Examiner's report
F7 Financial Reporting
June 2012

General Comments
I am pleased to say that the overall performance of candidates on this diet maintained the recent improvement shown in December 2011 and delivered a creditable a pass percentage.
Most commentators believed this to have been 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, but overall there were better attempts than in many past diets. I hope this is a sign that the majority of candidates are studying the wider syllabus. Not only does this aid success in the F7 paper, but will also give a good grounding for the further studies at the P2 paper.
There were many excellent scripts scoring 70 or more and even some in the 90s; a truly impressive performance.

As usual there were some examination technique issues that caused problems:

Several figures needed detailed workings, notably the goodwill and retained earnings in question 1 and the cost of sales in question 2. For these some candidates wrote down a long line or list 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. This was particularly noticeable in question 3(b) where the requirement of the question specifically stated that working capital ratios and analysis of them were not required. Many candidates ignored this and wasted considerable time producing large sections of answers that gained no marks.

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.

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. There were fair value adjustments for plant and unrecorded deferred tax. Further adjustments required the elimination of intra group loans and current account balances after dealing with goods in transit (including an element of unrealised profit (URP)) and cash in transit.

An equity accounted associate was included by way of a note.
The majority of candidates clearly have a good working knowledge of consolidation techniques which showed through in very good marks for this question; as usual it was the more complex aspects where errors occurred:
Consolidated goodwill

Some candidates did not correctly discount the deferred consideration or account for its related finance cost in retained earnings; similarly it was not shown as a liability in the statement of financial position. Many also ignored the unrecognised deferred tax or treated it as an increase rather than a decrease in the fair value adjustments to compute net assets acquired.

Other consolidation errors:
Many candidates did not read the question properly regarding the associate. The question clearly stated that the retained profits of the associate had increased by $2 million since 1 October (the date of acquisition), but many candidates treated the $2 million as the annual profit of the associate and incorrectly time apportioned it by 6/12.
Some candidates got hopelessly confused with the intra group trading and calculation of the URP. Another error was to record the acquisition share exchange by increasing share capital and share premium despite the question saying that the parent had already recorded the share issue. Another frequent mistake was to increase the fair value of the other equity investments **by** $2.8 million rather than **to** $2.8 million
Although the principle of the consolidated retained earnings seemed well understood the question required several adjustments to this figure and many of these were omitted. As well as the finance cost of the deferred consideration already mentioned, other omissions were the share of the associate's post-acquisition profit, the deduction of the URP on inventory and the gain on the other equity investments.

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

Question Two
This required the preparation of financial statements from a trial balance combined with several adjustments including: a suspense account reflecting an unrecorded share issue, a revaluation of property at the start of the year, accounting for a finance lease, accounting for a fraud and the usual provisions relating to taxation.
There was a small section requiring the calculation of basic earnings per share.

As question with question 1 this was very well answered, with most candidates showing a sound knowledge of preparing financial statements in this format. As usual, it was the adjustments that caused most of errors:
Statement of comprehensive income
Many candidates, surprisingly, deducted the loss on the fraud directly from revenue rather than treating it partly as a prior-year adjustment and partly as an irrecoverable receivable (not applicable to UK and IRL variants).
There were several errors in the calculation of the amortisation of the lease but in general the non-current assets and related charges were well answered.
The treatment of the finance lease caused difficulty with the calculation of interest in the income statement and with the liabilities in the statement of financial position. This was often due to using the incorrect initial fair value of the lease or the timing of the lease payments, particularly the initial deposit. This is disappointing as finance leases have been examined many times on this paper.
Many candidates got confused with the calculation of taxation; the most common error was failing to realise that the tax for the year was a refund rather than a charge and also there was the usual problem of being unable to account for deferred tax correctly. This is also rather disappointing as similar requirements are asked in almost every diet.
Another common error was a failure to record the revaluation surplus as other comprehensive income.

Statement of changes in equity
This was generally well answered, but the most common errors were ignoring the prior period adjustment element of the fraud and a failure to make a transfer to retained earnings in respect of part of the revaluation surplus (these adjustments were not applicable to UK and IRL variants).

Statement of financial position
This was generally well prepared with most errors being a 'knock on' from errors made when calculating income statement items. Generally such errors are not penalised as ACCA adopt a "method marking" principle which means the same error is not penalised twice. That said other errors were apparent; receivables were not adjusted for the fraud, the tax refund was often shown as a liability (and at the wrong amount), conversely the bank overdraft was shown as an asset and the opening provision for deferred tax rather than the closing provision for deferred tax was included as a liability.

