation of the two markets M1 and M2). However, the following errors were observed.

1. Fixed cost had been accounted twice in the profit calculation of the two markets.
2. The given selling price of Rs. 70 was not considered in the calculation. Eg $80/0.01 = 8,000$, $250/.2 = 1,250$. A number of candidates had applied this method to calculate the quantity.
3. Some candidates had added two equations together to solve for quantities.

Many candidates lost marks for part (a) due to the above reasons.

Answers to part (b) were good although some answers had been focused on different approaches to calculate sales quantities and new prices of each market. The following errors were noted during marking.

1. They had no knowledge of cost behaviour at the point of maximisation of profit. That is $MR = MC$.
2. Most of the candidates had not taken into account $MC = Rs. 60$ in the calculation and deriving of formulas was incorrect.

Answers to part (c) were mixed. While there were some very good answers, some candidates who had answered part (b) had not answered part (c). Answers to part (c) was based on the calculations done for part (b). Some answers had only the calculation but no comments were given. Only a few had given comments on the calculation. Common mistakes found were as follows.

1. Fixed cost taken twice in the calculation under the two markets.
2. Wrong calculation of sales revenue and fixed & variable cost.

Question 06

General Comments

This question is one of the easiest questions on which to score in the paper. This is a 10 marks question and consists of 2 parts. 1st part requires to prepare the monthly expenditure budget at 2 different levels of production and the 2nd part tests the knowledge on top-down and bottom-up budgeting. The marks allocated are 7 and 3 respectively.

Overall, many of the candidates have scored between 5-7 marks. On average, 4 out of 20 candidates have not attempted this question (optional).

Part (a)

This part requires the candidates to prepare monthly budgets at 2 different levels of production. Here, the students have to identify all the cost and compute the necessary costs based on the information given. Following costs were identified by the students easily as they did not have to compute anything.

- Security Rs. 18,000
- Rent Rs. 40,000

Direct material had to be computed after identifying the number of units of output per month. Many candidates have calculated it per day. (in general many candidates have computed the expenditure budget per day and not month).

Direct labour and lunch and tea computations had a number of errors. Following are the general mistakes noted in such computation.

- Students have assumed that Rs. 800 is for an hour and not day.
- Calculated per day not per month.
- Lunch and tea, students have assumed that it is Rs. 80 and Rs. 25 per hour.

Machinery maintenance had been correctly computed by most of the students (per day basis).

Semi variable administration cost has been tricky and following mistakes were noted in general:

- Multiplying VC per unit by no. of units per day and not month.
- Multiplying FC per month by 24 assuming it to be per day cost.
- Completely ignoring VC portion and including only FC in the budget.

Other mistakes noted are as follows:

- A few students have assumed and calculated the budget for 30 days and not according to 24 days as mentioned in the question.
- Budget calculated on per day basis and not per month.
- A few candidates have computed additional lunch and tea for 2 hours for 1200 units production as the question states "if daily operations exceed 10 hours, an additional snack is provided at Rs. 25 per worker".
- Some candidates have apportioned the security and rent expenses of Rs. 18 and Rs. 40 between 800 units and 1,200 units production based on the output level.
- A few candidates have treated the highest administration cost to be the administration cost of 1,200 units of production and lowest administration cost to be the administration cost of 800 units of production without computing variable cost based on high low method.

Part (b)

This question requires the students to explain the difference between top down and bottom up budgeting.

Most of the candidates have scored 2 marks and a few candidates have mixed up the captions and hence provided wrong explanation for the wrong type of budgeting.

A few candidates had no idea about these types of budgets and have tried their luck with the following general advantages and disadvantages.

- Easy to calculate/difficult to calculate.
- Easy to understand/difficult to understand.

Most general answers were:

Bottom up

- Time consuming
- Motivating employees

Top down

- Time saving
- De-motivating employees

Question 07

General Comments

The performance of the candidates was not satisfactory as the majority failed to score at least 50% of the marks allocated to the question. The question consisted of five parts that tested the candidates' knowledge on absorption costing, activity based costing and variances.

Part (a) for which three marks were allocated, required the candidates to calculate the fixed overhead cost absorbed per unit of products X, Y and Z. In part (b), where the marks allocation was three, the candidates were required to prepare a profitability statement showing the fixed overhead over/under recovery. Part (c) required the candidates to explain the reasons or conditions prevalent in NPL that justifies the statement made by the head of finance of NPL that Activity Based Costing method is more appropriate in charging fixed cost to products of NPL, for which four marks were allocated.

In part (d), where the marks allocation was four, the candidates were required to calculate the direct material price, direct material usage, direct labour rate and direct labour efficiency variances for product X. Part (e) consisted of two parts, three marks being allocated for each part. Part (e) (i) required the candidates to explain the importance of analysing the material cost variance into price and usage variances. The requirement in part (e) (ii) was to explain the impact of the production manager's plan on labour rate, labour efficiency and material usage variances, where the production manager had planned to partially replace unskilled labour with skilled labour.

Specific comments

Majority of the answers to part (a) were not satisfactory, as most of the candidates had calculated the total fixed overhead cost absorbed to products X, Y and Z, instead of the fixed overhead cost absorbed to each unit of X, Y and Z. Some candidates had absorbed fixed overheads to the three products based on the budgeted units of production. Some others had calculated the fixed overhead absorbed based on the labour cost per unit of products X, Y and Z (e.g. for product X – $11,700 \times 45 \div 135$). Some candidates had incorrectly calculated the fixed overhead cost absorbed to each product of X, Y and Z by dividing Rs. 11.7 million by the labor hours of X, Y and Z, i.e. 7,500, 6,000 and 6,000 respectively.

Part (b) wasn't satisfactorily answered by most of the candidates, as they failed to calculate the fixed overhead under absorbed correctly. Many candidates had incorrectly taken the monthly budgeted

fixed overheads of Rs. 11.7 million as the fixed overhead absorbed and arrived at a fixed overhead under absorption of Rs. 1.3 million. Some candidates had calculated the fixed overhead absorbed correctly but calculated the fixed overhead under absorbed incorrectly by comparing Rs. 12.12 million with Rs. 11.7 million. Some of the candidates had calculated the fixed overheads under absorbed only, without preparing the profitability statement.

Part (c) wasn't satisfactorily answered, as a number of candidates explained generally why ABC is more appropriate in charging fixed overheads to products without explaining reasons or conditions prevalent in NPL that would make the ABC method more appropriate in charging fixed overheads to products of NPL. Many others failed to give adequate reasons or conditions prevalent in NPL explaining only one reason or condition. Many candidates didn't recognise that the production overheads are a high proportion of the total production cost and that the amount of overhead used for each product is different.

The answers to part (d) varied. Some, candidates provided good answers while some others' performance was average. Some candidates had answered poorly. In calculating direct material price and usage variances, majority of the candidates had thought that the standard price of a kg. of material was Rs. 100, without considering that the standard material utilisation per unit of product X is 0.5 kg. Further, some candidates had taken the budgeted production of 50,000 instead of actual production of 40,000 when calculating the standard usage for the direct material usage and labour efficiency variances.

The candidates' performance for part (e) (i) varied. Some candidates had provided good answers whereas some hadn't explained adequately the importance of analysing the material cost variance into price and usage variances.

Part (e) (ii) was the best answered. A number of candidates had explained the impact of the production manager's plan on labour rate; labour efficiency and material usage variances correctly. Some candidates had just stated the impact on the variances without explaining. Some candidates had misunderstood the question and thought that skilled labour was being partially replaced with unskilled labour.

KE3 – Fundamentals of Taxation and Law

September 2016

Examiner's Comments

General Comments

Candidates had the habit of not reading the question well and understanding it properly before they started to answer. Due to this many had focused their attention in incorrect directions and provided irrelevant answers. As usual, illegible handwriting, grammatical and spelling mistakes could be observed in answers.

The subject matter covered in all the questions was within the syllabus and adequately covered in the textbook published by CA Sri Lanka.

The overall performance was excellent and in fact unexpected since over 70% of the candidates scored 50% or more of the total allocated marks.

