Examiners' report

F7 Financial Reporting
June 2009

General Comments

Many markers, tutors and other 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 which include 15 minutes reading and planning time.
The report has two main functions; it gives an assessment of the actual performance that candidates achieved and, secondly, to be of use to candidates attempting the paper in the near future to highlight areas of poor examination technique and some of the common errors made by previous candidates. The structure of the paper is that of all compulsory questions, with questions 1, 2 and 3 being for 25 marks each, question 4 is 15 marks and question 5 is 10 marks.

I have to report my disappointment in the overall performance of candidates on this diet. After an encouraging increase in the pass rate in December 2008, success levels are back to the disappointing levels of June 2008. The causes of the poor performance are familiar, but they seem to present on a much more widespread basis than ever before. One marker commented that it seemed like when some candidates reached the end of question 3 (a), they stopped writing. This rather pointedly illustrates that a significant number of candidates did not attempt either question 4 or 5 or even both. Questions 1, 2 and 3 on groups, company financial statements and interpretation/cash flow respectively are considered the 'core' topics whereas questions 4 and 5 cover the reminder of the syllabus. Another marker commented that she had never had as many scripts that had scored 20 or more on question 1 and yet failed to achieve an overall pass mark. It is clear more than ever that large numbers of candidates believe they can pass the paper by just learning the core topics or that they engaged in unsuccessful 'question spotting'. It is probably true to say that poor time management meant that some candidates ran out of time on their last question. Another factor contributing to poor performance was weak or non-existent answers to the sections of the paper requiring written comment, interpretation and analysis. Once again there was evidence that many candidates did not answer the question that was asked; candidates must read the question requirements very carefully. Restating the scenario and facts given in the question as an answer will not earn marks. This was particularly prevalent in Question 3 (b) (see detailed comments below).

Overall candidates' performance can be summarised as very good on question 1, good (but not as good as past diets) on question 2, good on the cash flow element of question 3 with questions 3(b), 4 and 5 being very poor.

It is worth mentioning a number of factors that make marking the examination difficult for markers:

- poor, sometimes illegible handwriting
- starting a question, leave it unfinished, then going on to a different question, then returning to the first question later in the script (an example of poor planning)
- a large number of candidates did not follow ACCA instructions to start each question at the top of a new page and indicate at the top of each page which question it related to
- unnecessary workings. Only the more complex calculations need (referenced) workings. In extreme cases some candidates produced pages and pages of unhelpful workings – this is very time consuming for both candidates and markers
- the converse of this is also a problem; many incorrect figures were not supported by workings, meaning markers could not give partial credit where it may have been merited.

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

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Specific Comments

Question One

This question required the preparation of a consolidated statement of financial position (balance sheet) for a parent, a subsidiary (line-by-line consolidation) and an associate (equity accounted). The question required the calculation of goodwill with the consideration based on a cash payment and loan note issue (that had already been accounted for) and included some fair value adjustments. This was the best answered question demonstrating that most candidates have a sound knowledge of consolidation techniques.

The main areas where candidates went wrong were:

- goodwill calculation: a failure to account for loan note element of the consideration and/or the non-controlling interest element of the goodwill (not applicable to UK stream) and incorrectly accounting for the new property by using its fair value rather than the excess of fair value over cost
- not realising the post-acquisition period was two years, many candidates only accounted for one year's additional depreciation on the new property and amortisation of the brand
- the detailed components of the consolidated retained earnings were often missed; depreciation adjustments, unrealised profit (URP) in inventory (often calculated wrongly as well - see below), gain/loss on available-for-sale investments
- many candidates did not calculate the non-controlling interest under the revised Standard by taking the fair value at acquisition (as given) and then adjusting for post-acquisition profits/losses (not applicable to UK stream)
- the URP was often calculated as a gross profit percentage, whereas the question stated it was a mark up was on cost. Some candidates eliminated the cost of the inventory rather than the URP in the inventory and many incorrectly split the URP between the parent and the subsidiary even though the parent had made the sale-
- a small minority of candidates are still proportionally consolidating the associate (some even proportionally consolidated the subsidiary); others fully consolidated the associate and computed a non-controlling interest of 70%
- many candidates did not account for the effect of the share exchange on acquisition of the interest in the associate on the share capital and share premium.

Question Two

This was a familiar question of preparing financial statements from a trial balance with various adjustments. These involved a revaluation of a non-current asset, dealing with a finance lease agreement, accounting for a construction contract, a revenue recognition issue, an effective rate finance cost for a financial instrument and taxation.

