Examiner's report

F7 Financial Reporting
June 2013

ACCA

General Comments

The overall performance of candidates on this diet was rather disappointing compared to the trend of previous recent papers. The main cause seems to be a return to many of the old 'bad habits' I had hoped had been overcome; poor performance on questions 4 and 5 (due to poor coverage of the wider syllabus) and not answering all five questions. This also extended to parts of questions; particularly part (b) in questions 1 and 2 for 5 and 3 marks respectively, which were left unanswered in many scripts.

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.

The normal pattern was seen, with questions 1 (except part (b)) and 2 and the cash flow element of Q3 again being the best answered.

Despite overall disappointment, there were many very good scripts scoring 70 or more and some were in the high 80s; a truly impressive performance.

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

Not reading the question properly seemed to be a common problem particularly with those that attempted part (b) of question 1. Similarly for part (b) of question 3 (the interpretation), many candidates calculated and interpreted working capital ratios which were not required; the question specifically asked for only ROCE and its constituent elements (profit margins and asset utilisation) and gearing.

Yet again poor handwriting was an important concern for many markers (particularly for the written elements). I have commented on this issue in every one of my recent reports and, if anything, handwriting has got worse. All markers do their best to read what candidates have written. But if markers cannot read what a candidate has written, no marks can be awarded. I have also commented before on the use of excessive workings which only serve to waste candidate's time; the answers published on the ACCA website provide a useful guide to the level of detail required for a successful answer. At the other extreme, it is worth mentioning that candidates who show no workings at all are likely to get nil marks for unsupported figures.

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 adapted papers, with the exception of question 3 (b) on the UK and IRL papers, thus these comments generally apply to all F7 papers.

Specific Comments

Question One (a)

This required the preparation of a consolidated statement of financial position. It included a fair value adjustment for plant which was **below** its carrying that many candidates treated as a surplus. Some of the candidates that did get the plant write down in the right direction and then proceeded to make the consequent depreciation adjustment the wrong way. Further adjustments were required for the elimination of intra group trading/current accounts, cash in transit and unrealised profit (URP) in inventory.

A slight twist in this question was that candidates did not have to calculate and time apportion to derive the pre-acquisition losses as this figure was available from draft financial statements prepared by the subsidiary at the acquisition date.

The majority of candidates displayed 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:

Most candidates correctly calculated (and accounted for) the value of the share exchange and the NCI, however there were a number of errors in the calculation of the loan notes issued. The main error was NOT basing the loan note issue on the shares acquired by the parent (instead it was often based on the number of shares issued by the parent).
The other area that caused several problems was the calculation of the (unadjusted) post-acquisition profits of the subsidiary. The profit for the full year was $8 million and there were pre-acquisition losses of $2 million, this meant the post-acquisition profit was $10 million; many candidates calculated this as a net $6 million.

Other consolidation errors:
Several candidates eliminated the intra-group inventory ($4.6 million) from the total inventory, rather than just the URP in the inventory of $600,000. There was also confusion with the elimination of current account balances. Cash in transit (CIT) of $900,000 from the subsidiary to the parent meant that the payable of the subsidiary ($2.8 million) was $900,000 less than the receivable of the parent. The treatment of this should be relatively straightforward: eliminate the balance each company shows in its own books from payable/receivables and the difference (CIT) is added to bank. Conventionally the CIT is added to the parent's bank, but it was marked as correct if the CIT had been deducted from the subsidiary's overdraft.

Although the principle of the parent's retained earnings seemed well understood the question required adjustments to this figure for URP in inventory (as the parent had sold the goods to the subsidiary) and a loss on the parent's equity investments which were often omitted. Other common errors were that the reduction in depreciation of the plant (resulting in an increase in the subsidiary's post-acquisition profits) and the gain on the subsidiary's equity investments were often treated as those of the parent.

A minority of candidates decided to time apportion the assets and liabilities of the subsidiary, presumably as it had been acquired part way through the year; this is clearly meaningless in the consolidated statement of financial position.
Despite the above errors there were many high marks for this part.

Question One (b)
This required candidates to advise a prospective purchaser of the subsidiary on the appropriateness of using the consolidated financial statements as a basis for an investment decision. As mentioned earlier, less than half of candidates attempted this part, and those that did generally performed badly.
The most common error was that candidates treated this part as a 'mini interpretation' answer, commenting on the overdraft, current ratios, liquidity, gearing, etc. of the subsidiary (which would not be available if only the consolidated financial statements were accessible). The main issue is that consolidated financial statements are not useful for assessing the performance of a single company within the group as they contain the aggregated results of all the companies within a group. So, the main point to be made is that the entity statements of the subsidiary itself must be used for this purpose; even then there are problems. In this case it was apparent that the subsidiary's post-acquisition results had been improved due to favourable pricing of the inter-company trading (supported by the closing inventory) originated by the parent on the terms stated in the question. This is an example of the possible effect of related party transactions which are an (normally) unknown danger when dealing with a subsidiary. Very little of this was mentioned by the vast majority of candidates.