Question-wise comments

Question 01

There were five multiple choice questions (MCQs) that required candidates to select the most appropriate answer. They tested candidates' knowledge in the following areas of taxation:

- 1.1 Rent income received by a company – s.25 (1) (d) and s.217
- 1.2 Tax administration – due date for filing a value added tax (VAT) return
- 1.3 Theory – dividend tax
- 1.4 Computation of Nation Building Tax
- 1.5 Economic function of taxation

Overall performance in this question was excellent. About 30% of candidates scored 100% of the allocated marks whilst about 50% of the candidates scored between 60% – 80% of the allocated marks.

Where mistakes were made, they generally related to a lack of subject knowledge and understanding of the question.

- 1.1 Majority of candidates chose option C, which was 100% of the repairs.
- 1.2 Some candidates chose option C, which was a due date for payment of VAT.
- 1.3 A few candidates chose option B, which was 10% of the net dividend.
- 1.4 Some candidates chose option A, which was 2% of the total turnover while some chose option C, which was 2% of 50% of the turnover.
- 1.5 A good number of candidates chose option A, which was a social function of taxation.

There were five parts in this question and candidates were required to:

- 2.1 Explain the residence rule in the case of an individual for the purpose of the Inland Revenue Act (Section 79).
- 2.2 Calculate the gross income tax liability and the balance tax payable by a company that is engaged in exporting handmade ornaments.
- 2.3 State the possible actions the Inland Revenue Department can take when a company has not filed the income tax return for the year of assessment 2014/15.
- 2.4 To compute the PAYE tax liability of an individual receiving remuneration from recorded employment.
- 2.5 List four (04) excepted services under the Nation Building Tax Act.

Overall performance in this question was fairly satisfactory. About 50% of the candidates scored 50% or more of the allocated marks.

Where mistakes were made they generally related to:

- **Lack of subject knowledge**

- 2.1
 - a good number of candidates did not mention the period (year of assessment) during which the 183-day presence in the factor falls.
 - some candidates had mentioned different erroneous periods of stay e.g. 180 days, 188 days etc.
- 2.2
 - a few candidates had claimed tax credits from taxable income, while a few others had applied progressive tax rates in computing the company tax liability.
- 2.3
 - a few candidates had written answers by guessing e.g. the Inland revenue department can close down the company.
- 2.4
 - some candidates had computed PAYE on the net income.
- 2.5
 - some candidates had written answers by guessing e.g. charitable activities, social work, etc.

- **Understanding the question**

- 2.1
 - a few candidates had mentioned that income from one residence is exempt.
 - a few candidates had mentioned the residence in the case of a company. This was a waste of valuable exam time earning no extra marks.

- 2.3 - some candidates had mentioned the possible action for non-payment of taxes.
2.5 - a good number of candidates had listed excepted articles instead of services.

- **Errors of principle**

- 2.2 - a good number of candidates had claimed tax credits from taxable income.

Question 03

The question required candidates to calculate the gross income tax liability and balance tax payable by a resident individual who is also a professional in receipt of income from different sources.

The question included the calculation of statutory income from the following sources:

- (a) Employment → This included calculations of:
- Housing benefit
 - Vehicle benefit
 - Non cash benefit
- (b) Land and property
- (c) Interest
- (d) Sale of shares in listed companies
- (e) Businesses

The question also included identification of items deductible under Section 32 and qualifying payments relief under Section 34.

The majority of candidates made a good attempt at the question and more than 80% of them scored over 50% of the allocated marks. They displayed excellent skills in the presentation and identification of the statutory contents of an income tax computation of a resident individual.

Candidates demonstrated sound knowledge in:

- Identifying sources of income
- Identifying the benefits and receipts taxable under employment income
- Identifying allowable/disallowable expenses and charges under S.25 and S.26 respectively of the Inland Revenue Act.
- Identifying deductions under S.32
- Identifying qualifying payments relief under S.34
- The application of progressive income tax rates

Where mistakes were made, they generally related to the following:

Employment income

Housing benefit – a few candidates made mistakes in the calculation process.

E.g. failing to compare gross rent paid with the rental value and taking the higher of the two.

Vehicle benefit – a good number of candidates merely mentioned that the vehicle allowance was exempt or not taxable, without mentioning the limit to exemption. A few others mentioned that a vehicle is exempt.

Income from land and property

A few candidates made computational mistakes.
E.g. deducting repairs allowance from gross rent received.

Income from interest

The majority of candidates mentioned that this income is liable to tax since withholding tax has not been deducted. They were not aware of S.9 (hhh), which is effective from the year of assessment 2015/16, and thereby interest up to Rs. 5,000 per month from one or more savings accounts is exempt.

Sale of shares in listed companies

A good number of candidates mentioned that this is a capital gain and therefore exempt.

Business income

Some candidates commenced the computation of adjusted trading profit from the turnover figure. Some others had entered allowable and disallowable expenses/charges/allowances on the wrong side of the adjusted trading profit computation.

A few candidates had also misunderstood the question. It states "Lalith carries on an educational institute where classes are conducted for professional courses". A few misunderstood this as Lalith carrying on a professional practice and attempted to tax such income under S.59F.

Other mistakes included the following:

Qualifying payments – S.34

Candidates did not have up-to-date knowledge on recent tax legislation and amendments to the Inland Revenue Act.

- Employment allowance – a good number of candidates claimed Rs. 100,000.
- Payment to the community project – a few claimed 100% of the payment without limiting it to Rs. 1 million.

Calculation of income tax liability

A good number of candidates demonstrated poor knowledge in computing the overall tax liability when the taxable income comprises of employment income, business income taxable at concessionary rates of tax and other sources of income taxable at the standard rates of tax.

Tax credits

A few candidates did not know that payments like self-assessment tax and PAYE are advance payments of tax. Such candidates claimed those payments as deductions from statutory income or taxable income or as a qualifying payment relief.

Candidates are advised to give detailed, relevant workings that display their knowledge to the examiner when building their answer. In this subject, arithmetical accuracy and the final answer usually do not score marks.

Question 04

Although the five multiple-choice questions (MCQs) were easy, performance was not satisfactory. Only a handful of candidates got all five answers correct.

Candidates had chosen incorrect answers as they were not very familiar with the areas tested and some of them had selected the following as the most appropriate answer:

- 4.1(A) the agent indicates that he is contracting as an agent for an unnamed principal.
- 4.2(D) to frame the economic and trade policy of the government.
- 4.3(A) the employer should have a minimum of five (05) employees in order to fall within the purview of the Act. Candidates were not aware that it is a minimum of fifteen (15) employees and not five (05) employees.
- 4.4(C) the document should be signed before a notary and two witnesses.
- 4.5(C) the lessor should inform the lessee of his (the lessor's) intention to recover the asset through a parate execution.

Due to a lack of comprehensive knowledge and understanding of the topics covered in the question, not reading the question properly, misunderstanding the points given in question and other various reasons, candidates were incapable of selecting the correct answer. Since these were MCQs, if they had wide knowledge in the subject areas and a clear understanding of the question, they could have answered the questions without much effort and scored full marks.

A minor percentage of candidates were able to identify the most appropriate answers for all the MCQs and had selected the following answers:

- 4.1(B) an agent can be held liable personally when the agent contracts on behalf of a non-existing principal.
- 4.2(C) one of the main functions of Sri Lanka Customs is to exercise certain powers of the Sri Lanka Police.
- 4.3(D) Payment of Gratuity Act No. 12 of 1983 does not apply for employees who are entitled to a pension under the non-contributing pension scheme.
- 4.4(B) it should be retained in its original form for a document to be accepted in Law under the Electronic Transaction Act No. 19 of 2006.
- 4.5(A) under the Finance Leasing Act No. 56 of 2000, the lessor should notify the police regarding the breach of the agreement by the lessee and his intention to recover the possession of the asset without obtaining a court order.

Question 05

Performance in all the parts except 5.1 of the question was below the standard of knowledge expected by the candidates. This may have been mainly due to inadequate preparation for the examination.

