Examiner's report
F7 Financial Reporting
December 2012

General Comments
I am pleased to report that candidates' performance on this diet was much improved compared to recent diets with a pass rate of over 50%.

The paper was regarded by most commentators as a fair test where a well-prepared candidate would readily succeed. There appeared to be very little evidence of time constraint problems.

Maintaining the familiar trend, the best answered questions were the consolidation in question 1 and financial statements preparation in question 2. Question 3 on the calculation and analysis of ratios was more mixed, with candidates being weaker on the interpretation aspect. Answers to questions 4 and 5 (relating to the wider syllabus areas) were also mixed, reflecting whether candidates had studied the wider syllabus topics.
There were many very good scripts scoring 70 and some really impressive answers scoring well into the 80s.

As usual I have to report some examination technique issues almost all of which I have commented on in previous reports:

Not reading the question properly was a problem, particularly in question 3 (b) where many candidates treated the 'sector average' ratios as being the previous year's ratios of the company being appraised. Such a misreading rendered many of the points made by candidates meaningless.

Several figures worth a high number of marks had no workings, making it impossible for markers to know how the figures have been derived. Thankfully this was only a minority of scripts but where this happens it is difficult to award marks.

Many answers were a repeat of rote learned material and not applied to the question asked. For example, question 3 (c) asked for the limitations of the usefulness of comparing a company's own ratios with the 'sector averages'. Many, indeed most, answers to this were an iteration of the general limitations of ratio analysis and not those related specifically to a sector average comparison.

Yet again poor handwriting was an important concern for many markers (particularly for the written elements); if markers cannot read what a candidate has written, no marks can be awarded.

A lot a time is wasted by needless repetition of points and providing unnecessary numbered workings for the simplest of calculations/adjustments where inset figures would be quicker for candidates and easier for markers to assess. The format and style of the answers published on the ACCA website provides a useful guide as to the amount of detail required for a successful answer.

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

The main part of the question (part (b)) required the preparation of a consolidated income statement (statement of profit or loss) for a parent and a subsidiary that was acquired three months into the reporting year. This was preceded by the calculation of consolidated goodwill as at the date of acquisition and followed by a small written section testing how a fair value increase in leased property should be treated on acquisition together with any post-acquisition increase in its value.

Further adjustments required the elimination of intra-group sales and unrealised profit (URP), impairment to goodwill and additional depreciation from the fair value adjustments.

Most candidates scored very well on the calculation of the goodwill, many scored full marks. Where problems arose, they were mainly not discounting the deferred consideration (and consequently not charging an additional finance cost in the income statement (statement of profit or loss)), ignoring the non-controlling interest and not taking account of the pre-acquisition movement in profit since the beginning of the year. On this latter point a number of candidates took the retained earnings at the start of the year as being the year end retained earnings despite the fact that the start of the year date was typed in **bold** in the question. Also a significant number of candidates incorrectly included post - acquisition items (additional depreciation and URP) and omitted (or incorrectly signed) the contingent liability as a fair value adjustment in the calculation of goodwill.

The main consolidation was also done well with the vast majority of candidates clearly having a good working knowledge of consolidation techniques. Though, as might be expected, it was the more complex aspects where errors occurred:

- incorrect calculation of the URP and additional depreciation adjustments (particularly not time apportioning the depreciation)
- not eliminating the dividend of the associate
- time apportioning the investment income from the associate (the question stated this had been held for several years)
- not time apportioning the additional finance cost or ignoring it altogether
- not adjusting the non-controlling interest calculation for the additional depreciation and goodwill impairment

Some candidates did not realise that the subsidiary's results must be included on a time apportioned basis (i.e. for only nine months) and a small number of candidates continued to apply proportional consolidation to the subsidiary's results.

Several candidates wasted considerable time calculating the retained earnings and non-controlling interests as they would appear in the statement of financial position. The question did not require these items.

The main source of problems in question 1 was part (c), the treatment of increases in the fair value of a subsidiary's leased property on consolidation. The question asked how a fair value increase at the date of acquisition should be treated followed by the treatment of any subsequent increases. Bizarrely, a significant number of candidates thought this was a question about whether a lease was a finance lease or an operating lease. Others did not distinguish between pre-acquisition and post-acquisition increases. Most did identify that the fair value increase should be reflected in the carrying amount of property, plant and equipment and some referred to additional subsequent depreciation, but not many stated the effect on consolidated goodwill and that (where group policy requires) post-acquisition increases are reported in other comprehensive income (OCI), create a revaluation reserve and will impact on the non-controlling interest if the subsidiary is not wholly-owned.