Question Two (a)
This question was a traditional preparation of financial statements from a trial balance combined with several adjustments including: a sale and repurchase of goods which was an in substance loan; a non-current asset held-

for-sale; a revaluation of property at the start of the year; a rights issue of shares and the usual adjustments relating to taxation.
Part (b) was a small part requiring the calculation of basic earnings per share.

As with question 1, this was generally 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 errors:

Statement of profit or loss and other comprehensive income
Most candidates correctly deducted the in substance loan from revenue, but did not make an adjustment to the cost of sales or closing inventory to bring the goods back into inventory. It was also very common for the finance cost of the in substance loan to be omitted (or not time apportioned).
There were several errors in the calculation of the depreciation of property, plant and equipment, partly due to incorrect revaluation techniques and partly by not treating the held-for-sale plant correctly. Some of those that did separate the held-for-sale plant still classed it as non-current, some revalued it to its market value rather than leaving it at its (lower) carrying amount and many failed to depreciate it up to, but not beyond, the date of reclassification.

There were the usual errors in the tax charge: adjusting the prior year balance the wrong way and charging the whole of the provision for deferred tax rather than the movement in the provision. Similar tax calculations are examined nearly every diet.

Statement of changes in equity
This was generally well prepared, but the most common error was not realising that the share capital and premium in the trial balance were stated after accounting for the rights issue, thus in the statement of changes in equity it was necessary to 'work backwards' to the opening figures. Many candidates still do not seem to understand that equity dividends paid are not an expense but a deduction from retained earnings in this statement.

Statement of financial position
This was generally well prepared with most errors being a 'knock on' from errors made when calculating profit or loss items e.g. incorrect carrying amounts of property, plant and equipment, not accruing for loan interest (or omitting the loan completely), incorrect deferred and current tax provisions. Generally such errors are not penalised as ACCA adopt a 'method marking' principle which means the same error is not penalised twice. A surprisingly common and worrying error was that the bank overdraft was shown as a current asset. Many candidates did not show the (accrued) directors' bonus as an expense and a current liability and seemed unable to distinguish between 1% and 10% (the latter amount often being used to incorrectly compute the bonus).

Question Two (b)
Answers to the earnings per share (EPS) were rather mixed. With a similar calculation having appeared as recently as June 2012, I was expecting this to be well answered, but many candidates did not even attempt it and, of those that did, several struggled with it. That said with the application of method principle, there were a good number of maximum scores. It seems that those who knew the procedure to compute basic EPS did well, but many candidates appeared to have no idea of the approach required.

However, despite the above errors, this was a high scoring question.

Question Three
This should also have been a familiar type of question with part (a) being a 15 mark statement of cash flows and part (b) requiring some ratio calculations and interpretation.

As expected, the statement of cash flows was generally well answered (especially the operating cash flows) although the interpretation rather less so.

(a) Statement of cash flows

The main errors were:
For some reason many candidates thought the finance lease interest was not a cash flow. Taxation caused some difficulty, mainly in relation to the deferred tax element of the property revaluation. A similar issue often caused a wrong cash flow for the purchase of property, plant and equipment because many candidates calculated the revaluation surplus net of the deferred tax. The correct treatment of the deferred tax on the property revaluation is to debit the revaluation reserve and credit deferred tax; it does not affect the carrying amount of the property. Many did not adjust development expenditure for its amortisation when calculating the cash outflow. The (capital element) repayment of the finance lease was often incorrectly calculated due to omitting the new finance leases acquired in the year and some incorrectly included the lease interest payment in the calculation.
Those that remembered to test the movement in retained earnings for an equity dividend paid usually got the correct amount (although some candidates incorrectly used total comprehensive income instead of profit for the year), but many omitted this process altogether.

(b) INT Ratios and performance assessment
Up to 4 marks were available for appropriate ratio calculations. Most scored well on this as it was a relatively flexible requirement, but ratios for items that were NOT required (mainly working capital ratios) in the interpretation scored no marks.

Whilst the ratios scored well, the same cannot be said for their interpretation. Although there were some good and insightful answers, particularly in the attempt to analyse the change in the ROCE, far too many answers were of the type' this has gone up, that has gone down'. Such comments are not interpretation; they merely reiterate what the ratio calculations say. There were several indications in the financial statements and notes which should have prompted comments, including: additions to property, plant and equipment; development expenditure coming on stream; the effects of the repayment of the loan notes and the increase in finance lease obligations on gearing.