5.1. Candidates are reminded that contracts can be terminated in many different ways under law of contracts. The question required them to state four (04) such ways of termination. Some candidates had either failed to understand that or were not competent enough to understand it, and had provided some answers that were not relevant. In their answers they had covered some areas like:

- Discussing the requirements to be fulfilled for the formation of a contract i.e. there should be a valid offer, valid acceptance, consideration and so on.
- Explaining various instances where a valid contract is not formed i.e. by non-acceptance of the offer (e.g. counter offer), by not accepting the offer within the time prescribed or within a reasonable time, by revocation of the offer (offeror can revoke the offer made to the offeree before it is accepted by the offeree)
- A contract can be terminated by implied conduct of the parties or through a reliable resource.

A high percentage of candidates had correctly understood the question and given four (and sometimes even more) correct different ways by which contracts can be terminated. In their answers they had stated different ways of termination such as by performing the contract, subsequent agreement to terminate the contract, giving a termination notice, actual breach of the conditions of the contract, by anticipatory breach of the contract, by frustration, operation of law and so on.

5.2. This was a straightforward question asking candidates just to explain what is meant by case law. Most were not competent enough to explain correctly what is meant by case law and had tried to say that judgments given by courts will go down as case law and all the courts will follow that when there are similar cases.

Candidates had failed to realise that only the relevant decisions given by superior courts will be taken as 'case law' and not the judgments given by all courts.

A very high percentage of candidates had tried to explain only the point that the relevant judgment given by superior courts will be followed as precedents in giving judge made law, un-enacted law or judicial decisions.

Many others had explained various irrelevant areas such as:

- Case law means if a case is filed by a person in courts the court examines the case clearly and efficiently and gives the judgment.
- Legislation refers to the laws passed by Parliament. Ordinances and acts are examples of legislations. An Act is a law introduced by a country after getting independence and an ordinance is a law passed prior to independence.
- Customs are also treated as a source. Certain customs are recognised as a source of law if the following requirements are fulfilled.
 - * The custom must be ancient, which is produced for an unknown long period.
 - * It is something that is not illegal and contrary to public law.
 - * There must be reasonable ground for practicing such customs.

A minor percentage of candidates who had knowledge in the subject area had provided some satisfactory answers in correctly explaining case law and covered the following areas to earn good marks.

Case law refers to the decisions made by superior courts. It is also known as judge made law, un-enacted law or judicial decisions. Case law as a source of law means that these decisions given by superior courts are treated as laws or the decisions given in the case will be binding on similar cases.

- 5.3. Candidates were required to state four (04) places that are recognised as shops, as defined by the Shop and Office Employees (Special Provisions) Act No. 19 of 1954. A very high percentage of candidates were not familiar with the definition given in the Act. Therefore, they had provided names of places based on their own assumptions, which had no connection to the definition given in Act.

As a result, candidates had given various irrelevant answers including the following;

- Some had confused this Act with the Payment of Gratuity Act No. 12 of 1983 or the Termination of Employment (Special Provisions) Act No. 45 of 1971 and provided answers with the following details:
 - The employer should employ more than 15 employees in an average year.
 - The employee should have worked more than 180 days in the preceding 12 months.
 - Permanent employees cannot be terminated by immediate action.
 - Employees should be paid EPF and ETF.
 - Some candidates had dealt with sales transactions and stated:
 - The intended place where the transaction is completed.
 - Physical places and the buildings where goods have even transferred to the seller.
 - Businesses that have no legal entity.
- Shops in public places, on private land owned by particular owners, worship places, shops nearby tourist hotels.
- Various shops dealing with a variety of goods, medicine including liquor shops, pharmacies, electrical items selling shops, statutory shops and commercial shops.
- Companies/partnerships, vocation carters, venture capital or proprietorship entities.

However, a handful of candidates who were familiar with the definition given in the Act had provided satisfactory answers such as:

- Places where retail or wholesale business is carried out.
- Residential hotels.
- Places where the business of sale of food or drink takes place.
- Places where the business of a barber or hairdresser is carried out.

- 5.4. Candidates were required to state the main features of a freezing order under the Prevention of Money Laundering Act No. 05 of 2006. Knowledge of candidates on this area was very poor and they did not know what a freezing order was. Many had stated that it is an order issued by a Magistrate to confiscate the property of a suspected person who is guilty of money laundering. Others had given various incorrect answers such as:

- A certain amount of foreign currency should have been exchanged with the approval of the exchange rate control department of the Central Bank of Sri Lanka.
- Transactions with a value of over Rs. 1 million should be informed to the chief risk officer of the Central Bank of Sri Lanka.
- Unauthorised investment plans will be prevented.
- The money deposited in banks should be sealed.

- There are two defenses to prevent a freezing order i.e. consent defense and reasonable defense.

Some candidates had stated the types of punishments like ceasing of property, offences for holding black money etc. and wasted their time.

There were only a very few candidates who seemed familiar with freezing orders under the Prevention of Money Laundering Act. They had provided satisfactory answers covering the following facts:

- It is an order issued to prohibit any transaction in relation to an account, property or investment, which is or has been used in committing money laundering.
- Such an order is effective once it is confirmed by the High Court. A freezing order is valid for 7 days and validity can be extended by the High Court.
- Whilst the freezing order is in force, any transaction affecting an account, property or investment to which the freezing order applies, shall be null and void or not valid.

- 5.5. Candidates were expected to state four (04) duties imposed on a seller under a cost, insurance and freight (CIP) contract. Many had not understood the question properly or did not have knowledge in the subject area, and had tried to answer the question with their general knowledge and stated that the seller has to supply quality products on the due date, the seller has to bear the expenses as the parties have agreed etc. Some others had confused CIF agreements with insurance contracts and explained the insurable interest.

Due to insufficient knowledge on the duties of a seller imposed under a CIF contract, many candidates had focused their answers in various irrelevant directions such as:

- A seller's liability ends only when the goods have reached the buyer's destination.
- Any other cost related to transportation should be borne by the seller.
- The seller is liable to pay for any damages during transport.
- Safeguarding (protecting) of goods and doing things to keep the goods alive.
- Not exporting any illegal products.

Some candidates had displayed sound knowledge on the duties of a seller under a CIF contract, and provided satisfactory answers including the following points:

- Shipping goods in keeping with the description included in the contract.
- Processing a contract of carriage by sea under which the goods will be delivered to the destination contemplated by the contract.
- Arranging an insurance policy, which will be available for the benefit of the buyer.
- Issuing an invoice for the goods shipped.
- Tendering within a reasonable time after the shipment, the Bill of Lading certificate insurance and the invoice to the buyer to enable him to obtain delivery of the goods if they arrive, or recover their loss if the goods are lost during the voyage.

Question 06

- (a) Varuna, a 17 year old minor, intends to study law and wishes to enter into a contract of apprenticeship with his uncle Karu, a lawyer.

Candidates were required to explain whether Varuna could enter into the said contract with Karu. Although many had realised that a minor has no capacity to enter into legally binding contracts, they completely failed to realise that there is an exception to the rule and a minor **can** enter into a legally binding contract if such a contract is for his/her educational purpose and is not detrimental to him/her. Therefore, candidates were not able to provide a correct answer to this simple question. Some of them had given incomplete answers that deserved only 1 or 2 marks. In their answers, they had stated that a 17 year old person is a minor, and a minor has no capacity to enter into legally binding contracts. Varuna is a minor and therefore he cannot enter into the proposed apprenticeship since he has no capacity to enter into contracts.

Those who had not understood the question, had focused their answers in completely irrelevant directions and stated points such as:

- Under contract law there are six (06) elements that should be satisfied namely agreement, consideration, intention, capacity, consent and legality.
- A contract between two can be entered into orally, by implication or by conduct.
- A contract is an agreement entered into by two parties in order to create a legally binding relationship. The two parties are the offeror and offeree. The offeror is the person who makes the offer and the offeree is the person to whom the offer is made. A contract is formed when an offer is accepted.
- There are several elements of a contract and one such element is the capacity to contract. This means that the parties should have contracted capacity in order to form a valid contract.
- Under law of contracts, domestic and social agreements are not legally binding. In this case Varuna entered into a contract with his uncle, so it is a domestic agreement.

