Examiner’s report

F7 Financial Reporting
December 2011

General Comments
I am delighted to say that the overall performance of candidates on this diet was very good.
Most commentators believed this to be a fair paper for which a well-prepared candidate could readily attain a pass mark within the time constraints of the examination.

As with past papers, the best answered questions were the consolidation in question 1 and financial statements preparation in question 2. This was closely followed by the cash flow element of question 3. Answers to questions 4 and 5 (relating to the wider syllabus areas) were more mixed and rather polarised into either very good or very poor attempts. The overall effect was that there were many solid scripts scoring 70 or more; a truly impressive performance.

One area of concern was that there appears to be a return to the practice of a significant number of candidates not attempting all questions, particularly questions 4 or 5 (and sometimes both).

There were some examination technique issues that caused problems:
Several figures needed detailed workings, notably the cost of sales in question 2. Many candidates wrote down a long line of figures with no written description of what the figures represented or how they had arrived at them. When this happens it is almost impossible for markers to determine whether incorrect totals deserve any credit.
Not reading the question properly, or answering a different aspect of a question from the one set.
Poor handwriting is still an important concern for many markers (particularly for the written elements): put simply, markers cannot award marks if they cannot read what has been written.

The composition and topics of the questions was such that on this diet there was very little difference between the International Paper (the primary paper) and all other variant papers, thus these comments generally apply to all streams.

Specific Comments

Question One
This required the preparation of a consolidated statement of financial position, including an associate. There were fair value adjustments for plant and the need to recognise a ‘customer relationship’ intangible asset. Further adjustments required the elimination of current account balances and unrealised profit (URP) on inventory due to intra-group trading.

The majority of candidates clearly have a good working knowledge of consolidation techniques which showed through in very good marks for this question; there were a noticeable number of full marks. As usual it was the more complex aspects where errors occurred:

Consolidated goodwill
Some candidates did not discount the deferred consideration (or ignored it altogether) when calculating the purchase consideration. Also the non-controlling interest's consideration was sometimes calculated as $35 million (10 million shares x $3.50 x 100%), rather than as 20% of this figure).
Many candidates did not include the customer relationship as an asset at the date of acquisition, and many deducted the post-acquisition additional depreciation/amortisation charges when calculating goodwill. As a point of technique, many candidates are calculating goodwill as a two-stage process; the parent’s element and the non-controlling interest's element. Whilst this does give the same answer (if done correctly) it over complicates the calculation and wastes time.

Other consolidation errors:
Occasionally candidates added (rather than deducted) the additional depreciation/amortisation charges.

Incorrect calculation of the associate's post-acquisition profit; either not time apportioning it or using the retained earnings figure rather than the profit for the year.

Taking a 25% share of the impairment loss (rather than all of it) on the investment in the associate without understanding it was the investment itself that was impaired. Unrealised profit in inventory was often taken as $2.6 million (which was the intra-group sales figure, not the profit) or $300,000 (based on the profit in the current account balance rather than the sales) or $780,000 (based on 30% as the margin rather than mark up). The correct figure was $600,000 ($2.6 million x 30%/130%).

A common error was to offset the subsidiary's overdraft against the bank balance (in hand) of the parent. This is incorrect; there is no right of offset, they are two different legal entities.

Some candidates managed to account for a non-existent outstanding share issue by recognising the shares issued by the parent on acquiring the subsidiary, although the question stated this had already been recorded. The calculation of retained earnings proved problematic. The share of the subsidiary's and associate's post-acquisition profit was often incorrect and the non-inclusion of URP, unwinding of deferred consideration and the impairment loss was common.

There were some instances of candidates using proportionate consolidation (and consolidation of the associate), but thankfully these were very few.

Despite the above errors, as said earlier, many candidates achieved high marks for this question.

Question Two

This question was a traditional preparation of financial statements from a trial balance combined with several adjustments including: a goods on sale or return transaction, manufacture of own plant, property revaluation, a dividend calculation, fair value of a financial instrument and accounting for taxation.