Some answers showed a lack of understanding: many candidates said that the increase in revenue was the cause of the increase in the gross profit percentage. This is simply not true: it is perfectly possible to increase revenue and **decrease** the gross profit percentage. It was also common to read that the increase in property, plant and equipment had led to the improvement in the asset utilisation ratio. Again this is not the case: an increase in property, plant and equipment, without a proportionately higher increase in the revenue they generate, would actually lead to a **decrease** in asset utilisation (although creditably to the company in this question, the increase in property, plant and equipment was also accompanied by an increase in asset utilisation). Many of these misunderstandings appear to be based on interpreting absolute numbers rather than the ratios of the absolutes. As referred to above, just because revenue increases it does not necessarily mean gross profit (or gross profit percentage) will increase.

(b) UK and IRL
This part was in two sections. Section (i) asked how the UK treatment may differ to the international treatment for the revaluation of non-current assets (including deferred tax effects), the finance lease and the development expenditure. This was often not answered at all (neither was part (ii)) and where it was answered, it seemed mostly incorrect guesswork. Section (ii) asked candidates to state how the differences in section (i) would affect the ROCE and gearing as compared to the international treatment. Surprisingly, in view of the answers to section (i), where this was answered many candidates did identify the correct differential effects.

Question Four

This was on the topic of IFRS5 *Non-current Assets Held for Sale and Discontinued Operations.*

Part (a) was straightforward, asking for the definition of a discontinued operation and why its disclosure was important. Most candidates had a fair understanding of the definition element in terms of discontinuance, but very few identified the important aspects of a separate line of business or a geographical area with distinguishable results and cash flows (they are often cash generating units). As regards the importance of the disclosure of discontinued operations, answers were mixed; some appreciated its importance in terms of comparability and assessing future prospects, whilst weak answers just referred to 'true and fair view' or simply repeated that it was important without saying why. An answer to the definition that simply said this was an operation that had been discontinued scored no marks.

Part (b) gave two examples for which candidates had to decide (and explain why) whether they should be treated as discontinued operations or not. The first example was clear cut in that it was a discontinued operation as it met the 'geographical' criteria; the second example was less conclusive and really required some debate. Most answers said it was not discontinued on the basis that the hotels were still trading (which was worth a mark), but very few debated whether or not the change of target market for the hotels represented a change in a 'separate line of business'.

Part (c) was about a factory closure (that constituted a constructive obligation) and what items should be provided for. The question specifically said the closure was NOT a discontinued operation, but despite this many candidates said it was and tried to answer accordingly. Most answers were very vague in that they just listed the cost and revenue items given in the question without explaining what should be done with them; specifically whether or not (and when) they should be provided for. This type of 'non-commitment' gains no marks as it means candidates do not demonstrate any understanding of the issues raised by the question.

In terms of the constructive obligation, the cost of retraining cannot be provided for (until it is incurred). The redundancy costs should be provided for as should the impairment of plant and the onerous contract (at the lower amount) and the penalty payments. The surplus on the fair value of the factory cannot either be recognised in the year (as it had not been sold) or be used to offset any other costs.

Question Five

This question tested candidates' knowledge of IAS 40 *Investment Property.* Section (a) was in two parts ; one requiring the definition of an investment property and why it is treated differently from owner-occupied property, and the second part focused on the difference between the fair value model for investment property and the revaluation model for owner-occupied property. Of the candidates that answered this question, most were quite good on the definition of investment property, but were less forthcoming as to why their accounting treatment was different (very few mention investment property generating cash flows independent of other assets). Similarly most candidates were aware that investment property is not depreciated (and owner-occupied is) and that fair value gains and losses on investment property go to profit or loss whereas for owner-occupied property revaluation gains go to a revaluation reserve via other comprehensive income.

Part (b) was a numerical example testing the understanding of the above. Property A was an owner-occupied property that had to be reclassified as an investment property during the year due to a change of use, and property B was a property sub-let to a subsidiary which meant it was an investment property in the parent's entity financial statements and owner-occupied from a group perspective. Many candidates correctly calculated the depreciation on property A up to reclassification (some did not time apportion) and identified the gains on both properties, but it was a surprisingly common mistake for the fair value gains to be treated as revaluation gains, despite correctly stating how they should be treated in part (a). Weak answers listed a collection of calculations and seemed to expect the marker to decide where they should be reported.

Conclusion

Overall this was a rather disappointing performance with many candidates displaying poor technique and adopting 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 the case. There were many excellent papers that were rewarded appropriately.