Examiner's report
F7 Financial Reporting
December 2013

ACCA

General Comments
The paper was regarded by most commentators as a fair test of familiar topics which a well-prepared candidate could have comfortably passed.

However, candidates' scripts showed evidence of the bad habit of focussing on the 'banker' questions (consolidation, preparation of single company financial statements from a trial balance and cash flow statement) to the point where most of the rest of the syllabus is given very little, if any, attention. This approach often leads to a lot of undoubtedly capable candidates getting good marks of 40 to 45 for the first three questions and then either scraping through on the last two questions or completely running out of steam and ending up with a marginal fail. It was also probably responsible for an increase in the number of candidates that did not answer all five questions.

A salient feature of this diet's performance was that in certain sections candidates either did not read the question properly or did not apply sufficient thought before answering. For example, question 4 part (a) required candidates to distinguish between fundamental and enhancing qualitative characteristics of information, but most answered this by adopting a rote-learned approach of listing the supporting secondary characteristics in the Conceptual Framework with no attempt to explain the distinction. Another example, in the same question (part (b)(ii)), was of a sale and lease back. A majority of candidates ignored the fact that the transactions were on normal commercial terms and 'automatically' assumed it was an example of applying substance over legal form (which it was not).

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

The issue of answer workings is important; any detailed calculations must have legible and referenced workings that are laid out in a logical manner that can be followed by markers. Several figures worth substantial marks had scant or no workings making it impossible for markers to know how the figures have been derived.

Poor handwriting is still 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 minority of candidates wasted a lot of time; needless repetition of written points (for example, answers to 3(b)(ii) often repeated parts of 3(b)(i)), writing out a question's requirement before answering it, providing unnecessary workings (for simple line item calculations) and sometimes even duplicating an answer by writing it out again more neatly.

The composition and topics of the questions was such that on this diet there was no difference between the International Paper (the primary paper) and other adapted papers, except for question 1 where separate comments are provided for the UK/IRL adapted papers.
Thus these comments generally apply to all streams.

Report on individual questions

Question One
This required the preparation of both a consolidated statement of profit or loss and statement of financial position. Because of this, the required consolidation adjustments were relatively few; a fair value adjustment for a leased property, intra-group trading with unrealised profit (URP) and a valuation adjustment to fair value through profit or loss investments.

The majority of candidates displayed a good working knowledge of consolidation techniques and gained appropriate marks. Although answers to this question were good, they were not as good as I would have expected. Many candidates made errors which confused the accounting treatment in profit or loss with that of the statement of financial position, especially in the area of the non-controlling interests, eliminating intra-group sales from receivables/payables and also URP from inventories and profit. A small number of candidates time apportioned the figures for line items in the statement of financial position. It is hard to imagine that such candidates have ever practiced past examination questions. A similar fundamental error, though quite rare, was the use of proportional consolidation in both statements. It should not be used in either; indeed, this technique is not examinable in F7.

For the benefit of future candidates the common errors were:

Consolidated goodwill
The question clearly stated that a 'bargain purchase' was expected. Some candidate's calculations came out as positive goodwill (which should have flagged they had made an error) and, of those that did arrive at a bargain purchase (negative goodwill), few knew that it should be credited in full to profit or loss; most showed it as a negative asset, some even showed it as a liability.
The main errors in the calculation of the negative goodwill were:

- basing the cash consideration (and value of non-controlling interests) as if the shares in the subsidiary were $1 each (they were 50 cent shares)
- using the year-end estimate of the contingent consideration, rather than its initial estimate (the difference should be accounted for in profit or loss, not in goodwill)
- the value of the non-controlling interests based on the share price paid by the parent ($1.50), rather than the market price of $1.20
- many treated the **losses** of the subsidiary for the pre/post-acquisition split as if they were profits
- it was common to see post-acquisition figures for URP and additional depreciation included in the calculation of goodwill; these, by definition, are post-acquisition adjustments and should form part of the post-acquisition results in the statement of profit or loss and retained earnings.