This question was very well answered and many candidates achieved high scores. Most candidates have a sound knowledge of preparing financial statements in this format and, as expected, most of the problems involved the required adjustments. The most common of these were:

Statement of comprehensive income

Surprisingly, an inability to correctly apply a gross profit margin to a sales figure; many candidates grossed up the sales figure and others took 25% as a mark up on cost rather a gross profit margin. The question required the cost of an item of manufactured plant for own use to be removed from the related costs in the trial balance figures and capitalised. The question said that normally the company adds a profit margin of 40% to cost to arrive at a selling price. Many candidates proceeded to add 40% to the manufactured cost to arrive the capitalised value. This is not permitted; a company cannot make a profit out of itself.

Many candidates did not include production labour and factory overheads as part of costs of sales. A surprising number of candidates did not appreciate that the cost of sales calculation required the inclusion of opening and closing inventories - the former was often ignored completely. A smaller number of candidates noted the increase in inventory and reported it as a revaluation in other comprehensive income which has no logical basis.

Many did not add back the cost of the goods on sale or return to the closing inventory.

An incorrect calculation of the dividend was common with most making the mistake of not realising the shares had a nominal value of 25 cents each (they assumed $1 instead).

There were a lot of problems in calculating the deferred tax, particularly in relation to the deferred tax on the revaluation of property. This lack of understanding also fed through to the statement of financial position figures and the revaluation figure in other comprehensive income.

The loss on fair value of a financial asset (equity investment) should have been charged to the income statement, but it was often shown in other comprehensive income.

Only a minority of candidates correctly deducted the deferred tax element of the revaluation as part of other comprehensive income.

Statement of financial position
This was again generally well done with some errors being due to the knock on effect of those made in the statement of comprehensive income which are not generally penalised under the method marking principle.
A very common error (more than 50%) was to take the date of the revaluation of the leased property as being at the end of the year rather than the beginning.
The adjustment to revenue for the sale or return was not followed through to the receivables.
Many candidates omitted the revaluation reserve, even though they had calculated the figure in other comprehensive income.
Not surprisingly, weaker candidates reported a credit bank balance as an asset.

Despite the above comments, this was high scoring question.

Question Three
Most of the marks for this question (19) were for the preparation of a statement of cash flows. In general this was very well answered with many candidates scoring full marks. The main errors were:
- incorrect adjustment for depreciation (this surprised me as the charge for the year was given in note (ii) of the question and did not need calculating)
- the disposal proceeds of a property was often shown as the profit on disposal (and vice versa)
- the decrease in product warranties provision was treated as an increase (other elements of the cash flows also were often incorrectly signed)
- several problems in the calculation of the tax paid (often ignoring the effect of the deferred tax)
- many treated the new finance lease additions ($6.7 million) as a cash outflow, perhaps confusing this with the repayment of the finance leases (which was also often calculated incorrectly)
- all of the investment income ($1.1 million) was treated as a cash flow when in fact only the dividend received of $200,000 was a cash flow
- various incorrect figures for the shares issued; the increase in the share capital of $6 million should have been reduced by $3.6 million for the effect of a bonus issue (which is not a cash flow)

Although this is a long list, most candidates only made two or three of these errors such that it was a good scoring question.

Part (b) (International) required candidates to focus on two aspects of the statement of cash flows they had produced in part (a); operating performance and the investment in property, plant and equipment. The question required candidates to assess the different perspective of the above two areas that the accruals based financial statements (the income statement and the statement of financial position) gave when compared to the equivalent information in the statement of cash flows. The majority of candidates seemed to misinterpret this requirement. The main issue of operating performance was that the income statement reported a profit of $3.3 million whereas the cash generated from operations was a deficit of $4.9 million, clearly a very different indication of performance. The question wanted candidates to discuss what had caused this difference (mainly depreciation, working capital adjustments, product warranties and profit on disposal of property), but few candidates got beyond a mention of depreciation and working capital items.

Similarly the statement of financial position showed a net increase in property, plant and equipment of $8.5 million, but the net cash actually spent was only $200,000, again very different perspectives. Here the main differences were due to non-cash finance lease acquisitions and the profit on disposal, but few candidates gave

such an explanation. Some candidates completely ignored the question's wording and did a 'rote-learned' interpretation including calculating lots of accounting ratios.
Overall part (b) was badly answered, and often not at all.

