

Examiners' report

F7 Financial Reporting

June 2008



Introduction

This was the second 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; 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 are 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. Many markers reported that they believed the poor performance was in part due to weak answers to those sections requiring written comment and analysis. A significant number of candidates did not attempt any of the written sections at all. On this paper 33 marks were for written/interpretive answers; clearly anyone not attempting these sections was trying to obtain a pass mark of 50 out 67 marks – a very tall order. It must be stressed that it is highly unlikely a candidate will pass this paper by relying entirely on their computational ability. Another important issue raised by many markers was poor handwriting (almost illegible in some instances) and poor question planning (despite a 15 minute time allowance). A common error of poor examination technique on several questions was that many candidates simply did not answer the question that was asked, Candidates should read question requirements very carefully. Many answered displayed a rote learning approach and a lack of interpretive and application skills.

The overall performance can be summarised:

The first two questions (on group accounting and redrafting financial statements) were widely expected and generally done quite well by many candidates. Question three required the preparation of a cash flow statement followed by its interpretation, candidates often scored well on the cash flow, but their interpretation was generally weak. Question 4 on accounting concepts was more mixed, but the remaining question dealing with the accounting treatment of a financial instrument was very badly answered by most candidates.

An 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 instructions 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/variant papers and therefore these comments generally apply to all streams of paper.

Report on individual questions

Question 1

Required the calculation of goodwill and the preparation of a consolidated income statement for a parent, subsidiary and an associate (equity accounted) followed by a short 4 mark section requiring an explanation of how an investment in an associate should be treated after it became a subsidiary of another company. The consolidation was generally well answered, but answers to the written section were more 'patchy'.

The main areas where candidates went wrong were:

In part (a)

- goodwill calculation
- most candidates correctly calculated the share exchange consideration, but failed to discount (for two years) the deferred cash consideration correctly. The calculation of the pre-acquisition equity was also done quite well, but the most common mistakes were not including an apportionment (4 months) of the current year's profit as part of the pre-acquisition figure and incorrectly including post acquisition adjustments for additional depreciation and unrealised profits as pre-acquisition items. It was also common for candidates to forget to include the subsidiary's share capital in the calculation of equity.

Part (b)

- consolidated income statement
- a surprisingly common error was not time apportioning (for 8 months) the subsidiary's results, instead a full year's results were often included. This is a fundamental error showing a lack of understanding of the principle that a subsidiary's results are only included the consolidated accounts from date it becomes a member of the group. A small minority of candidates proportionately consolidated, rather than equity accounted, the associate (some even proportionately consolidated the subsidiary), however this error is now becoming much less common.
- many candidates did not correctly eliminate the intra-group trading; either no adjustment at all or eliminating pre-acquisition trading as well.
- the unrealised profit in inventory was often calculated as a gross profit percentage, whereas the question stated it was a mark up was on cost. It was also common for this adjustment to be deducted from cost of sales rather than added.
- impairment/amortisation of goodwill was often omitted.
- the finance cost relating to the unwinding of the deferred consideration was omitted by most candidates.
- the calculation of the minority interest (now called non-controlling interest) was sometimes ignored or did not take account the post acquisition additional depreciation adjustment or time apportionment.

In part (c) the answers were very disappointing; many not attempting it all. The question was based on how an associate, that had previously been equity accounted, would be treated in the following year when it had lost its 'significant influence' due to the associate becoming a subsidiary of another entity. Of those that did attempt this section many wasted time by reproducing (as an answer) the scenario given in the question rather than actually answering the question. Others did not think the investment should be treated any differently in the following year saying that the percentage of share ownership is all that matters (despite the loss of a seat on the board). Some candidates thought the question asked for an explanation of how the investment should be treated in the current year. The correct answer is that it should be treated as an 'ordinary investment' (no longer an associate) under IAS 39.

Question 2

This question asked candidates to recalculate the annual profit, prepare a statement of changes in equity (SOCIE) and redraft a given statement of financial position (balance sheet) after accounting for a series of adjustments. The adjustments required were for: reversing a sale or return transaction, depreciation (after a revaluation), an increase in the value of investments, correcting for a discovered fraud, tax and deferred tax and dealing with the effects of a share issue and dividend payments.

For those that knew how to tackle this type of question, the recalculation/restatement of the annual profit was done quite well with many candidates gaining 5 or 6 out of the 8 marks available. The most common errors were:

- failing to add back the dividends to the retained earnings for the year to give a starting point for the profit for the year

- adjusting for the sales revenue rather than the profit made on goods subject to an outstanding sale and return agreement (some adjusted for both the sales revenue and the cost of sales which was marked as correct)
- taking the revaluation of the land and buildings as if it were at the beginning of the year (the question clearly stated it was at the end of the year)
- deducting the whole of the cost of a fraud from the current year's profit (part of it related to the previous year and should have been treated as a prior period adjustment in the SOCIE)
- taking the whole of the increase in deferred tax to the income statement (part of it related to the property revaluation and should also have been included in the SOCIE)

Many of the errors made in the recalculation of the profit for the year were carried on to the SOCIE or/and the statement of financial position. Additionally in the SOCIE many candidates did not realise that the share issue had already been accounted for (the question made this quite clear) thus they treated the figures in the statement of financial position as if they were at the beginning of the year rather than at the end of the year and consequently calculated the wrong share capital and share premium movements. Very few included the deferred tax effect of the revaluation and an incorrect calculation of the dividends was also common (or omitted completely).