Despite the above errors there were many high marks for this question.

Question Two

This question was a familiar preparation of financial statements from a trial balance combined with several adjustments including the exclusion of deferred service income from revenue; issue of a loan note; accounting correctly for an equity dividend; revaluation of land and buildings; a fair value movement in an equity financial asset; and the usual accounting for current and deferred tax.

As with question 1 this was very well answered, most candidates showing a sound knowledge of preparing financial statements in this format. Also, as usual, it was the adjustments that caused most of the errors:

- only a minority of candidates correctly accounted for the deferred service income; many just used the cost of $600,000 (rather than include the profit element of a further $200,000), some took one or three years (the two years outstanding was correct) and most failed to account for the deferred income in the statement of financial position. Many candidates deducted the cost of the servicing from cost of sales even though those costs had not yet been incurred.
- a majority of candidates had problems with the finance costs and the loan note, specifically: not deducting the issue cost before calculating interest; not using the effective rate of 8%; and not following through the addition of accrued interest (the difference between the correct finance cost charge and the interest actually paid) to the carrying amount of the loan as a single (non-current) liability
- there were many errors in the calculation of tax; wrong signing of the adjustments and deducting the year end provision for deferred tax (rather than the movement in the provision)
- most candidates calculated the revaluation of the land and buildings correctly and included it in other comprehensive income, but, within the statement of changes in equity of part (b), only a few included the transfer to realised profit in respect of the realisation of excess depreciation. A significant number of candidates incorrectly transferred the whole of the revaluation reserve to retained earnings. It was also common (but wrong) to include in OCI the loss on the equity financial asset investment (the default treatment is to include this in profit or loss).

Most answers to the statement of changes in equity were very good although the dividend was often incorrectly calculated (not realising the shares were 25 cents each) or ignored. Weaker candidates included the loan note and/or (more commonly) the equity financial asset investment as part of equity, showing a worrying lack of basic knowledge of what constitutes "equity".

The statement of financial position was generally very well prepared with most errors being a follow through of errors made when calculating profit or loss items. Generally such errors are not penalised as ACCA adopts a "method marking" principle which means the same error is not penalised twice. That said, both current and deferred tax were often incorrect, current tax incorrectly included the previous year's under provision and deferred tax was stated as the temporary difference (of $5 million) instead of the liability itself (20% of $5 million).
I am pleased to say that after many years of reporting candidates' poor ability in dealing with property revaluations, in this session most candidates appeared to have practiced past questions and mastered the topic. That said, a number of candidates did (incorrectly) depreciate the land.

Overall this was a well-answered question.

Question Three

This was a three part question. Part (a) required the calculation of eight ratios equivalent to the sector average ratios given in the question. The main part (b) was to assess the relative performance of the company compared to the sector average, and finally a 4-mark section on the limitations of the use of sector averages.

Although many scored well on the calculation of the ratios, many candidates made mistakes in this part. It was common to see a calculation of the return on equity (ROE) rather than the return on capital employed (ROCE) and many other errors were, I believe, simply careless:

- calculating the profit after tax margin (rather than the operating profit margin)
- inventory days rather than inventory turnover or using closing inventory instead of average inventory or inventory turnover based on revenue rather than of cost of sales
- trade payables period based on cost of sales rather than purchases
- debt/(debt + equity) instead of debt/equity

Whilst many of the incorrectly given ratios may be useful ratios in themselves, it invalidates the comparison to the sector average ratios (required in part (b)) if precisely the same ratios are not used.