This question was the second best answered question, but it was not as well answered as I have come to expect. The most common errors were:

- deducting from revenue the agency sales, without recognising the commission earned
- rather worryingly, a number of candidates deducted the closing inventory from the cost of sales (by definition it has already been deducted)
- basing calculations of the depreciation and impairment reversal of the leasehold property on the revaluation as if it had been at the beginning of the year (the question clearly stated it was at the end of the year)
- taking the reversal of the impairment to reserves rather than through the income statement as, on this occasion, this reversed a previous impairment loss recognised in the income statement
- also worryingly, a number of candidates depreciated the owned plant and equipment using cost rather than carrying value; the distinction between straight line and reducing balance depreciation should be very familiar to candidates at this stage
- a number of candidates decided that the leasehold property and the leased plant (and hence the finance lease payment) were the same asset; this produced some very unhelpful workings and balances
- many complex (and unnecessary) lease calculations were provided - if future payments are to be discounted, the appropriate factors will be provided as part of the question - the finance cost of the redeemable preference shares was incorrectly calculated at the nominal rate of its dividend rather than at the effective rate based on the

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carrying amount at the start of the period. Also the dividends are part of the finance cost in the income statement and the shares themselves are classified as debt on the statement of financial position; redeemable preference shares do not have the characteristics of an equity instrument
- there were errors in the treatment of the taxation in both the income statement and the statement of financial position, these included: crediting the under provision of tax from the previous year to the income statement (as a debit balance it should have been charged); treating the closing provision for deferred tax as the charge in the income statement (it should be the movement on the provision that appears in the income statement); showing the current tax net of the under-provision as a current liability (only the current year's tax is a current liability).
- many candidates made a fair attempt at the construction contract figures in the workings (credit was given for this), but often did not follow them through to the financial statements
- the treatment of the finance lease caused problems, many candidates based the finance cost and current/non-current liability on the carrying amount of the leased asset rather than on the opening liability for the lease obligation
- a number of candidates are still showing equity dividends in the income statement rather than as part of the retained earnings (or statement of changes in equity if it had been required).

The statement of financial position was generally well done and most of the errors that were made generally related to the following through of errors from the income statement.

Question Three

Part (a) required the preparation of a statement of cash flows for 15 marks followed by some 'targeted' interpretation for 10 marks. Cash flows are generally popular with candidates and many scored well, however, again the overall performance was not as good as I would have expected with surprisingly few candidates earning the maximum marks. Less well-prepared candidates showed poor format knowledge with little idea of which items should appear in which section of the statement nor did they know the difference between cash and non-cash flows, for example reserve movements, provisions (for warranties) and the loss on the disposal of the displays were sometimes treated as cash flows. A number of candidates had difficulty with the accumulated depreciation being reset to zero after a revaluation and the cost of the disposal of an asset was often treated as the sale proceeds. Many candidates could not work out the movement on the accumulated depreciation as they could not follow the impact of the disposal of the displays which gave them a depreciation amount to be *credited* to the income statement. An area causing many marks to be lost was getting the cash movements the wrong way round (signing errors). For example, the marks for the movement in working capital items are normally for correctly identifying them as inflows or outflows rather than for correct arithmetic. Some candidates split the two finance costs both within the adjustments and the cash outflows (often in different sections of the statement) which was not necessary.

Part (b), gave information about percentage changes in the sales and the cost of sales instigated by the directors actions which was accompanied by information on changes in credit periods. Part (b)(i) required candidates to calculate the gross profit margin that should have resulted from the cost and revenue changes. Many candidates got this correct, but a number did not seem to read the requirement correctly and calculated the actual profit margin (rather than the 'theoretical margin'). A number of candidates made the adjustments to the 2008 revenue and cost of sales figures rather than to the 2009 figures, which may have been caused by not reading the question carefully enough.

Part (ii) was a written section effectively requiring candidates to identify other factors (apart from the cost and revenue changes) that could have caused the change in gross profit margin. This was generally very badly answered; many candidates discussed exclusively the cost changes instigated by the directors as being solely responsible for the overall change in the margin, despite the previous section having already identified the effect of those changes. The same candidates were usually convinced that the changed credit periods were the cause of the changes in the gross margin which shows a lack of understanding between profit and cash. Those candidates that did realise the question required other examples of causes of changes in gross profit margin often

gave examples of items that do not affect gross profit such as higher bad debt charges, cash discounts and additional finance costs – these do affect net profit, but not gross profit. A number of candidates did refer to quality issues and returns of goods to suppliers and from customers, with a small number of very perceptive candidates even noting the latter was reinforced by the disproportionate increase in the warranty provision.
Part (iii) was again a targeted area of ratio understanding related to the changes in the credit periods (for payables and receivables). The question wanted candidates to quantify the effect it would have had on the bank balance if the previous year's (2008) credit periods been maintained in the current year (2009). This involved calculating 2008's credit periods and then applying those to the credit sales and credit purchases of 2009 to give 'theoretical' receivables and payables balances for 2009. These could then be compared to the actual payables and receivables balances of 2009 to identify the 'theoretical' effect on the bank balance. Many candidates presented a simple comparison of this year's credit periods with those of the previous year; either those candidates did not read the requirement properly or they only have a 'mechanical' understanding of the ratios and cannot adapt to a different scenario. Weaker candidates decided to calculate the inventory turnover figures for both years and then compute the working capital cycle which was of no relevance to the question set.

