Examiners' report

F7 Financial Reporting December 2008



Introduction

I am pleased to report that the overall performance of this diet saw a much needed improvement in the recent trend of lower pass rates. Feedback from markers, tutors and other interested parties 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 (including 15 minutes of 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.

General comments on the paper

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.

Despite the welcomed improvement in performance, there are many areas where candidates can improve still further, both in terms of application of their knowledge and examination technique. The best answered sections of the paper were invariably the computational elements; sadly the analysis and discursive areas of the paper were again generally much weaker. A significant number of candidates did not even attempt these sections which accounted for 32 marks in this paper therefore it must be stressed that it is highly unlikely that a candidate will pass this paper by relying entirely on their computational ability.

A small number of candidates wrote in their paper that they were short of time. Sensible time allocation and the avoidance of time wasting activities is an important part of examination technique. Examples of time wasting in this paper were:

- Over-elaborate workings, unnecessary journals and needless written explanatory comments. Whilst it is
 important that complex figures need referencing and clear workings, some candidates take this to an extreme
 and waste a lot of time producing workings for almost every figure in their answers. In many cases simply
 putting the make up of a figure in brackets as part of the line answer is sufficient to enable markers to award
 the appropriate marks.
- Question 3 part (a), required the calculation of ratios, candidates often produced an unnecessary summary of the ratios after they had calculated them. Then in the comparative analysis of the ratios (part (b)), they again repeated the ratios immediately before the commentary. Marks for the ratios can only be given once, yet some candidates wrote them down three times.
- Some candidates, who are perhaps running low on time, give a blank pro-forma answer (to say the income statement and statement of financial position (balance sheet) in question 2). Such an answer would gain little if any marks and as such is a waste of time. It would be far better to complete the numerical elements of only part of a required statement than to produce a complete statement with no figures.

Another important issue raised by several markers was the difficulty in marking poor handwriting (almost illegible in some instances). In a few extreme cases markers returned scripts to me reporting that, despite spending a good deal of time, they could not read parts of candidates' scripts. Put simply, if any part of a script cannot be read, it cannot be given any marks.

A general comment regarding many scripts was that they displayed a much disorganised approach with confusingly presented workings. In some cases these scripts are very difficult to mark as markers cannot work out what candidates are doing. These candidates need to spend more time thinking and organising their answers.



Another common error of poor examination technique, perhaps caused by poor timing and planning, was that many candidates did not answer all five questions (and sometimes parts of questions).

A summary of the overall performance would be:

- The first two questions on group accounting and production of financial statements were widely expected and generally done quite well by many candidates.
- Question three required the calculation of specified ratios and comparing them to another company's equivalent ratios. Candidates often scored well on the ratios, but the comparative assessment was poor.
- Question 4 on liabilities/provisions was more mixed and
- Question 5 on aspects of the capitalisation and depreciation of a non-current (fixed) asset was done either well or poorly.

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. An exception to this was that in question 1 the new requirements of IFRS 3 Business Combinations, required the goodwill and non-controlling interest to be a different calculation to some variant papers.

Report on individual questions

Question 1

Required the preparation of a consolidated income statement and statement of financial position for a parent and a single subsidiary that had been acquired half way through the accounting period. The question involved a share exchange, fair value adjustments and the elimination of intra-group trading and current accounts.

This was generally well answered by most candidates with a number achieving full marks. There was evidence of a rote learned/mechanical approach to parts of the question which is not necessarily a bad thing, as it can increase speed and accuracy, but several candidates clearly did not understand the principle of such an approach and came unstuck with some of the more challenging adjustments.

There were two areas of particularly serious errors which demonstrated a poor understanding of the principles of consolidation:

- Failure to time apportion the results of the subsidiary to include only its post-acquisition results (many candidates included a full year's results in the consolidated income statement)
- Incorrectly consolidated 60% of the subsidiary' figures (proportional consolidation). This perhaps is the most worrying of the errors.

The above are fundamental errors that display a lack of understanding of consolidation procedure and principles. The main areas where candidates made more routine errors:

- In part (a), income statement
 - o eliminating the cost of the intra-group sales from the cost of sales (the selling (transfer) price of the goods should be deducted from both sales and cost of sales)
 - o incorrect calculation of the URP in inventories
 - o charging a full year's additional depreciation, when it should have been only for the post-acquisition period of six months
 - o non-controlling interest in the income statement was often confused with the figure for the statement of financial position



- o unrealised profit on inventory and the additional depreciation as an adjustment to the parent's profit (it should have been to the subsidiaries).
- Part (b), statement of financial position
 - o goodwill calculation: many candidates had difficulty determining the pre-acquisition reserves; often taking 6/12 of **the entire** subsidiary's retained earnings (the 6/12 adjustment should been applied to the profit of the year of acquisition to obtain its pre and post acquisition split).
 - o In the INT based papers was the new requirement to include in goodwill the non-controlling interest's share (of \$1.5 million as given in the question). This was ignored or sometimes deducted (rather than added) to the parent's goodwill. A similar error occurred in calculating the non-controlling interest for inclusion in the statement of financial position.
 - o recording the new share capital and share premium created by the share exchange
 - o difficulties with eliminating cash in transit and intra- group payables/receivables
 - o group retained earnings were often not adjusted for the URP in inventory and additional deprecation

As said, and despite the above, this was the best answered question and many candidates gained good marks.

Question 2

This was a fairly standard question requiring candidates to prepare an income statement, a statement of financial position and a statement of changes in equity (SOCIE) after accounting for a series of adjustments.