There was a fair percentage of candidates who were capable of providing some satisfactory answers, as they were familiar with the subject area. Their answers included the following:

Generally, a minor cannot enter into legally binding contracts, and Varuna is a minor as he is less than 18 years old. However, there are exceptions to this general rule and a minor can enter into legally binding contracts if such contracts are for his educational purposes and they are not detrimental to him/her (the minor). In the given scenario, the proposed contract is a contract of apprenticeship for learning the practical aspect of law and such contracts can be entered into by a minor and will be binding on the minor. Therefore, Varuna can enter into the said contract of apprenticeship

- (b) Mani has offered to sell his car to Ravi for Rs. 2.5 million, payable at the time of sale. Ravi has not accepted the offer as it is, but has made a counter-offer by enclosing a cheque for Rs. 500,000 and a written undertaking to pay the balance Rs. 2 million within a week from the date of sale.

Candidates were required to explain whether a valid contract had been formed between the two.

Many had not understood the question correctly and expressed the view Mani had made a valid offer and subsequent to that Ravi has made a new offer to buy Mani's car with some conditions, and if Mani accepts the offer of Ravi, a legally binding contract can be formed.

They failed to understand that the first offer of Mani will be terminated if the offeree makes a counter-offer or conditional offer and therefore no valid contract is formed.

Many candidates had focused their answers in completely incorrect directions and provided irrelevant answers that included the following:

- Defining what a contract is, the parties to a contract and the way in which a contract is formed i.e. making an offer and it being accepted by the other party.
- An offer can be terminated by revocation, rejection, unrealisation of conditions, lapse of the period and so on. Rejection of an offer can be done in two ways i.e. expressly or by counter-offer.
- An offer can be revoked by the offeror though he has agreed to keep it open for a certain period of time under the following circumstances.
 - If such an offer is bound by certain specific terms
 - If such an offer is given by way of a deed
- According to law in order to be a sale of goods contract, the consideration should be money. However the consideration in money need not be paid fully (i.e. total value of the goods). If part of the value is paid in money and the balance is in any other form, it will be treated as a sale of goods contract.
- Ravi has given a cheque for Rs. 500,000 at the time of sale and a written undertaking to pay the balance Rs. 2 million within a week from the date of sale. Therefore, there is a sale of goods contract between Ravi and Mani. The contract is legally binding as Mani offered to sell his car to Ravi at a price payable at the time of sale. Ravi responded to it by promising to pay later (i.e. in the future).
- Ravi accepted the offer but with the condition of late payment. So the material fact is breached here. Therefore, acceptance is not valid and it does not come under a legally binding contract as the concept of a contract is missing.
- Repeating the question in a different manner and stating that Mani has a car worth Rs. 2.5 million, which is going to be sold to Ravi. Mani offered Ravi to buy his car for Rs. 2.5 million payable at the time of sale but Ravi gave a cheque for Rs. 500,000 and a written undertaking to pay the balance within a week. Can Ravi buy this car as a part paid item? Can Ravi negotiate the price of the car at the time of sale? Does Mani like to enter into a contract? Is it a legal contract? Can Ravi later say that he can pay the full amount and buy the car?

However there were a few candidates who were familiar with rules regarding the offer and acceptance and the requirements for forming a legally binding contract. They had focused their answers in the following direction to earn high marks.

As there is a valid offer made by Mani, in order to form a valid contract there should be a valid acceptance of the offer of the offeror i.e. the acceptance must be absolute and unqualified. However, the acceptance made by Ravi is a qualified and conditional one and it varies from the original offer, which then amounts to a counter-offer.

In law of contracts, the counter-offer or conditional acceptance will result in termination of the original offer. Accordingly no valid contract has been formed between the two.

Some candidates even quoted the relevant case *Neale vs. Merrett*.

Question 07

(a)

Yassis, the owner of a Land Rover Jeep, intends to sell it to Garwin for Rs. 2 million. They are contemplating two options under the law of sale of goods; to go for an outright sale or enter into an agreement to sell and then sell subsequently.

Candidates were required to state the implied conditions and warranties relating to the title of the jeep under each of the options.

Majority of the candidates had not attempted this optional question, and a high percentage of those who did, had not properly understood what was required by the question. Therefore, many of them failed to note the implied conditions and warranties relating to the title of the jeep and stated conditions and warranties applicable in general under law of goods, whilst many others explained what conditions and warranties are under the sale of goods law. In their answers they had dealt with various irrelevant areas including the following:

- A contract of sale of goods is an agreement whereby the seller agrees to transfer the property in the goods to the buyer for a money consideration called the price.
- The conditions and warranties under sale of goods law are that – it should be of merchantable quality, it should correspond with the sample/description (i.e. it should be the same Land Rover Jeep Yassis showed to Garwin before) etc.
- Even if they enter into an agreement to sell, the price of Rs. 2 million should be paid at the time when the contract is made. Only specific goods are allowed to be paid for under the subsequent payment method.
- Conditions are stipulated to the root of the contract and if a condition is breached, the contract can be repudiated. A warranty is also like a condition but it is not stipulated to the root of the contract, and if a warranty is breached, a claim can be made for damages.
- In the given scenario under outright sale, the title of the jeep shall be passed from Yasis to Garwin. When the contract is made under an agreement to sell, the title of the jeep shall be passed from Yassis to Garwin after the contract of sale is made.

A few candidates, who were familiar with the correct implied conditions and warranties relating to the title of goods, had focused their answers in the following directions and were awarded high marks.

The following implied conditions/warranties in relation to the title of goods sold are applicable under both outright sale and the agreement to sell.

In an outright sale there is an implied condition on the seller that he has a right to sell the goods. In an agreement to sell, there is an implied condition on the seller that he will have a right to sell the goods at the time the property in such goods passes to the buyer. There is an implied warranty that the buyer shall have and enjoy quiet possession of the goods.

Also there is an implied warranty that the goods shall be free from any charge or encumbrance that was not known to the buyer before the contract was made.

(b)

The question stated that the sale of goods ordinance provides certain remedies to an unpaid seller when the buyer breaches the contract of sale and an unpaid seller has a right of lien on goods as a remedy if he/she still has possession of the goods.

Candidates were required to explain the circumstance under which the unpaid seller is;

- i. entitled to exercise the right of lien
- ii. not entitled to exercise the right of lien

Less than 50% of the candidates had attempted this optional question. Majority of those that did attempt, had no sufficient knowledge on the areas tested and mentioned various irrelevant points such as:

- an unpaid seller means the price of goods has not been paid to him/her, payments made by cheque have been subsequently dishonoured.
- The following two types of remedies are available for an unpaid seller:
 - Remedies against the goods
 - Remedies against the buyer
- Under the Sale of Goods Ordinance, an unpaid seller is given certain remedies when the buyer has breached the contract of sale. Accordingly, an unpaid seller is entitled to exercise the following rights.
 - Not pass the other goods to the buyer till he pays for the previous goods
 - Sell after giving reasonable time to the buyer
 - Claim damages from the agent
- If the seller has passed the title of goods, then he is not entitled to the goods and he can:
 - File a case for the amount receivable
 - Claim damages and other expenses
- The right of lien means the unpaid seller can put the goods sold under his possession until the buyer pays the price for the goods sold. This is one of the remedies that can be used by an unpaid seller to collect his price for the goods sold.
- Right of lien can be exercised when the buyer has failed to make the payment in time and where the buyer has given his consent to the seller for such right of lien at the time of entering the contract.

Only a very few candidates had satisfactory knowledge on right of lien available for an unpaid seller and explained it correctly by covering the following facts.