The statement of financial position was generally well done and most of the errors that were made generally related to the following through of earlier (previously mentioned) errors. For example it was common not to eliminate the sale and return receivable and not to include the related inventory in current assets. Strangely a few candidates spent time trying to calculate an ex-rights price for the share issue. This was not asked for.

Question 3

Part (a) required the preparation of a cash flow statement followed by an interpretation of the company's cash flow management. Cash flows are generally a popular question and this one proved no exception with many candidates scoring well. A significant number of candidates had very little idea of which item should be included in which section of the statement (poor format knowledge).

A number of candidates had difficulty with the fact that the tax cash flow was a refund rather than the usual payment and the revaluation of a property was often not taken into account when calculating the cash outflow on non-current assets.

Weaker answers did not seem to know the difference between cash and non-cash flows, for example reserve movements, provisions (for a warranties) and the loss on the disposal of plant were treated as cash flows. Other common errors included getting the cash movements the wrong way round and incorrectly calculating the dividend as \$30,000 instead of \$150,000 by not realising the shares were 20 cents each.

Part (b), the interpretive part of the question, often lacked depth by failing to draw valid conclusions from correctly calculated figures and not really making any attempt to analyse/interpret the cash flow statement. Many candidates calculated and commented on ratios, even though the question specifically gave instructions not to calculate ratios and that no marks would be awarded for them. This led to discussion of many aspects of performance such as return on capital employed, asset utilisation and profit margins that are not part of cash management which was the topic of the question that was asked, thus illustrating the dangers of 'question spotting'. Many important issues were not mentioned at all such as the good operating cash flow generating capacity of the company, the effects of a huge investment in non-current assets, the changes in the capital structure due to issuing new shares and redeeming a loan. Hardly anyone mentioned that the company had benefited from a tax refund of \$60,000 (implying losses in the previous year) and that a tax payment estimated at \$160,000 would be expected next year.

Very weak answers simply described the figures in the cash flow statement such as inventories have increased by \$400,000 or finance cost incurred were \$50,000 – this is not interpretation.

Question 4

Part (a) asked candidates to explain the meaning of five common accounting concepts/assumptions followed by a section requiring candidates to illustrate how these could be applied to a specific item, namely inventory. The first part of this question really bordered on the level of the lower paper F3 Financial Accounting. Not surprisingly many candidates did very well on this section, but there were a significant number of candidates that showed a very poor and deeply worrying lack of knowledge of basic concepts. There was also evidence of further poor examination; the question asked candidates to **explain** the concepts whereas many answer gave unsupported examples of the concepts. For example an answer that says providing for bad debts is an example of prudence is quite true, but it is not an explanation of prudence. Other weak answers said things like income and expenditure should be matched or accountants use substance over form; again these are not explanations of the concepts. A few candidates got carried away with this section not realising that there was only 1 mark for each explanation.

Part (b), requiring the application of the concepts to inventory, was very mixed. Well-prepared candidates often gained full marks and weaker candidates scored very little.

Many markers reported that candidates were repeating their answers to part (a) and made no attempt to relate the concepts to inventory. Some candidates related the concepts to other accounting items, for example leasing was often cited as an example of substance over form; it is, but this is nothing to with inventory.

Other candidates wrote all they new about the rules for inventory without relating it to which concepts the rules were applying. Neither of the above examples would gain any marks because they are not answering the question asked.

A few candidates seemed to think it was an auditing paper and described the audit work they would do in relation to inventory.

Question 5

This question proved to be the most difficult question for the majority of candidates with a significant percentage not even attempting it. A few answers were very good, although the majority were very poor.

The question required candidates to account for the issue of a \$10 million convertible loan and comment on some misguided views expressed by a financial assistant in relation to its issue.

The convertible loan note had a coupon (nominal) interest rate of 3%, but an effective rate of 8%. The proceeds of the loan had to be split between debt and equity by discounting the future cash flows at 8% to give the debt element with the balance being the value of the equity option. Common mistakes were to project the cash flows with an interest rate of 8% (rather then 3%), to discount them at 3% (rather than 8%) and to calculate the interest charge to the income statement as 3% of \$10 million (rather than 8% of the debt element).

The financial assistant suggested that the profit would be higher (implying he/she assumed the interest cost would be only 3%) and the loan note could be included as equity because most loan note holders would be expected to choose the equity option. Both of these comments are wrong, but many weaker candidates found themselves agreeing with them, thus showing a complete lack of understanding of this type of financial instrument.

Taken as a whole this was by far the worst answered question, which is surprising as this topic has been asked on many occasions, often as part of a larger question.

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 and time management. Markers reported that the scripts of weaker candidates did not seem to have mastered the understanding and techniques examinable at the F3 level.

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 may appear to give an overly pessimistic view of performance. This is not the intention, nor is it necessarily the case. There were a good number of excellent papers where it was apparent that candidates had done a great deal of studying and were rewarded appropriately.