The adjustments required were for depreciation (after a revaluation), correcting a sale of plant included as a revenue sale, capitalisation of development costs, dealing with a contingent liability, using the effective interest rate on preference shares and current and deferred tax.

As with question 1 this was a popular question and many candidates scored well. The ability to produce financial statements from a trial balance seems well understood, but some of the adjustments created difficulties:

- careless mistake was to add back the sale proceeds of the plant to revenues (it should have been deducted)
- timing of the revaluation of a leasehold property was at the end of the period, but many candidates answered as if it was at the beginning of the period
- research and development caused many problems. Development costs can only be capitalised from the point at which management become confident of the success of the project. Up to this point they must be written off along with research expenditure. Very few candidates could put this into practice.
- reversal of a provision for a contingent liability (they should not be provide for); however the associated unrecoverable legal costs should have been provided for. Candidates often only got one of these two adjustments correct. A similar error occurred with the related current liability.
- Most candidates did realise that the effective interest rate should be used for the preference shares, but made common errors of adding the nominal rate as well (thus double counting it) and/or not realising the shares were issued half way through the year thus only 6 moths interest was required.
- deferred tax caused problems; ether the movement was credited to income (it should have been debited) or the whole of the provision was charged to income (rather than the movement).

The statement of financial position was generally well answered when allowing for 'knock on' errors from the income statement calculations.

The SOCIE was more mixed; it was often completely ignored and errors such as including in the SOCIE the issue of the redeemable preference shares and their dividend (they are debt) and not including the equity dividend.



Question 3

Part (a) required candidates to calculate ratios (8 marks) for a company equivalent to those given for another company and then do a comparative assessment of the two companies from the prospective of a potential acquisition (12 marks). This was followed by a 5 mark section explaining the limitations of ratios and what further information would be useful. Most candidates scored well when calculating the ratios, but there were some very worrying papers that showed even simple ratio calculations were not understood.

Analysing and interpreting the ratios was a different matter. Weaker scripts simply reiterated what the ratios were or that one company's ratio was higher (or lower) than the other's. Some did not even say which was better; a higher or a lower ratio. There also seemed to be an over emphasis on working capital ratios which was not a fundamental difference between the two companies and therefore not of particular importance.

Much of the information in the scenario, which should be used as 'clues', was often ignored. Fore example:

- one company revalued it assets the other did not; this could (partly) explain the difference in the ROCEs
- one company owned its premises; the other (presumably) rented its premises
- one company owned its plant (and therefore obtained governments grants); the other company leased its plant
- not many candidates picked up that the plant of one company was old (and would therefore need replacing in the near future) or that its dividend policy was risky given a low the cash balance

All these are very relevant factors affecting the interpretation of the ratios and which company may be the best company to acquire, but very few candidates spent much time, if any, commenting on them.

The final part was either ignored, thereby throwing away some relatively easy marks, or answered very well, many gaining the full 5 marks.

Question 4

Part (a) asked candidates to define liabilities and provisions and describe when and when they should not be recognised, along with giving two examples of how the definitions have enhanced the reliability of financial statements. In general this was well answered with most candidates scoring well on the definitions, but many of the examples given were rather trivial such as accrued audit fees or trade creditors. These types of liability have never been at issue in terms of the reliability of financial statements, whereas when and if environmental provisions should be recognised and the use of 'big bath' and 'profit smoothing' provisions do need robust definitions in order to ensure their correct treatment.

Part (b) (i) asked candidates how the construction of an oil platform and the related environmental 'clean up 'costs should be treated. It required candidates to discount the future clean up costs and provide for them immediately with the same amount being added to the cost of the oil platform.

On the whole most candidates that attempted this question had the right idea, if not a perfect understanding. Common errors were not to include the clean up costs in non-current assets (some even deducted them), failure to discount the clean up costs and it was very common not to 'unwind' the liability to arrive at a finance cost. Weaker candidates thought this was a construction contract question.

In part (ii) of this section, the question asked how the answer would differ if there was no requirement to undertake the environmental costs. Most candidates did say that the company would not have to provide for the costs, but stopped at that. An important aspect of this subject area is whether, in the absence of a legal requirement, there may be a constructive obligation. Only a few candidates discussed this aspect.



Question 5

This question was rather better answered than the equivalent question of recent diets, although a significant number did not attempt it. This was possibly a timing issue, it being the last question.

The question gave details of the purchase of a machine with related expenditures and its estimated life expressed in machine hours.

Candidates had to identify which related expenses should be capitalised and which should be expensed. Most candidates did reasonably well on this question, but common errors were;

- treating an early settlement discount as a reduction of cost rather than discounts received
- failing to deduct the residual value before calculating the machine hour depreciation
- even when items where correctly excluded from the cost of the asset, candidates often forgot to include them in the income statement thus missing out on some easy marks

During year three there was additional expenditure on the machine and revisions to its estimated residual value and life. Most candidates that got this far correctly identified the expenditure as an improvement (and capitalised it) and also correctly accounted for the revisions.

Conclusion

As reported in the introduction, the overall performance of candidates was rather pleasing reversing a decline in pass rates over the last two diets. However, there are still too many candidates trying to pass by just learning the main topics or relying on numerical skills alone. Markers reported that the scripts of ill-prepared candidates did not seem to have mastered the understanding and techniques examinable F3 level, let alone progressed to F7 level. Thankfully these were fewer in number this diet.

It should be borne in mind that 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.