- i. Instances where an unpaid seller can exercise right of lien are:
 - when the goods have been sold without any stipulations to credit
 - when the goods have been sold on credit but the credit term has expired
 - when the buyer has become insolvent
- ii. instances where an unpaid seller has lost the right of lien are:
 - when he has delivered the goods to a carrier or bailee in order to be transmitted to the buyer, without reserving the right of disposition of goods
 - where the right of lien has been waived

Question 08

(a)

Anura had authorised his wife Sunitha to buy food items from Sour Food Centre on credit, indicating that those credit bills will be paid by Anura. Though Anura subsequently became mentally incapacitated, that position was not informed to Sour Food Centre and Sunitha continued to buy food items on credit from Sour Food Centre. Candidates were required to discuss whether Anura is liable to pay for the credit purchases done by his wife after he become mentally incapacitated by giving reference to a decided case.

Many had correctly identified that a contract entered into by an incapacitated person cannot be legally enforced and the principal is not liable for contracts entered into on his behalf by his agent after he becomes mentally incapacitated. However they completely failed to understand that if the third party has not been informed about the mental incapacitation of the principal, he is liable for the contracts made on his behalf by the agent even if he has become mentally incapacitated.

A lot other candidates had misinterpreted the incident and had expressed the view that an agency has been created under estoppel and Anura is liable to pay for the credit purchases made by his wife. In addition, a very high percentage of candidates who had failed to understand the question correctly, focused their answers in various irrelevant directions and provided answers covering the following areas:

- in the given case Sunitha has a right to buy food on behalf of her husband on credit. However later, as soon as Anura became mentally incapacitated, the contract with the shopkeeper ended and he is not liable for anything after he became mentally incapacitated.
- after marriage generally the person who earns a living, the husband, has an obligation to fulfill the needs of his wife. In the given scenario Anura and Sunitha are husband and wife, and Anura has authorised Sunitha to buy goods from Sour Food Centre on credit terms. Sunitha continued to buy goods on credit terms from Sour Food Centre even after Anura became mentally incapacitated. Therefore Anura cannot be prevented from the liability under estoppel.
- Anura and Sour Food Centre have created a contract when Anura was in good health. Sunitha, Anura's wife, who is authorised to buy goods on credit, has purchased goods from Sour Food Centre on credit. The innocent party, Sour Food Centre, has issued the goods on credit basis due to good faith and not knowing about Anura becoming mentally incapacitated. This is a mutual mistake.

However, a minor percentage of candidates were competent to provide some satisfactory answers as they had sound knowledge in the subject area tested. Their answers had covered the following points:

- In the relevant case, *Drew vs Nunn*, the court decided that the husband was liable to pay for the loss of goods purchased by his wife under a similar situation.
- Generally the mental incapacity of the principal terminates the contract of agency. However, the principal will be bound by the contract made by his agent with third parties who had no notice of the mental incapacity of the principal.
- Under these circumstances, Anura is liable to pay for the goods purchased from Sour Food Centre by Sunitha on credit, even after he became mentally incapacitated.

(b)

Gangana and Kevin had formed a partnership and the partnership deed contained a clause to say that Gangana can introduce his son Susith as a partner when he reached the age of 18. However, when Susith reached the age of 18 and Gangana proposed to admit him as a partner, Kevin rejected this proposal. Candidates were required to explain whether Susith could be made a partner of the partnership.

The majority of candidates had failed to understand the question correctly and focused their answers in various irrelevant directions such as defining what a partnership is, the ways by which a partnership can be formed, proposing the forming of partnership rights, the duties of partners and numerous other aspects of partnerships. It was due to a lack of proper knowledge that they had focused their attention in irrelevant areas such as:

- In a partnership agreement, all the partners should sign the agreement and before signing it they should read it properly. If they have done so, they cannot later do anything new.
- In a partnership business there should be four (04) main rules, namely:
 - There must be a valid agreement between the partners
 - The business must be related to the view of making profit
 - It must be related to a business process.

Even though a partnership deed contains a clause to say that Gangana can introduce his son Susith as a partner upon reaching the age 18, according to partnership law a new partner can be appointed only with the decision of all the existing partners. Accordingly, Susith cannot be appointed as a new partner since Kevin has refused it and it is the right of Kevin as per partnership law.

Question 09

(a)

Peter has applied for a life insurance policy from ABC Insurance Ltd. In the application form, there was a question asking him whether he had applied for such a policy from any other insurance company. Peter disclosed the fact that he already has two life policies with two other insurance companies, but did not reveal that his applications for life insurance were rejected by several other insurance companies in the past. Candidates were required to explain whether ABC can set aside this policy for the reason of non-disclosing of material facts.

Many candidates had not understood the question or were not much familiar with insurance law, and provided various irrelevant/incorrect answers that included:

- Repeating the question under a sub-heading as 'facts'.
- The life insurance policy of Peter should not be set aside. It should be accepted. In life insurance, contingency is the main routine. Therefore, it is not a matter of how many policies are maintained by a particular person, and it is not material to disclose in the application form that several other insurance companies had rejected the application before.
- British law is applicable for life insurance in Sri Lanka and under this law, life insurance is a contingency insurance used in contingent activities.

- ABC cannot accept the application of Peter because he has already committed fraud with other companies and they had rejected his applications in the past.
- Peter replied stating that he already has two life policies, but he did not reveal that his applications for life insurance were rejected by several other companies. However two insurance companies have already accepted his application recently. So the rejected applications are not material facts as they are not relevant to his life. As a result, the policy could not be set aside by ABC for non-disclosure of material facts because it is not a material fact.
- In the application form, the insurer had not asked whether earlier insurance application forms were rejected by insurance companies. Therefore, Peter did not disclose the refusal of his life insurance applications and it is not a non-disclosure of material facts. So ABC cannot set aside his life policy.

There were some candidates who were familiar with insurance law and had provided satisfactory answers that included the following points:

Any person who wishes to obtain a life insurance policy has to fill an application or proposal form issued by the insurance company. When answering the questions contained in that form, if any untrue material facts are given or if material facts are **not** disclosed, the policy so obtained becomes voidable at the option of the insurer.

In all insurance contracts, there is a very important aspect imposed on the person applying for the insurance cover to exercise utmost good faith (*uberrimae fidei*) in all his declarations to the insurer. That means a person seeking to obtain insurance cover owes a duty to disclose to the insurer every material fact that he knows or ought to know, to enable the insurer to properly evaluate the risk that will be undertaken.

In the given case, even though the application had not specifically asked whether previous applications had been rejected or not, it is the duty of the applicant to disclose such facts as it is a material fact that helps the insurer to properly evaluate risk. Accordingly, non-disclosure of the fact amounts to a breach of the principle of “*uberrimae fidei*” by Peter, and the policy can be set aside by ABC.

(b)

Eric wishes to open a current account in a bank and issue cheques from that account. Candidates were required to explain the legal effect of crossing a cheque and the different types or crossings used.

A fair percentage of candidates had failed to provide satisfactory answers even though this was a straightforward question. Candidates at this level are expected to have standard knowledge in these areas as it is normally involved in day-to-day accountancy functions. Any average person who maintains a current account in a bank is familiar with the legal effects of crossing a cheque and the different types of crossings used. However, a large number of candidates had failed to provide acceptable answers for this simple question, and explained irrelevant/incorrect areas such as:

- The legal effect of crossing a cheque is that anyone cannot play or misappropriate the cheque. It is not easily transferable. The legal owner has the right to sue against the offender who misused the cheque.
- If there is any issue found in the cheque, banks refuse to make the payment for the cheque to the holder.

- Cheques have a legal effect when they are crossed.
- If a cheque is crossed, it is valid only for that crossing.
- If it is a wrong crossing, the drawer can reject the payment. Crossed cheques can be given to another person by endorsing it. By crossing a cheque it can be used only within a limited or particular group of persons.
- Banks have introduced different types of crossings in cheques and when a cheque is crossed it cannot be negotiated any further.

Some candidates had gone on to explain blank crossings, conditional crossings, unconditional crossings, limited crossings and various other types of crossings that are not even in existence.