Statement of profit or loss
The intra-group sales elimination caused real problems; most candidates eliminated only the sales from the subsidiary to the parent and ignored the sales from the parent to the subsidiary. A similar issue seem to cause problems in calculating the URP in inventory.
It was also a recurrent error for the adjustment for additional depreciation to be based on a full year rather than the six months post-acquisition period.
Many candidates did not include the loss on equity investments or the decrease in contingent consideration (as a gain) in profit or loss even though they had included these items in their working for retained earnings. The reverse was also true.
A careless mistake was to treat the subsidiary's tax relief on its losses as a tax charge.
The previously mentioned confusion of the losses (being treated as profits) was also present in the calculation of the non-controlling interest in the statement of profit or loss. Even some of the candidates who did recognise they were losses, then deducted the adjustments for URP and additional depreciation from the losses (they would increase the losses).

Statement of financial position
On the whole, the statement of financial position was well done. Other than 'knock on' errors from the points mentioned above (such as additional depreciation being for a full year and not including items in retained earnings), the common errors were:

- not deducting the cash consideration and the loss on the equity investments from the balance on the parent's investments when determining the carrying amount of the residual equity investments.
- not deducting URP from inventory (even when it had been correctly treated in cost of sales).

inexplicably, a significant minority of candidates treated the **cash** consideration as if it had been an issue of shares and created various amounts of share capital and share premium.

Despite the long list of above errors there were still many good marks for this question.

UK and IRL adapted papers
The above papers had a shorter consolidation requirement to allow for a part (b) which asked candidates to describe how the treatment of the negative goodwill under UK GAAP differs to that under International Financial Reporting Standards.
This was not answered at all by a large number of candidates, and very few of those that did answer it gave good answers. The UK GAAP treatment of negative goodwill as a "negative asset" and its subsequent recognition in profit or loss was mentioned by very few candidates.

Question Two
This question was a traditional preparation of financial statements from a trial balance combined with several adjustments including: a construction contract, a revaluation of land and buildings (at the start of the year), a finance leased property (in its second year), the reversal of a provision for self-insurance and adjustments relating to taxation including deferred tax on the property revaluation. There was also a loan note where the effective interest cost had to be accrued and rolled up into a redemption premium.

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

Statement of comprehensive income
I was surprised that most candidates did not account for the construction contract correctly. Common errors were an incorrect calculation of the estimated profit (usually caused by not taking into account estimated future costs) and basing the percentage of completion on cost rather than on the percentage of the work completed and certified. Some candidates took a single figure of profit to profit or loss (rather than include the relevant items in revenue and cost of sales) and many candidates either ignored the amount due from the customer in the statement of financial position or calculated it incorrectly.
Most candidates scored well on accounting for the non-current assets including the revaluation of the land and building and subsequent depreciation of the building; however, many did include the deferred tax on the revaluation in profit or loss rather than in other comprehensive income. For some reason a minority of candidates did not calculate depreciation on the leased plant at all or charged depreciation based on the opening net carrying amount ($28 million) rather than the initial carrying amount ($35 million).
The self-insurance caused some problems; most candidates adjusted administrative expenses for a reversal of the $400,000 provision, but did not then account for the $250,000 costs incurred (or sometimes the other way round).
It was common for candidates to miss or incorrectly account for the various finance costs. Most got the mark for the bank interest, but some did not accrue for the loan note interest and some based the 10% lease finance cost (and the statement of financial position liability) on the initial carrying amount of the asset ($35 million) or its net carrying amount ($28 million) rather than on the opening finance lease liability of $29.3 million.
Most candidates had a good attempt at the income tax charge, but there were several fairly common errors: the credit for the overprovision in the previous year was often debited and, as mentioned above, the deferred tax on the revaluation was included in the profit or loss charge rather than in other comprehensive income where the revaluation surplus itself was reported.

On this point, some candidates that calculated the revaluation surplus on land and buildings in their workings (and included it the carrying amount in the statement of financial position) did not report the surplus in other comprehensive income.