Answers to the section on the basic earnings per share calculation were very disappointing. This was not a particularly difficult or newly examined calculation, but very few candidates scored well with many, perhaps even a majority, not even attempting it.

Again, despite the above errors, this was high scoring question.

Question Two
Section (a) of this question required the preparation of a statement of cash flows for 11 marks. Traditionally these questions are popular with candidates and it was generally very well answered with a significant number of candidates scoring full marks. Section (b) of the question gave information in respect of a new contract that had been undertaken during the year and the requirement was for candidates to explain how the contract had affected the company's operating performance. It should be noted that the interpretation required was for this specific area, indeed analysis of working capital was explicitly stated as **not** being required. Although there were some insightful answers, this was a weak area for many candidates and a significant minority did not attempt it at all.

The main errors were:

Statement of cash flows
The calculation of the income tax paid, the purchase of non-current assets and the failure to account for the equity dividend were by far the most common errors. Other errors included showing the revaluation of property as a cash flow and not clearly distinguishing cash inflows from cash outflows.

Performance assessment and the effect of the new contract
A good number of answers treated this section as if it were a general interpretation question and calculated lots of ratios (despite a specified 4 mark limit on ratios) most of which were not required and therefore irrelevant. This general type of answer failed to focus on the important effect that the new contract had had on the performance of the company. The company had experienced significant increases in revenue (perhaps due to the contract) yet its return on capital employed (ROCE) had fallen dramatically. Many candidates failed to identify/discuss the component elements of the ROCE nor did they comment on the consequences of taking on the new contract. The most important of these were: substantial investments in new property, plant and equipment, the acquisition of an expensive licence and the purchase of an investment in another company to secure supplies of specialised materials. In combination it appeared that the contract was detrimental to Tangier's operating performance, however more information (which the question asked candidates to refer to) would be needed to confirm or refute this.

Although it is a generalisation, answers tended to be either very good when candidates focused on the requirements or quite poor where a 'rote learned' approach was adopted.

Question Four
This was on the topic of IAS 36 *Impairment of assets.*
Section (a) asked for an explanation of an impairment review with specific reference to cash generating units (CGUs). The answers to this were rather mixed, again those answers that were kept relevant to the requirement scored well, often full marks, but many answers digressed into discussing the indicators of impairment (specified as not being required) or describing small scenarios to illustrate impairment situations rather than explaining what an impairment review was. Many answers completely ignored CGUs.

Section (b) contained two numerical examples testing the application of section (a).
The first example required a simple calculation of the carrying value of an asset and then the present value of its future cash flows. These were to be compared to determine if the asset was impaired. There were some rather

alarming elementary mistakes in the calculation of the carrying value, many candidates ignored the asset's estimated residual value when calculating annual depreciation and some deducted the estimated residual value from the initial carrying value of the asset before applying the annual depreciation charges. The most common mistake (made by the vast majority of candidates) in the present value calculation was not including the residual value as part of the cash flows. Despite these errors, the last part of the question was marked on whether an impairment had occurred based upon candidate's own figures. Several candidates missed an easy mark by not coming to a conclusion on the impairment.

The second example was based on the apportionment of losses to the component parts of a cash generating unit. Many candidates gained good marks and some full marks for this section. The main errors were not treating the damaged plant as a separate loss and a failure to allocate part of the impairment loss to specific assets in a specific order (goodwill and the patent) and the remaining impairment loss across the correct assets (the factory and the remaining plant).

Question Five

This question tested candidates' knowledge of the two main systems of regulation for accounting standards; rules-based systems and principles-based systems. As in common with past diets, question 5 is often not answered. Of those that did answer this question, weaker answers simplistically stated that rules-based systems were based on rules and principles-based systems were based on principles. There was no attempt to explain the main differences between the two which were mainly the rigid nature (though less prone to manipulation) of rules-based systems compared to the flexibility (though sometimes abused) of principles-based systems, nor did candidates come to a conclusion as to whether IFRS is rules-based or principles-based.
Section (b) of this question required candidates to identify the advantages a company could gain by adopting IFRS. The short scenario of the question gave several pointers to the areas candidates should have discussed. I have to say that I was pleasantly surprised by the many good answers to this section. Most commented on the advantages in the areas of: simplifying consolidations, raising finance, improved comparability issues and the general enhancement of reputation/credibility.

Conclusion

Overall this was a solid performance with candidates scoring better 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 scripts where it was apparent that candidates had done a great deal of studying and they were rewarded appropriately.