Nevertheless, there were some candidates who were familiar with the subject area and competent enough to provide satisfactory answers that included the following facts:

Legal effect of a crossing on a cheque

When two parallel lines are drawn across the cheque, it is referred to as a crossing on a cheque. Further there can be some words within the parallel lines. A crossing on a cheque will act as a direction to the paying bank that the crossed cheque should be paid only through a bank account and not over the counter.

Different types of crossings

There are four (04) different types of crossings, which are generally used:

1. General crossings – when two parallel transverse lines are drawn on the face of a cheque with or without the words “and company” or “not negotiable”
2. Special crossings – when a name of a bank is added on the face of a cheque with or without the words ‘not negotiable’
3. Not negotiable crossing – when a person gets a crossed cheque with the words ‘not negotiable’, the bearer does not get a better title than that of the person from whom he received it.
4. Account payee crossings – when the wording ‘account payee only’ are written within the parallel lines, it serves as a notice to the paying bank that only the account of the payee should be credited by the proceedings of the cheque. Though the Bills of Exchange Ordinance does not refer to this type of crossing, banks use it as a practice.



KE4 – Processes, Assurance and Ethics

September 2016

Examiner's Comments

General comments

It was observed that candidates had managed their time well. Many had understood the question requirement and displayed sound technical knowledge. Although there were good scripts, certain scripts demonstrated poor performance. Common reasons for poor performance were:

- Difficulty in understanding the subject
- Failure to understand the question requirement

Question-wise comments

Question 01

Many candidates were able to score about 75% of the marks allocated for this question. Many had selected option B for question 1.9, which was incorrect. The trend of answers was as follows:

| | |
|------|-----|
| 1.1 | 50% |
| 1.2 | 20% |
| 1.3 | 20% |
| 1.4 | 5% |
| 1.5 | 30% |
| 1.6 | 20% |
| 1.7 | 20% |
| 1.8 | 30% |
| 1.9 | 40% |
| 1.10 | 60% |

Question 02

2.1 Many candidates had obtained less than two marks for this part. It was noted that they were unable to understand the question requirement. They had written insignificant points such as:

- Inform shareholders of important events and decisions
- Distribute dividends
- Provide welfare facilities to shareholders
- Help the auditors
- Ensure going concern of the company

The examiner expected candidates to demonstrate their knowledge on prime responsibilities of directors such as providing leadership to achieve the objectives of the company.

2.2 Candidates were expected to explain the role of an information and communication system within the overall internal control system. The examiner expected candidates to touch on risks and controls in the organisation and write relevant on time effective and communicating sufficient details to the people who are responsible for applying controls.

Many candidates had written irrelevant answers such as:

- Use developed technology
- General and application controls
- Prevent fraud and errors

2.3 The performance of candidates on this part was satisfactory, and most scored almost full marks. However some had written irrelevant answers such as:

- To compare prices
- To obtain discounts
- When a new product is launched
- When selecting a supplier

Some candidates had incorrectly understood the question as the selection of suppliers instead of quotations.

2.4 The average performance on this part was not satisfactory. The majority of candidates had misunderstood the question and written about the external business environment. The examiner expected the candidates to write on operational risks in inventory management. Many had produced irrelevant answers such as:

- Competition with imported tiles
- Goods being outdated
- Delivery being difficult
- Idle machine hours
- Insufficient storage

2.5 Candidates were expected to explain the areas that required professional judgment of the auditor. Many had written facts given in the question such as:

- Professional judgment is required to reach an opinion
- It is required when planning the audit

Candidates were expected to use technical knowledge and not their general understanding. Some had produced irrelevant answers such as:

- Due to complexity
 - When auditing banks and plantation companies
 - When managing information technology
- 2.6 The average performance on this part was satisfactory. Some candidates had written the old definition instead of the COSO framework. The examiner expected candidates to know recent developments in the subject area. There were some scripts that carried irrelevant answers such as:
- Procedures to control the internal environment
 - Procedures implemented by the internal audit division
 - Controls to provide services
- 2.7 Candidates were required to identify the way in which the company given in the question could diversify its business. Many had not understood this in relation to risk diversification. Although many candidates had produced satisfactory answers, some had written irrelevant answers such as:
- Open a new business in Europe
 - Get into a joint venture
 - Instead of selling developed software, develop the software (not a specific answer)
 - Open branches in other countries
- 2.8 Candidates were required to state reasons as to why accountants need to behave ethically. There had been a similar question in the examination last March. However, the performance was poor. It demonstrated that candidates had not practiced past papers. Many had written the fundamental principles of ethics such as integrity, objectivity, professional competence and due care. Some had written irrelevant answers such as:
- Minimise fraud and errors
 - Work honestly
 - Update knowledge
 - Provide a good service
- 2.9 Candidates were required to identify financial statement assertions relating to land. Many demonstrated poor knowledge on financial statement assertions. They were expected to have sound technical knowledge. Some had ignored the action verb whilst some others had mixed it up with the action verb state. Although the average performance on this part was satisfactory, there were irrelevant answers such as:
- Check the deed
 - Check the revaluation calculation
 - Depreciation
- 2.10 Candidates were required to explain the difference between sufficiency and appropriateness of audit evidence. Majority had written that sufficiency of audit evidence is a measure of quantity, and appropriateness of audit evidence is a measure of quality. They failed to explain that the quantity of audit evidence is required to assess the risk of material misstatements and the quality of audit evidence is required to provide support for conclusions upon which the opinion is based. Some had written sufficiency is the value of audit evidence and sufficiency helps to take decisions.

Question 03

This was an IT based question and many candidates had not attempted it.

- (a) Candidates were required to discuss the importance of having IT general controls and IT application controls. The question was not specific to the given scenario and candidates had tried to link it to the scenario. This reflected that they had not read the question properly. There were some candidates who demonstrated practical knowledge and wrote that general controls assure that the system functions properly and application controls are over the data process. However, most candidates had irrelevant answers such as:

- It is a system that operates automatically so that it helps to update the stock level
- It will help to improve the work environment and employees will be motivated
- It will help to avoid theft and stocks
- It will avoid stock pilferage

Some candidates had written advantages of having an IT system whilst some others had simply written IT general controls.

- (b) Candidates were required to identify IT general controls the company given in the scenario should implement in order to ensure continuity of operations. Many had failed to answer this part satisfactorily. They had written general IT controls ignoring the fact that the question was in relation to continuity of operations. They had failed to understand that the controls for continuity of operations are part of general controls. If they had studied the textbook, they could have easily answered this part.

This part of the question did not relate to the scenario. Candidates had referred to the scenario and produced irrelevant answers such as:

- Record stock issues
- Record slow moving items
- There should be sufficient stocks

Some candidates had written internal controls such as segregation of duties. Some others had written irrelevant answers such as in order to continue operations:

- develop inputs
- update the computer system

- (c) Candidates were required to state application controls that exist in the IT system of the company in the given scenario. Majority had answered well as they had picked points from the given facts. There were some irrelevant answers such as how stock levels should be inspected.

Some had written general IT controls such as:

- Input controls
- Process controls
- Provide password
- Check the link

Question 04

- (a)(i) Candidates were required to state threats to professional ethical behavior. This part was answered satisfactorily. Almost all scored marks.
- (a)(ii) Candidates were required to identify potential threats to the principle of professional competence and due care. Although some had given satisfactory answers, many had repeated the facts given in the question, stating accountants should have professional competence and due care. Many were unable to identify the relevant threats. They had written threats to ethical behavior such as:
- Familiarity threat
 - Advocacy threat

It was disappointing to note that many candidates had not studied the textbook. If they had studied it, they could have identified the fundamental principles that accountants have to comply with and the nature of the threat.

- (b) Candidates were required to explain the ethical issues faced by Supun in the given scenario. The examiner expected candidates to address the following issues:
- Supun accepting the gift
 - Supun recording the sales as sales for August 2016
 - The undue influence by the employer

Many candidates were unable to relate these issues with the threats to ethical behavior and the fundamental principles of ethical behavior. They had written all threats and stated that Supun should behave in an ethical manner.