Question Four
I was particularly disappointed with candidates' performance on this question. Part (a) was straightforward for anyone who had read IAS 10 *Events after the Reporting Period* (or variant equivalents) and the three illustrative examples are well documented in the Standard and text books. In part (a) many candidates attempted to distinguish between adjusting and non-adjusting events through the use of examples rather than by description. Examples were not asked for in Part (a) and therefore did not earn marks.

In part (a) there was a lot of confusion over the period covered by the Standard, many candidates thought there is a set time (e.g. 3 or 6 months) or that the period extends to the AGM. To state that an adjusting event requires adjustment - and a non-adjusting event doesn't - did not earn any marks as it says nothing and certainly does not relate to the issues raised by IAS 10. Many candidates also thought that the determining factor regarding whether to adjust or not lies with whether the item is material or not. Several candidates suggested that examples (ii) and (iii) were not material, despite the note to the question providing clear guidance on this point. Weaker candidates confused the topic with prior period adjustments and the use of provisions and contingent items.
Unsurprisingly, if candidates were not able to correctly answer part (a), they did not gain many marks in the examples in part (b), however many candidates who did know the definitions in (a) still could not apply the circumstances to the part (b) scenarios. There were a lot of comments in (b) that contradicted definitions given in part (a).
(b)(i) This example dealt with the consequences a fire after the reporting period. The common errors were to say this was an adjusting event (it was non-adjusting), most candidates netted off potential insurance proceeds from the losses and did not appreciate that the losses and the related insurance claim required different considerations. Hardly anyone realised that the subsequent disruption of trading may have brought into question the going concern of the company (which would then make it an adjusting event). Even those candidates who correctly stated this was a non-adjusting event proceeded, often at great length, to itemise the journal entries needed as if it was an adjusting event (without any mention of the going concern aspects).
(ii) This was an example of sale of inventory at a loss after the reporting period. Most candidates focused on the sale itself and said it should be dealt with in the following year therefore no adjustment was required. Some correctly appreciated that the relevant issue was that the inventory's value should be adjusted because its net realisable value was below cost. However two further errors were common; either they did not extend the lower of NRV or cost principle to the whole of the inventory (instead just the 70% that had been sold) or they wanted to put the sale through the current year's accounts rather than just write the inventory down. Weaker candidates stated the transaction was a non-adjusting event, as it took place after the reporting date, but, in contradiction, then proceeded to explain at great length the adjustments that the sale and commission would create.
(iii) This concerned a change in taxation legislation after the financial statements had been authorised. The main point of this example was the timing of the event, specifically after the financial statements had been authorised

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by the board and was thus neither an adjusting nor non-adjusting event (it was outside the scope of the Standard). Most candidates did not appreciate the timing of the event and even those that did still wanted to adjust for it and proceeded to explain the nature and purpose of deferred tax.
I would also point out that there were many candidates that were on the right lines with this question, but simply did not discuss all the elements of the scenarios which inevitably limited the marks gained.

Question Five
This question required candidates to depreciate the separate components of a 'complex' asset (an aircraft) dealing with different methods of depreciation and distinguishing between capital and revenue expenditures.
A significant number of candidates did not start this question and many more that did appeared to run out of time. There were no general issues here with candidates not understanding what they were meant to do or not reading the requirements properly, however many answers lacked a methodical approach meaning they got hopelessly lost in the detail. Generally the exterior structure of the aircraft was dealt with correctly although many capitalised the repainting costs (which is revenue expenditure). For the cabin fittings, the upgrade was often correctly capitalised but then the depreciation was calculated on (total) cost, not the new carrying amount and also over the wrong period. The engines caused the most problems. Candidates often tried to perform the calculations of them together, instead of separating them, and then became confused in what they were doing.

Conclusion
As reported in the introduction, the overall performance of candidates was rather disappointing with too many candidates pinning their hopes on passing by just learning the main topics or relying on numerical skills alone. There was evidence of poor examination technique, including poor planning, time management and question spotting. Markers reported that the scripts of poorly prepared candidates did not seem to have mastered the understanding and techniques examinable at F3. Basic depreciation, accruals and an inability to correctly classify items in the financial statements (e.g. receivables included in the income statement) were notable weaknesses of some of these candidates.

In fairness, many of the above comments on the individual questions have concentrated candidates' weak areas. This has been done for reasons of directing future study and highlighting poor techniques such that candidates can improve future performance. This does give a pessimistic view of performance, but I would like draw attention to a good number of excellent papers where it was apparent that candidates had done a great deal of studying and were rewarded appropriately.