Question Four
This was on the topic of IAS 37 *Provisions, contingent liabilities and contingent assets.*
Section (a) asked for a definition of provisions and contingent liabilities and how these definitions improve consistency in financial reporting.
Most candidates had learned the definitions well and scored appropriate marks, but were not as good at explaining the consistency aspects. Weaker candidates guessed at the definitions getting confused between which were probable and which were possible and between constructive obligations and contingent liabilities. Some just gave examples of provisions and contingencies without attempting to define the terms (this was not answering the question and gained no marks) and others defined contingent assets which was not asked for. Very few mentioned that requiring companies to provide for certain types of provisions (e.g. decommissioning/environmental costs, taking a cue from part (b) of the question), that prior to the IAS had often not been provided for, was an example of improving consistency.

Part (b) tested two examples of the application of IAS 37; environmental costs and a contingent liability. The environmental provision was made up of a fixed amount ($20 million) and a variable amount that was based on the amount of oil extracted annually. Most candidates correctly accounted for the fixed element by adding it to the cost of the licence (thereby amortising it over ten years) and treating it as a non-current liability. The treatment of the variable amount was not as well answered with many treating it the same as the fixed cost; the variable element is a liability, but it is not added to the cost of the licence, instead it is charged to the income statement annually on an accruals basis. Many candidates tried to discount the values given in the question despite the question clearly stating they were already discounted values. In effect the provision should have been increased (compounded) each year by 8% representing the unwinding of the discount as a finance cost.
The second example was a guarantee given by a parent for part of a loan held by its subsidiary. The guarantee was for $10 million out of a total loan of $25 (the other $15 million was secured on the subsidiary's property). An interesting aspect of the question was that it asked candidates to consider the issue in the consolidated financial statements and the parents own (entity) financial statements. Candidates often assumed that Borough had lent the money to Hamlet, and discussed intra-group elimination issues, but the question did not state this and Borough would not need to guarantee its own loans.

This was badly answered showing a lot of misunderstanding on the part of candidates.
Many completely ignored consolidated/parent aspect and some answered from the perspective of the subsidiary, which was not asked for. Many did appreciate that there was a contingent liability somewhere, but could not identify in which financial statements it should be disclosed. The correct answer was that from a group point of view there is no contingent liability, the whole $25 is an actual liability, and it is from the parent's own perspective that there is a discloseable contingent liability. A further complication is that the going concern of the subsidiary was in doubt; this meant that the parent might need to treat the contingent liability as an actual (current) liability. Many candidates discussed aspects of how a potential loss on the value of the subsidiary's securing property should be treated. The question specifically said that this should not be considered; indeed the point was that the shortfall in the value of the secured property had no effect on the treatment of the loan or the contingency.

Question Five
This question tested candidates' understanding of a compound financial instrument: a convertible loan note.
Section (a) was a two-part written element asking why a convertible loan had a lower interest rate than a loan without conversion rights followed by a requirement to comment on the directors' proposal of treating the loan note as equity (on the basis that conversion to equity was expected) and using the nominal interest rate for the charge to the income statement. Candidates who had studied this topic could explain that there was an expected

benefit in having the share option on the convertible loan which justified a lower interest rate and went on to say that the directors' proposals were not acceptable; the instrument needed to be split between a debt and an equity element. Fewer candidates referred to the interest rate issue (i.e. the requirement to use the effective interest rate for a non-convertible loan) and fewer still discussed the impact of this on the financial statements (improved earnings, lower gearing, etc).

Section (b) required candidates to show how the convertible loan should be treated in the financial statements. Strangely, some candidates correctly explained how the loan note should be treated in part (a), but could not put this into practice in part (b). Broadly, candidates either got full marks on this section or wrote down meaningless figures for the marker to try and make some sense of. The latter type of answer gained few, if any, marks.

Conclusion

Overall this was an excellent performance with many candidates scoring well on the wider topic areas of questions of 4 and 5 indicating appropriate coverage of the full range of syllabus topics.

Many of the above comments on the individual questions focus on where candidates made errors. This is intended to guide candidates' future studies and to highlight poor techniques with a view to improving future performance. This may appear to give an overly pessimistic view of candidates' performance. This is not the intention, nor is it the case. There were many excellent papers where it was apparent that candidates had done a great deal of studying and they were rewarded appropriately.