Examiners' report

F7 Financial Reporting
December 2007

Introduction

This was the first Financial Reporting paper under ACCA's new syllabus. Most markers 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 have been extended by the introduction of 15 minutes reading and planning time.

The report has two main functions for candidates and tutors; it gives an assessment of the actual performance that candidates achieved and, secondly, the report should be of use to candidates intending to attempt the paper in the near future as it will highlight areas of poor examination technique and some of the common errors made by previous candidates. The new Financial Reporting paper consists whollyof compulsory questions, with questions 1, 2 and 3 being worth 25 marks each, question 4 worth 15 marks and question 5, 10 marks.

As this is the first paper, the overall performance of candidates cannot be compared with an exact equivalent historic trend; however I was rather disappointed in the overall pass rate. A number of markers reported that they believed the poor performance was in part due to the poor performance on the answers requiring written comment and analysis. It must be stressed that it is highly unlikely a candidate will pass this paper by relying entirely on their computational ability. In extreme cases some candidates did not attempt any of the written elements of the paper and many others displayed an inability to express themselves clearly. This combined with poor handwriting (almost illegible in some instances) and question planning (despite the additional time allowance) contributed to attaining fewer marks. A common error of poor examination technique on several questions in this diet, was that many candidates simply did not answer the question that was asked. Instead they discussed, often at length, a related topic. This shows an inability to apply learned material to specific circumstances. A great deal of attention is paid to the wording of a question's requirements and candidates should read these very carefully and only answer what is specifically asked for. No matter how good or accurate a candidate's answer is, it will only attract marks if it relates to the question asked.

The overall performance can be summarised:
The first two questions (on group accounting and preparing financial statements from a trial balance) were widely expected and generally done very well. Question three required the calculation and analysis of company ratios. Candidates scored well on the ratios, but their analysis was generally poor. The remaining two questions, on average, gained significantly less than half of the available marks.

Another important aspect adversely affecting performance was the number of candidates not answering all five questions (or large parts of some of the questions). There was also evidence that a minority of candidates have not progressed their studies beyond that required in the Knowledge module of the earlier Financial Accounting paper.

Another unwelcome feature of a minority of answers was the tendency to start a question, leave it unfinished and go on to a different question, then return to the first question later in the script. This makes a script difficult to mark and review and shows a lack of planning and preparation. A large number of candidates also did not follow ACCA instruction to start each question at the top of a new page.

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 adapted papers and therefore these comments generally apply to all versions of the paper.

Report on individual questions

Question 1
Required the preparation of a consolidated balance sheet for a parent, subsidiary and an associate (equity accounted) followed by a short 5 mark section requiring an explanation of why fair values are used for the subsidiary's assets on its acquisition. The consolidated balance sheet was well answered, but few candidates got to grips with the written section and many did not attempt it at all.
The main areas where candidates went wrong were:
In part (a)

- most candidates incorrectly deducted a $500,000 reduction in the fair value of the land from the property, plant and equipment. This effectively double counted the fall in value as the question clearly stated that the land had already been written down in the post acquisition period. The point of the information is that the fall in the value of the land should have been treated as an adjustment between pre and post acquisition profits (affecting goodwill). Also many candidates failed to adjust for the $100,000 additional deprecation on the plant.
- some confusion existed over the value of the associate with many simply showing it in the balance sheet at cost rather than using equity accounting. A very small minority proportionally consolidated the associate (some even proportionately consolidated the subsidiary).
- many candidates did correctly calculate the unrealised profit on inventory (stock), but did not always eliminate it from retained earnings.
- surprisingly, many candidates failed to adjust share capital and premium for the share issue relating to the acquisition.
- generally candidates scored well in the calculation of retained earnings, but the most common errors were not adjusting the subsidiary's post acquisition profit for the revaluation of land (mentioned earlier), failing to adjust for the unrealised profit in the plant and not including the gain on investments (often incorrectly shown as a revaluation reserve).

In part (b) the answers were quite disappointing. Generally candidates stated that the use of fair values was simply a requirement of accounting standards or discussed, sometimes at length, the definition of fair values. Most answers did not even try to address the inconsistency between the value of the subsidiary's assets and those of the parent. Better answers did refer to fair presentation of the balance sheet and the effect that the use of fair values had on consolidated goodwill.

Question 2
This question asked candidates to prepare an income statement and balance sheet from a trial balance after dealing with several notes. A calculation of earnings per share (eps) was also required.
Most candidates did well on this question scoring good marks even if they did not fully understand all the issues or were not able to complete all the parts. The main adjustments contained in the question were generally well understood and correctly accounted for. Again, in order to assist future studies, the common errors were:

- confusion over the timing of the revaluation of the land and buildings. The question clearly stated that the revaluation was at the end of the year. This meant that the annual deprecation charge for the buildings should be based on the value at the beginning of the year (i.e. the value included in the trial balance) and the revaluation (giving a impairment/deficit in this example) should be based on the carrying amount of the asset after the year's depreciation had been deducted. It was common to see candidates performing the revaluation at the beginning of the year. Another surprisingly common error was calculating depreciation of the plant based on cost rather than the reducing balance. Most candidates did correctly identify the capitalisation of the internally manufactured plant, although many did not realise that this occurred half way through the year necessitating time-apportioned depreciation.
- another common error was to reduce cost of sales by the closing inventory; by definition cost of sales has already been adjusted for closing inventory.