Statement of financial position
This was generally well prepared with most errors being a ‘knock on’ from errors referred to above made when calculating profit or loss items such as contract costs, lease obligations, not accruing for loan note interest or non-current asset errors. Generally such errors are not penalised as ACCA adopt a 'method marking' principle which means the same error is not penalised twice. It is worth mentioning that candidates should not despair if they do not know how to deal with a particular adjustment, or if they think they have made some errors, as high marks can still be scored in spite of this.
As mentioned in several previous examiner's reports, a basic error was that the bank overdraft was often shown as a current asset.

Question Three
This question was on the familiar and popular topic of preparing a statement of cash flows (14 marks) followed by an analysis of the cause of a fall in profit (6 marks) and how rising prices may affect the interpretation of financial statements (5 marks).
As is common in this type of question, the statement of cash flows was generally well answered, many candidates got full marks on the operating cash flows; however there were the usual mix of errors in getting the signing of the cash flows wrong and including non-cash flow items, such as revaluations and the property transfer, within the statement. The written sections were not as well answered.

(a) Statement of cash flows
The main errors were:

It was common for candidates not to allow for the movement in the accrued finance costs when computing the interest paid and a significant minority simply treated the profit or loss expense for tax as a cash flow, rather than adjusting for the opening and closing provisions. I am very surprised at the latter as it is tested in almost every cash flow question.

The cash flow to acquire new property, plant and equipment was quite complicated and not surprisingly caused some problems. The most common errors in computing this figure were not allowing for the transfer from investment property to property, plant and equipment and treating a downward revaluation as an increase in value; also some candidates accounted for the disposal at its sale proceeds rather than its carrying amount. Some candidates did not include the sale of the property, plant and equipment or the purchase of a new investment property in investing activities (or anywhere else), and many did not include the cash received from investment property rentals in their statement.

The only other significant error was in relation to the dividends paid, many candidates did not reconcile the movement in retained earnings to see if a dividend had been paid and, some of those that did used the figure for total comprehensive income rather than the profit for the year in their reconciliation.

(b)(i) This was a relatively straightforward requirement asking candidates to explain the cause of the fall in the company’s profit before tax. There were some very good answers, but I was surprised by the many weak answers; such as not answering the specific question (in effect treating it as general ratio calculation and interpretation) and writing just one or two sentences. All that was required to achieve a good answer was to systematically go through the items of profit or loss and make sensible comments on what had caused the profit to fall.
The main issues to spot were: the fall in gross profit was due to failing to fully pass on (through selling prices) the 8% increase in cost of sales; an increase in overheads, particularly administrative expenses; and the performance of investment properties had deteriorated, both in terms of rentals received (perhaps due to changes in the portfolio) and fair value changes that had gone from a surplus to a deficit (perhaps due to market conditions).

In general most low scores were not so much a case of candidates getting things wrong, as an insufficient response to the question.

(b)(ii) It was a common occurrence for candidates not to answer this section at all, and many of those that did gave poor or irrelevant answers or repeated points that they had made in answering the previous section. The question required candidates to describe the main effects which rising prices may have on the interpretation of financial statements. The main thrust of the answer should have been around the issue that rising prising can distort trend analysis (year-on-year comparison). These have a tendency, over time, to understate comparative costs (thus overstating profit) and also understate asset values.
Many candidates discussed largely irrelevant items such as shareholders unwilling to invest or cash flows being tightened or working capital management being more difficult. Some candidates commented that rising prices (applying to costs) leads to lower profits, however this is only true (as was the case with the company in this question) if they are not passed on in selling prices; if rising prices are (fully) passed on, profits would actually rise.

Question Four

This question was on the familiar area of the Conceptual Framework.

Part (a) required candidates to distinguish between fundamental and enhancing characteristics and explain why faithful representation was important. Part (b) contained two examples involving the issue of faithful representation for which candidates had to explain how they should be treated in the financial statements.