Question 05

- (a) This question was on flowcharts and candidates were required to identify the controls missing in the chart. However, it was observed that candidates were not familiar with flowcharts. There was a similar flowchart in the textbook. Candidates who had studied the textbook had produced satisfactory answers.

Many had misunderstood the question when an arrow had been put for three copies to enable them understand better. They had written that there are no GRN copies and stated that no GRN is raised at the warehouse. Many candidates had mixed-up the purchase order with the purchase requisition. They demonstrated a lack of knowledge in the purchasing process. Candidates were required to give short answers, but they had wasted time by giving lengthy answers.

- (b) There were two easy parts but disappointingly, performance was poor. Some candidates were not conversant with adjusted cash books. They had stated that the bank statement should be adjusted with bank charges.
- (i) Candidates were required to state the purpose of a bank reconciliation statement. Many had produced satisfactory answers, but some had written irrelevant answers such as:
- In order to plan business

- To determine profitability
 - To avoid fraud
- (ii) Candidates were required to identify steps in the preparation of a bank reconciliation. The main item that the examiner expected from candidates was that the prepared bank reconciliation is signed by the relevant authority. However it was disappointing to note that only a small number of candidates had written that. Many had written insignificant and incomplete answers such as:
- Take the bank statements directly to the clerk
 - Check the balance in the cash book

Question 06

Many had not attempted this question, which was regarding assurance engagements.

- (a)(i) Candidates were required to state the objective of an assurance engagement. Although the examiner expected the answer to be based on the objective given in the textbook, candidates had written incomplete answers such as “expresses an opinion and arrive at a conclusion”. They were unable to score full marks due to incomplete answers. There were some candidates who had written in detail the definition based on the International Auditing and Assurance Standards Board, but they had not given the specific answer for the objective, which resulted in less marks.
- (a)(ii) Candidates were required to explain the type of engagements the auditor should undertake in relation to the issue given in the scenario. Many had written that the auditor will provide limited assurance, and some have written that it is a:
- Review engagement
 - Agreed upon procedure

Candidates demonstrated poor knowledge on related services. They were unable to distinguish the difference between an assurance engagement and a related service. There had been questions in past exams on related services. Candidates are encouraged to read the textbook and do past papers.

- (b) Candidates were required to explain the need for conducting an audit in accordance with Sri Lanka Auditing Standards. There was a similar question in the exam last March. Candidates demonstrated a lack of technical knowledge. It is advised that they read the textbook and do past papers. Many had written irrelevant answers such as:
- In order to compare with other audits
 - For good professional judgment
 - In order to provide guidance
 - To provide a flexible service
 - It helps to use/apply competence, confidentiality and direction.

Question 07

This was a compulsory question and carried 20 marks. It was regarding payroll management and the procurement process.

(a)(i) Candidates were required to identify risks in the payroll system in the given scenario. Almost all candidates had identified the weakness in the payroll system. However, it was disappointing to note that they were unable to link the weakness to a risk. They were unable to identify the possible outcome that affects the entity in order to classify the weakness as a risk. Most answers included weaknesses such as:

- attendance is not marked
- leave records are not maintained
- payroll officer enters the new employee to the system
- salaries are calculated based on the number of days worked
- not receiving actual overtime payment
- risk of misplacing attendance records
- arithmetical accuracy not being checked
- safety of cash for salaries
- fraud can happen

Some candidates had written about payment for overtime work, which is not in the scenario. There had been questions in past exams on risk. Despite that, candidates found it difficult to identify a risk.

(a)(ii) Candidates were required to explain the controls to be established to mitigate the risks identified in the scenario. This part was not answered well. Many had written that an attendance records system has to be implemented. There were some answers detailing a proper internal control system for payment of salaries. Candidates demonstrated poor technical knowledge. They were unable to think beyond a proper attendance system. There were irrelevant answers such as:

- Salaries should be paid for the number of hours worked
- Overtime work should be supervised
- Swipe cards should not be used as it is costly

Answers written reflected that candidates did not have knowledge about the payroll process although the textbook clearly illustrates the process.

(a)(iii) Candidates were required to identify possible issues in the use of a swipe card system. This part was answered satisfactorily.

(b)(i) Candidates were required to identify control weaknesses in the process given in the scenario. Majority of candidates had answered well, but they had not explained in detail as to how the budget and approvals are verified before starting the tender process.

Technical and financial evaluation of bidders

(b)(ii) Candidates were required to state risks for each weakness. Many had written satisfactory answers. However, some had written vague answers without any details, such as:

- unwanted goods will be purchased
- bribes will be taken
- call for tenders
- select best supplier

(b)(iii) Candidates were required to summarise a process to be implemented in relation to disposal of property. The only correct answer submitted by almost everyone was to obtain approval. Almost all the candidates had written irrelevant answers such as:

- check the cost and calculate profit on sale
- check the depreciation
- remove it from the fixed asset register
- inquire the reason to dispose it without being repaired

Candidates demonstrated poor knowledge in identifying the issue, as the other part was on the procurement procedure and they could have related it to the tender procedure.

Overall conclusion

Candidates could have obtained sufficient marks for the paper if they have studied the textbook. The better answers demonstrated sound subject knowledge and the use of technical terms.

KE5 – Commercial Insight for Management

September 2016

Examiner's Comments

Question-wise comments

Question 01

General comments

This question consisted of ten multiple choice questions (MCQs), which carried 20 marks in total. The overall performance of candidates was satisfactory. The MCQs were on description of an organisation, Responsibility, normal goods, point elasticity, form competitors, allocative and technical efficiency, economies of scale, marginal and average product curves, strategic level control and Maylor's 7S model.

Specific comments

- A fair number of candidates were unable to select the correct answers for questions 1.5, 1.6, 1.9 and 1.10.

Question 02

General comments

The overall performance of candidates was satisfactory. The question consisted of 10 parts and carried 30 marks in total. Candidates were required to:

- 2.1 List three (03) key areas where the accountant's role in the finance function has developed to include a proactive business partnership role.
- 2.2 Explain how supernormal profit earned by a firm in a perfect competition market is faded away.
- 2.3 Explain how a monopolist decides its level of output/price to maximise profit.
- 2.4 (i) State two (02) withdrawals that could be seen in the circular flow of income of an open economy.
(ii) Explain the impact on the economy as a result of a stated withdrawal.
- 2.5 State three (03) advantages of having a floating exchange rate system.
- 2.6 Explain three (03) cultural trends taking place in the environment that are creating an impact on business organisations.
- 2.7 Recognise three (03) economic benefits of globalisation.
- 2.8 State three (03) sources of commercial/marketing economies of scale.
- 2.9 Discuss the substitution effect of an increase in the wage rate as given by the labour-leisure model.
- 2.10 Identify three (03) purposes served by the information systems of an organisation.

Specific comments

- 2.1 Only a few candidates correctly mentioned functions like provision of useful information on business units, projects, products, customers, justification of new investments, collaborating in strategic planning, budgeting etc. Some just listed functions such as budgeting and marginal costing, which were not elaborated enough to earn the full marks allocated.
- 2.2 Most candidates explained that due to the fact that a perfect competition market has the feature of "free entry and exit", the short run supernormal profit fades away in the long run. A few candidates mentioned that the number of sellers in the long run will be less compared to the amount in the short run and therefore the profit will decrease in the long run.
- 2.3 Some candidates correctly explained that a monopolist's profit is maximised when $MC=MR$ and the price charged equals average revenue, using a graph. Some incorrectly mentioned that a monopoly has only one seller and therefore it could maximise profits.
- 2.4 (i) Almost all candidates stated tax, savings and imports as withdrawals. Some incorrectly identified government expenditure as a withdrawal.
(ii) Candidates who earned full marks mentioned that tax will discourage investments and economic growth and imports will increase outflows from the country. Some stated that withdrawals will contract the economy and the equilibrium national income.