The assessment of financial performance required in part (b) was quite disappointing with many of the usual weaknesses of past answers on this type of question. Some answers simply stated whether the ratios were higher or lower than the sector average (without even saying which was good or bad). Such an approach gains few, if any marks; it is simply not interpretation. A good answer requires candidates to identify comparative strengths or weakness and give a plausible explanation of why they may have occurred. As mentioned earlier, several candidates did not read the question properly and thought that the sector average ratios given in the question were the previous year's ratios of the company under assessment.
Common errors were to attribute a fall in the operating profit margin to the high finance costs (which is not the case as this ratio does not include finance costs) and arguing that an increase in the average inventory turnover was an indicator of a deteriorating situation (possibly obsolete inventory, etc) due to high inventory levels. The opposite of this is the case; I assume candidates confused the increase in inventory turnover with an increase in inventory holding period which would indicate higher inventory levels. Many candidates commented that the lower gross profit margin was a consequence of the high level of purchases, when what, I suspect, they really meant was that the cost of the purchases was high. Very few candidates noticed that the company's operating costs, as a % of revenue, were lower than the sector average as they did not take into account the lower gross margin. It was the case that the company's operating margin was below the sector average, but this was due to poor gross margins and not poor control of operating costs

Part (c) was the worst answered section. It seemed candidates gave little thought to what was being asked. Rather than consider what might be the inherent problems when comparing an individual company's ratios to the averages of its competitors, many answers just reeled off rote learned limitations of ratio analysis in general. Issues such as distortion due to inflation (rising prices), use of historical cost figures and year end balances not (necessarily) being representative of average values are common limitations to both the individual company and the sector as a whole. Relevant points would be the use of differing accounting policies/estimates, different year end (a clue to this was in the question) and possible differences (or misunderstanding) of how the ratios should be calculated.

Overall, despite relatively easy marks available for the ratio calculations, the performance on this question suffered from the problems explained above relating to the interpretation element.

Question Four

This question opened with a section on two of the Conceptual Framework's characteristics, those of understand ability and comparability and linking consistency to the concept of comparability.
Part (b) required candidates to calculate financial statement figures for the second year of a construction contract where the company had changed its method of calculating the percentage of completion. The final part asked candidates to explain why the change in part (b)(i) was a change of accounting estimate rather than a change in accounting policy.

Most candidates scored two to four marks on part (a) showing a reasonable understanding of the topic. My main criticism was that the lower scoring answers were too simplistic along the lines of 'understand ability means that financial statements should be in a form that users can understand'. Such answers failed to mention that users should have a reasonable accounting knowledge and be prepared to study the financial statements or take advice and that management should not 'clutter' the financial statements with so much detail as to obscure the underlying performance. There was also a lot of repetition in many answers to the comparability/consistency section. The better answers did not quite score full marks mainly because they did not cover enough points – there were six marks available for this section.

Part (b) was well answered by those making a serious attempt. The main errors were not deducting the first year's figures when arriving at the profit or loss figure for the second year, in effect their income statement (statement of profit or loss) contained the cumulative results. Some candidates tried to restate the previous year's results as if the question was based on a change in accounting policy. The statement of financial position answers were generally very good after allowing marks for some incorrect own figures from the income statement (statement of profit or loss).

In part (b) (ii) , most candidates said that changing the method of estimating the percentage of completion was a change in accounting estimate (which in fact the question told them), but did not really explain why. Most candidates also failed to distinguish the change in accounting estimate from a change of accounting policy mainly because they did not attempt to identify what the accounting policy was.

Question Five

In part (a), this question tested candidates' knowledge of a 'compound' non-current asset whose components required separate depreciation, together with a related government grant and environmental provision. Part (b) required candidates to advise on whether a provision was required for future environmental costs (fitting anti-pollution filters) and whether an existing provision should be reduced immediately as a consequence of the requirement for the new filters to be fitted.

Most candidates who attempted this question scored very well on part (a), indeed many scored full marks. The most common errors were discounting (rather than compounding) the environmental provision and failing to include either the deferred government grant or the finance cost of the provision in the income statement (statement of profit or loss).

Part (b) was less well answered. The majority of candidates believed that because the legislation requiring fitting of the filters was enacted within the current year, this meant a provision should be made immediately. This view ignored the fact that the legislation did not come into force for two years, and, perhaps surprisingly, even then it would not constitute a liability (as the costs could be avoided). It follows that if there should be no provision for fitting the filters, the existing environmental provision should NOT be reduced immediately. Where candidates had argued that the provision for fitting the filters should be made and, as a consequence, the environmental provision could be reduced, credit was given for the consistency of the argument.

Conclusion

Overall this was a solid performance with candidates scoring better on the wider topic areas of questions of 4 and 5 although the interpretation required in question 3 was disappointing.

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 should not detract from the many excellent papers where it was apparent that candidates had done a great deal of studying and they were rewarded appropriately.