Part (a) was answered disappointingly, with many candidates not really answering the question asked. Most candidates simply described fundamental and enhancing characteristics in terms of their component characteristics; faithful representation and relevance for fundamental and comparability, verifiability etc. for enhancing. Some credit was given for this, but it did not answer the question asked; fundamental characteristics are those that if they are not present render the presented information as **not useful** (maybe even misleading) to users, whereas an absence of enhancing characteristics means that financial statements would be less useful (but not useless) than if they were present.
In answering the issue of the importance of faithful representation, many candidates approached this by giving examples of its application in terms of reflecting a transaction's substance (such as the appropriate treatment of various finance arrangements), rather than actually explain its importance i.e. that the accounting treatment of transactions must faithfully represent the economic phenomena that they purport to represent.

The first example in part (b) was factoring trade receivables. In such an arrangement the main determining point for applying the correct accounting treatment is to look at which party bears the risk of slow/non-payment of the receivables. In this case it was the company 'selling' the receivables (Laidlaw). Most candidates scored well by correctly realising that the payment from the finance company was an in substance loan secured on the receivables and should be treated as such by reversing the original credit to receivables and instead crediting current liabilities and accounting for administration and finance costs as accrued expenses.
The second example was a different matter; it was an example of a sale and leaseback of a property. In some cases such transactions can be examples of financing arrangements where the leaseback is for the majority of the remaining life of the asset. Thus the risk of ownership has not been transferred and the asset should continue to be recognised on the statement of financial position (albeit as a leased asset) and the 'proceeds' treated as a loan.
It seems that most candidates believe **all** sale leaseback transactions are financing arrangements; this one was not. As the sale and the subsequent rentals were at commercial values, as indeed was the opportunity to repurchase the property, then this transaction is fairly represented by its legal form; it is a true sale on which the profit should be taken to profit or loss and the rental should be expensed as an operating lease arrangement. The opportunity to repurchase is not an asset (or a contingent liability as some suggested) and should be ignored.

As a result most candidates scored few or no marks on this section. My view is that candidates did not think about the question, they simply answered it along the lines of a perhaps a tutorial question that they may have studied which was an example of a financing arrangement.

Question Five

This question concerned the accounting treatment of alterations to a property leased under an operating lease together with a requirement to restore the property to its original condition at the end of the operating lease.
Part (a) asked candidates to explain how the items should be treated and part (b) asked for extracts from the financial statements reflecting the treatment. As referred to earlier this question had a relatively high number of candidates that did not attempt it. It is difficult to explain why this would be the case as the topics of an operating lease, capitalisation of non-current assets and provisions for rectification/restoration costs have all been asked (several times) in past examinations.

For part (a) several candidates wrote down everything they had rote learned about the difference between operating and finance leases. This gained no marks as it was not what the question asked. Those that had attempted to answer the question asked made some fundamental errors; many said that the operating lease rentals should be capitalised, effectively treating it as a finance lease when the question clearly said (**in bold print**) that it was an operating lease. Another common misunderstanding was to write off the cost of the alterations (they should be capitalised), and, although most said the restoration costs should be provided for, they either said they should be accrued over the 8-year remaining life of the lease, or they should be expensed immediately. The correct answer is that they should be provided for in full immediately and also capitalised by adding them to the capitalised alteration costs and then depreciated over the 8-year life.

Answers to part (b) generally reflected the answers to part (a). Most gained marks for expensing the rental cost and unwinding the finance cost of the restoration provision; gaining the marks available for the extracts of the statement of financial position depended on whether they had correctly capitalised the alteration and restoration costs. Several candidates who calculated depreciation in the statement of financial position failed to show the charge in profit or loss.

Conclusion

Overall many candidates displayed poor technique and adopted the bad habit of not answering all the questions, particularly questions 4 and 5, indicating inadequate coverage or understanding of the full range of syllabus topics. However the first three questions were generally very well answered.

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 necessarily the case. There were many excellent papers that were rewarded appropriately.