- the gain in the fair value of the investments was often treated as part of the revaluation reserve, rather than as income in the period.
- a number of candidates did not appreciate that the loan interest paid was for only six months and that the year's finance costs should be based on the effective interest rate of 6% rather than the nominal rate of 2%. Those that did correctly account for the accrued finance costs in the income statement often forgot to add it to the carrying amount of the loan in the balance sheet.
- the tax calculation was often confused. The opening credit balance of $400,000 was often treated as charge (debit) and the adjustment for deferred tax was often taken as $40 million rather than 25% of $40 million.
- similar to question 1, many candidates could not correctly account for the share capital and share premium of a rights issue, often showing a combined figure or showing it as a suspense account in the balance sheet.
- the revaluation reserve was often left at its opening balance without taking account of the revaluation of the land and buildings.
- a very common and basic error was to include the bank overdraft in current assets.
- answers to the calculation of the eps were very mixed. A significant number of candidates did not attempt it and those that did often struggled with effect of the rights issue on the ex-rights price and the weighting exercise.

Question 3
Part (a) required the calculation of eight ratios for 2007 equivalent to given ratios for 2006 and part (b) required candidates to assess the performance of the company in light of the given financial statements and calculated ratios.

In general candidates did well in the calculation of the ratios typically gaining six to eight marks (the maximum). The ROCE and gearing calculations were the most troublesome for candidates. Unfortunately the performance assessment report that followed was usually quite poor. Many candidates did not take sufficient notice of the question's requirement which specifically asked candidates to refer to the Chief Executive's comments and the effect of the acquisition of the net assets of a separate business (Fatima). Weaker answers did not even point out the rather obvious issues below;

- whilst the Chief Executive's comments may have been factually correct, they were very selective (biased) and potentially misleading. Few candidates recognised the fact that the focus of the Chief Executive's report hid the underlying poor performance; some candidates even said the company was doing well
- without the favourable purchase of Fatima, the underlying business would have made a loss
- the payment of the high (cover only 1.2 times) and increased dividend (calculated as $10 million) exacerbated the poor liquidity position
- the purchase of Fatima has left the company with high gearing (46.7%) and its subsequent risks including much increased finance costs

As with similar questions in the past, many candidates' attempt at interpretation was simply to reiterate in words what the movement in the ratios had been, without any attempt to suggest what may have caused the change in the ratio or what it may indicate for the company's future prospects.

Interpretation is an area where the majority of candidates need to improve their understanding and technique.

Question 4
Part (a) asked candidates to explain how faithful representation related to reliability followed by an example designed to illustrate (amongst other things) how the use of the principle of substance over form gives a more faithful representation of a lease transaction.

Answers to this question were very mixed and covered the whole range of marks. Good answers to part (a) recognised the important issues; however weaker candidates could not adequately identify that faithful representation necessitated reflecting the commercial substance of transactions rather than their legal form. Many answers dealt with the qualitative characteristics of financial information discussing relevance, completeness of information, comparability, accuracy and freedom from bias. These seemed more a regurgitation of what had been taught/learned rather than answering the question asked.

Part (b)(i) required candidates to assess the differential effect of treating a lease as an operating lease compared to a finance lease and relating this to the director's comments in relation to ROCE.

There were a number of good answers to this section, most recognising that the lease was in fact a finance lease along with the effect that this would have on the financial statements and the ROCE. Weaker answers spent too much time defining a finance lease (this was not required) and not addressing the issue of the effect on ROCE. In a few very poor answers the point was missed altogether with candidates discussing leasing as a means of purchasing assets when cash was unavailable.

In the answers to part (b)(ii) the most common errors were:

- when treated as an operating lease; taking the lease agreement as at the beginning of the year therefore not time apportioning the annual rental and not including the prepayment on the balance sheet
- (2) when treated as a finance lease; treating the rental as being in arrears (it was in advance). This meant that finance costs were based on a $350,000 liability (it should have been on $250,000) and again not realising that the lease agreement was dated half way through the year requiring time apportionment of the finance cost and depreciation. Many candidates also had difficulty with the split of the lease obligation between current and non-current liabilities.

Question 5
This question required candidates to apply the definition of an asset to the issue of research and development expenditure, followed by a calculation of the effect of changing from writing off development costs to capitalising them.

This was often the last question attempted and answers were generally quite poor.

In part (a) many candidates recited the definition of an asset then listed the criteria to be applied to determine whether development expenditure should be written off or deferred as two quite separate and unrelated issues. In other words, they did not attempt to apply the definition of an asset to the point at issue.

Some candidates who attempted part (b) assumed that amortisation commenced in the year of capitalisation rather than in the year following. Generally candidates found the approach to this question difficult, the answers were often confused and very rarely mentioned the prior period adjustment

Conclusion
As reported in the introduction, the overall performance of candidates was a little disappointing with too many candidates relying on passing by just learning the main topics or relying on numerical skills alone. There was some evidence of poor examination technique, including poor planning and time management. Markers reported that the weaker candidates did not seem to have mastered the understanding and techniques examinable at the previous Knowledge level.

The above comments on the individual questions have tended to concentrate on where candidates went wrong. This has been done for reasons of directing future study and highlighting poor techniques such that candidates can improve future performance. This may appear to give an overly pessimistic view of performance. This is not the intention, nor is it the case. There were many excellent papers where it was apparent that candidates had done a great deal of studying and were rewarded appropriately.