- 2.5 Some candidates mentioned that a floating exchange rate will automatically correct a deficit or surplus in the balance of payments and that it encourages efficient allocation of resources. A few stated that it would help calculations easy and show the real status of the country, which earned only a few marks.
- 2.6 Health and diet issues, women in work and environmentalism were the main cultural trends mentioned by some candidates who earned full marks. Some mentioned that demand has increased for culture-related items and garments, which indicated that they had not understood the question properly.
- 2.7 Elimination of trade barriers between countries, enhancing competitiveness, cross-national business mergers, moving away from planned economies to market systems were a few of the advantages of globalisation identified by some candidates. Some others just mentioned that globalisation would help reduce costs, provide broader market opportunities etc., which earned only a few marks.
- 2.8 Discounts due to bulk purchasing, savings in distribution and advertising costs due to bulk selling, lesser unit costs due to economies of scope are the main sources of commercial economies of scale. Some candidates incorrectly mentioned technical sources and sources based on power as sources of economies of scale.
- 2.9 A rise in the wage rate increases the opportunity cost of leisure. Some candidates had misunderstood the question and stated that due to a rise in the wage rate, producers tend to substitute labour for use of machines and computers, which earned no marks.
- 2.10 Recording each transaction and event, making well informed decisions, helping planning and performance measurement and monitoring and controlling the outcome of plans are some of the purposes of information systems. A few candidates did not adequately state the purposes of information systems (ISs), in that they only mentioned that ISs would help build better relationships between the management and other employees.

Question 03

General comments

The overall performance of candidates was not satisfactory. The question carried 10 marks and candidates were required to:

- (a) Define scarcity, opportunity cost and economic profit.
- (b) Discuss how to earn the maximum profit in the presence of scarcity.
- (c) Identify the best project using the information provided.

Specific comments

- (a) Scarcity is the excess of human wants over what can actually be produced. Nevertheless a few candidates identified scarcity as the scarcity of resources without a comparison being made to human wants. Most of the candidates correctly defined opportunity cost and economic profit.
- (b) Both the financial profit and opportunity cost of the investment need to be considered when an investment is made. Some candidates just mentioned that alternate investment opportunities need to be considered before an investment decision is made, which was not adequate enough to obtain the full marks allocated.
- (c) Most of the candidates had calculated the accounting profit for Project A and Project B as Rs. 1.5 million and Rs. 1.6 million respectively. Only a few arrived at an economic loss of Rs. 100,000 for Project A over Project B and an economic profit of Rs. 100,000 for Project B in relation to Project A, and concluded that Project B should be selected.

Question 04

General comments

The overall performance of candidates was satisfactory. The question carried 10 marks and candidates were required to:

- (a) Explain the difference between demand pull inflation and cost push inflation.
- (b) Explain how inflation would affect the balance of payments.
- (c) Discuss the necessity of cooperating both fiscal and monetary policy measures for controlling inflation effectively.

Specific comments

- (a) Demand pull inflation (DPI) occurs from an excess of aggregate demand over aggregate supply. Some candidates correctly cited examples of how DPI takes place (e.g. increased consumer income, increased government revenue), which earned full marks.

Cost push inflation (CPI) results from an increase in the cost of production of goods and services leading to a fall in aggregate supply. This was stated by those candidates who earned the allocated marks. Increased wages, cost of raw materials etc. trigger CPI.

Most candidates cited wrong examples for DPI. For example, if the demand for an item goes up, the price will go up due to insufficient production capacity. They should have mentioned increased income levels, increased government expenditure as examples of DPI.

- (b) Only a few candidates correctly explained that a higher rate of inflation would result in a fall in export demand due to exports becoming expensive, and also a rise in demand for imports, as they will be relatively cheaper. Some stated that high inflation in a country would lead to a depreciation of the exchange rate and thereby the balance of payments could be adversely affected.

- (c) Most candidates were unable to discuss the necessity of cooperating both fiscal and monetary policy measures for controlling inflation. Nevertheless they stated that higher taxation, higher interest rates and lower government expenditure would result in inflation being controlled.

Question 05

General comments

The overall performance of candidates was not satisfactory. The question carried 10 marks and candidates were required to:

- (a) Explain business and managerial skills that are important to become a good leader.
- (b) Discuss the validity of the statement, "Leaders are born, not made".

Specific comments

- (a) Only a few candidates correctly explained the expected skills of a leader (for example entrepreneurship, interpersonal skills, problem-solving skills, time management skills). Some stated that planning, organising and controlling are managerial skills to become a good leader, which earned no marks.
- (b) A fair number of candidates were not in agreement with the statement "Leaders are born, not made", saying that Trait theories pay scant regard for complexities of the leadership situation. Some concluded that "Leaders are born, not made" citing the fact that even though some work hard, most of them will not be successful.

Question 06

General comments

The overall performance of candidates was satisfactory. The question consisted of three parts and carried 10 marks. Candidates were required to:

- (a) Explain the term "market positioning".
- (b) Identify the positioning variables used by Star Cola and Light Cola to increase sales.
- (c) Explain four (04) promotional activities used by the two companies to increase sales.

Specific comments

- (a) Market positioning refers to how customers perceive a brand or product relative to other brands or products. This was stated by those candidates who earned full marks. Those who mentioned that firms that earned substantial market share are successful in market positioning, earned no marks.
- (b) Only a few candidates identified positioning variables correctly i.e. Star Cola uses quality and premium price and Light Cola uses low prices. Most re-wrote what is given in the question as positioning variables.
- (c) Some candidates correctly explained promotional activities under advertising, sales promotion, public relations and direct marketing. Some suggested to widen the distribution network so that rural people could purchase the products, and this earned no marks.

Question 07

General comments

The overall performance of candidates was satisfactory. The question carried 20 marks and candidates were required to:

- (a) Calculate the equilibrium price and quantity.
- (b)
 - (i) Explain consumer surplus and reasons for its existence.
 - (ii) Calculate consumer surplus.
- (c) Identify two (02) determinants of demand, which have led to the reduction of crude oil prices.
- (d) Demonstrate the likely impact on the equilibrium price and quantity due to new explorations of oil resources.
- (e) Discuss the possible consequences on the Sri Lankan economy, due to any curtailment of crude oil supply if:
 - (i) local prices continue to remain unchanged.
 - (ii) local prices are adjusted based on the market price.

Specific comments

- (a) Most candidates correctly arrived at the equilibrium quantity and price as 177.14 millions of barrels and USD 49.28 respectively. Some however forgot to indicate the unit of measurement i.e. millions of barrels and USD. A few candidates had made calculation errors in arriving at the correct answer.

- (b) (i) Some candidates could not state that consumer surplus is the gap between the total price the consumer is willing to pay for a number of units and the total sum actually paid for the same number of units.

Due to the varying relationship between market price and quantity demanded, consumer surplus exists.

Consumer surplus is the gain obtained by the consumer when purchasing items from the market according to some candidates who earned only a few marks. Some mentioned that due to utility theory, consumer surplus exists; but they failed to elaborate on this point.

- (ii) Some candidates arrived at consumer surplus correctly (i.e. USD 9,806.47 million). However, some applied the correct formula, but ended up with incorrect answers due to calculation errors.
- (c) Candidates that earned the full marks allocated stated the slowdown in global economic growth and introduction of more fuel-efficient cars as the main determinants of demand for crude oil. Some listed out the determinants of demand for any item without paying attention to crude oil.
- (d) Most candidates showed a shift of the supply curve to the right by drawing an appropriate graph. Some stated the impact without drawing a graph (i.e. there would be an increase in supply and as a result the equilibrium price would go down).
- (e) (i) Possible consequences would be, an increase in world market prices and high cost of importation, an adverse effect on the balance of payments, an increase in demand for USD, an adverse effect on the exchange rate and no impact on the consumer price index. A few candidates discussed all the possible consequences. Some incorrectly mentioned that the retail price of fuel in Sri Lanka would go up.
- (ii) Possible consequences would be, an increase in world market prices and as a result high cost of importation, an adverse effect on the balance of payments, an increase in the local consumer price index, an increase in transport costs, electricity generation, cost of production of almost all goods and services and thereby a possibility of cost push inflation. Some candidates had the wrong view that the government could earn more income by selling fuel. Only around 5% of candidates were able to earn the full marks allocated for this part.